

Mashreq Bank

Tickers:
MASQ.DU (Reuters)
MASQ UH (Bloomberg)

May, 2009

Reduce

Listing:
Dubai Financial Market

Fair Value:
AED101.52

CMP:
AED123.00 (As on May 27th, 2009)

Investment Summary

- In view of the difficult macroeconomic environment and deteriorating liquidity situation in the second half of the year, the profitability of **Mashreq Bank** declined during 2008. The balance sheet size of Mashreq Bank reached AED93.2bn at the end of 2008, a lower growth of 6.4% over the balance sheet size at the end of 2007. It is important to note that all the growth came in the first quarter of 2008. For the rest of 2008, balance sheet size was almost constant or even declined.
- Gross loan portfolio (including Islamic products) of the bank increased from AED36.4bn in 2007 to AED56.2bn in 2008, a significant growth of 54.2%. The net loan book increased from AED35.3bn in 2007 to AED55.0bn in 2008, a growth of 55.8% during the year. Contribution of net loans to total assets was 59.0% in 2008, up sharply from 40.3% in the previous year. This was due to sharp rise in loans and advances and also decline in the balances with Central Banks which was down 68.9% YoY to reach AED6.3bn.
- Lending growth has been strong for the bank; however NPL level has been managed well. Gross non-performing loans (NPLs) of the bank, in fact, declined from AED383.1mn in 2007 to AED364.2mn in 2008. Gross NPLs as a percentage of gross loans declined from 1.1% in 2007 to 0.6% in 2008. However we expect this ratio to go up in coming months on account of deterioration in economic scenario.
- Total interest income of the bank (including Islamic) increased from AED4.0bn in 2007 to AED4.8bn in 2008, an increase of 18.9%. The growth in interest income was mainly driven by the growth in loan volume as yield on interest earning assets declined to 6.5% in 2008 from 7.5% in 2007. The decline in yield was expected in view of declining interest rate scenario. However bank's yield on interest earning assets is comparatively higher than its peers because of its greater focus on lucrative retail segment.
- Total interest expense of the bank decreased from AED2.8bn in 2007 to AED2.7bn in 2008, a decrease of 4.3%. Cost of funds decreased from 4.9% in 2007 to 3.7% in 2008. Cost of funds of the bank is higher than some of the domestic peers since the share of low cost deposits is comparatively low and also due to lower share of government deposits. As

the decline in cost of funds was sharper than the fall in yield on interest earning assets, Mashreq Bank's net spread increased from 2.6 % in 2007 to 2.8% in 2008.

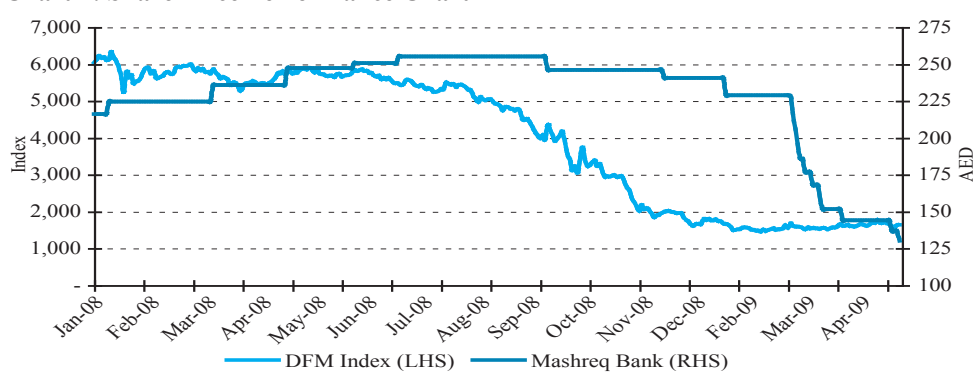
- Mashreq Bank's net profit declined by 13.6% to reach AED1.6bn, down from AED1.9bn in 2007. Return on average equity decreased from 22.4% in 2007 to 16.7% in 2008. Similarly, return on average assets declined from 2.6% in 2007 to 1.8% in 2008.
- Balance sheet size of Mashreq Bank decreased by 2.8% as compared to 2008 to reach AED90.7bn at the end of March 2009. Customer deposits (including Islamic deposits) increased by 6.0% to AED54.5bn at end of March 2009 as compared with AED51.5bn at the end of year 2008. As a result, the contribution of customer deposits to the total liabilities and equities increased from 55.2% in 2008 to 60.2% at the end of Q1-2009. Due to banks was down 24.7% during the period to reach AED9.3bn.
- During Q1-2009, gross loan book reached AED55.2bn, an YTD decline of 1.8% from the year-end 2008. Net Loans decreased by 2.1% YTD to reach AED53.9bn in Q1-2009, down from AED55.0bn in 2008.
- Net profit for the period AED484.1mn, up 4.0% from AED465.3mn in Q1-2008. Return on average equity (RoAE) was 19.0% for the period Q1-2009 whereas return on average assets (RoAA) was 2.1%.
- We expect the growth rate of the bank to slow down considerably in coming years in contrast with high growth rates achieved in the past years. This is not surprising given the slowdown witnessed across-the-board. Dubai has been highly impacted by this slowdown as it was depending mainly on non-oil sectors like real estate, construction, tourism, retail to drive growth. All of these non-oil sectors have experienced a significant slowdown in Dubai.
- One of our key concerns areas is quality of assets which we project to deteriorate in coming quarters in view of the economic slowdown especially Dubai which is highly impacted as compared to other Emirates of UAE. We have started to see some impact as gross NPLs as a percentage of gross loans have gone up in 1Q-2009. Though Mashreq Bank has been conservative in its approach, we are a bit concerned about the high retail exposure of the bank in the current scenario. Dubai has witnessed significant job losses over the past few quarters and this might impact the retail portfolio of the bank.
- In view of the difficult economic environment, we believe most of the banks including Mashreq Bank will focus on factors like monitoring of credit quality, setting up effective risk management systems and rationalizing cost bases etc. Mashreq Bank needs to rationalize its operating expenses which have grown at a higher pace in recent times. Therefore expansion plans are expected to take a back seat in 2009 and 2010.
- Our estimated value for this banking scrip is worked out to be AED101.52 based on DDM (80%) and adaptation of the Gordon Growth Model (20%). According to our fair value the banking scrip offers a downside of 17.5% at the closing price of AED123.00 per share (as of May 27, 2009). We therefore recommend a **REDUCE** on Mashreq Bank at the current price level.

Table 1: Investment Indicators

	Latest Price	Shares in Issue (*000)	Market Cap	52-week price range			
	AED123.00	161,026	AED19.81bn	AED122.90 – 254.55			
Year	Operating Income (AED'000)	Net Profit (AED'000)	EPS (AED)	BVPS (AED)	ROAE	P/E (x)	P/BV (x)
2010 F	4,120,234	1,995,206	12.4	77.8	16.8%	9.9	1.6
2009 F	3,696,835	1,679,279	10.4	69.9	15.7%	11.8	1.8
2008 A	3,621,576	1,642,830	10.2	62.5	16.7%	23.5	3.8
2007 A	3,542,101	1,900,632	11.8	59.7	22.4%	18.2	3.6

Price for future years are based on market price in the DFM as on May 27, 2009

Source: Mashreq Bank, DFM and **Global Research**

Chart 1: Share Price Performance Chart

Source: DFM

Recent Developments

- In May 09, Mashreq Bank opened its new Country Head Office in Amwal Tower in Doha's West Bay.
- In Apr 09, Badr Al-Islami, the Islamic Banking Division of Mashreq, and Standard Chartered Saadiq along with Abu Dhabi Islamic Bank PJSC, Dubai Islamic Bank, Emirates NBD, First Gulf Bank, Ajman Bank and Arab African International Bank arranged a US\$347mn Dual Currency Syndicated Islamic Finance Facility for Al Ghurair Center LLC. Mashreq and Standard Chartered Bank were the Bookrunners on this deal. The Facility has a door to door tenor of ten years. Proceeds of the Facility will be used to finance the expansion of Al Ghurair City, a mixed used (retail, commercial and residential) complex located in Dubai.
- In Apr 09, Mashreq Bank partnered with PayMate, India's leading mobile commerce company to launch mobile payments in the UAE. The scope of offerings would include paying for over-the-counter shopping, utility bills, and online purchases via the mobile as well as mobile applications enabling purchase of movie and flight tickets. This mobile payment service in the UAE would be available for 3.5 million credit card users in the UAE as well as Mashreq Bank account holders.

Trading of Mashreq Bank stock

The trading in the Mashreq Bank stock has been very low. This is due to the fact that the free float is very less as promoters hold 87% stake in the bank. The bank also does not permit any foreign shareholding which has contributed to illiquidity of the stock. The annualized turnover ratio of Mashreq Bank was a mere 0.01% for initial four months of 2009.

Table 2: Liquidity of Mashreq Bank

	2007	2008	Apr-09*
Traded shares ('000)	616.6	206.9	4.1
Annualized Turnover	0.38%	0.13%	0.01%
Market Price (AED)	215.38	240.00	129.35**
Market Cap (AED mn)	34,682	38,646	20,829* *

* For the four months ending Apr'09, ** Price at the end of Apr'09

Source: DFM

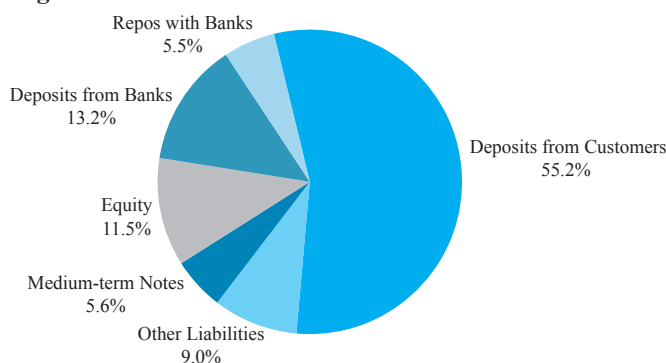
Financial Performance – 2008

In view of the difficult macroeconomic environment and deteriorating liquidity situation in the second half of the year, the profitability of Mashreq Bank declined during 2008. The balance sheet size of Mashreq Bank reached AED93.2bn at the end of 2008, a lower growth of 6.4% over the balance sheet size at the end of 2007. It is important to note that all the growth came in the first quarter of 2008. For the rest of 2008, balance sheet size was almost constant or even declined.

Modest growth in deposits

During 2008, customer deposits (including Islamic deposits) increased from AED48.3bn in 2007 to reach AED51.5bn, a growth of 6.6%. Deposit base as a percentage of total balance sheet remained almost constant at 55.2% in 2008. Deposit from banks declined during the year reaching AED12.3bn, down from AED13.4bn at the end of 2007. Repos with banks increased during the year reaching AED5.1bn, up from AED3.8bn at the end of 2007.

Chart 2: Funding Mix



Source: Mashreq Bank

Time deposits grew by 5.3% from AED37.0bn in 2007 to AED39.0bn in 2008. The contribution of time deposits to total customer deposits declined from 76.7% in 2007 to 75.8% in 2008. Current account deposits increased from AED10.6bn in 2007 to AED11.6bn in 2008, a growth of 10.0%. The share of current account deposits increased from 21.9% in 2007 to 22.6% in 2008. The share of savings account deposits increased from 1.4% in 2007 to 1.6% in 2008. Over the years, the bank has improved the share of low-cost deposits which is a positive development.

Government and public sector deposits increased from AED8.6bn in 2007 to AED9.2bn in 2008, a growth of 7.7%. At end 2008, the share of government deposits in total customer deposits (excluding Islamic) stood at 19.0%, up from 18.6% in 2007. During 2008, Mashreq Bank received AED3.4bn from UAE Ministry of Finance as part of the liquidity support made available to UAE banks in view of the recent credit crisis. Interest is paid every three months and calculated on prevailing coupon on the US Treasury benchmark 5 year note plus 120 basis points or 4% whichever is higher.

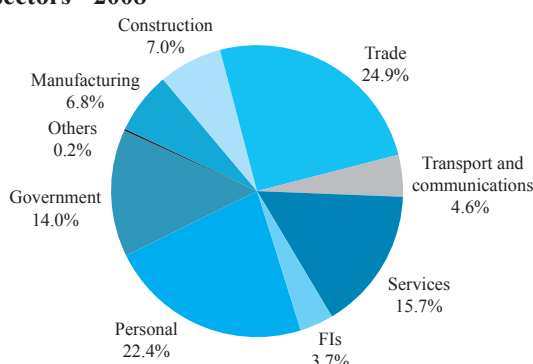
Good growth in loan portfolio

Gross loan portfolio (including Islamic products) of the bank increased from AED36.4bn in 2007 to AED56.2bn in 2008, a significant growth of 54.2%. The net loan book increased from

AED35.3bn in 2007 to AED55.0bn in 2008, a growth of 55.8% during the year. Contribution of net loans to total assets was 59.0% in 2008, up sharply from 40.3% in the previous year. This was due to sharp rise in loans and advances and also decline in the balances with Central Banks which was down 68.9% YoY to reach AED6.3bn.

Looking at the sectoral composition of loans, trade segment dominates by accounting for around quarter of total in 2008, up from 21.0% in 2007. The contribution of personal segment decreased from 25.5% in 2007 to 22.4% in 2008. The sectors which witnessed high growth during the year include services recording 101.2% YoY growth, trade (82.6%) and transport and communications (51.3%). Bank has limited exposure to real estate and construction sector which is viewed positively by us.

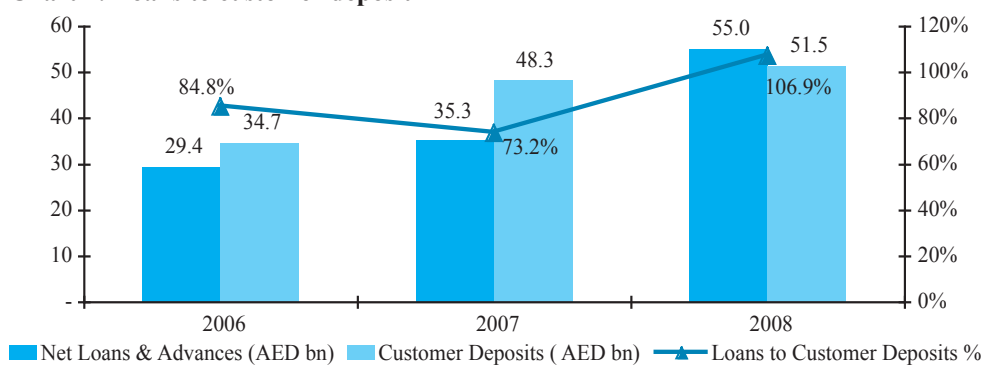
Chart 3: Loan by sectors - 2008



Source: Mashreq Bank

Historically the net loan to customer deposit ratio of the bank has remained below 100%. However this ratio was up significantly during 2008 to reach 106.9%, up from 73.2% in 2007.

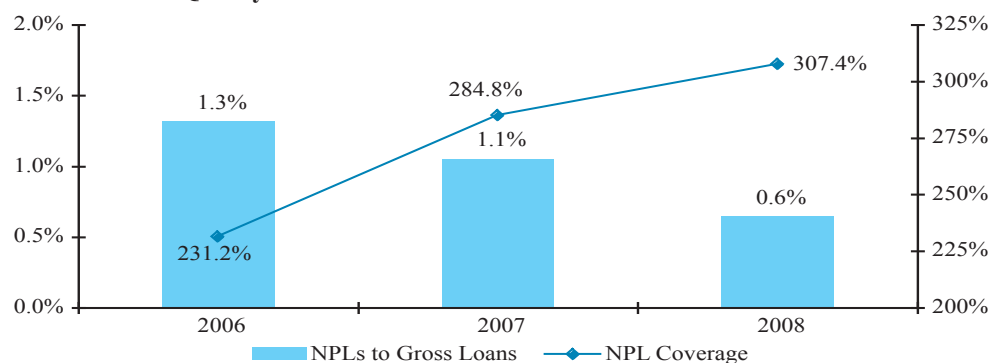
Chart 4: Loans to customer deposit



Source: Mashreq Bank

Non-Performing Loans

Lending growth has been strong for the bank; however NPL level has been managed well. Gross non-performing loans (NPLs) of the bank, in fact, declined from AED383.1mn in 2007 to AED364.2mn in 2008. Gross NPLs as a percentage of gross loans declined from 1.1% in 2007 to 0.6% in 2008. However we expect this ratio to go up in coming months on account of deterioration in economic scenario.

Chart 5: Asset Quality

Source: Mashreq Bank

The provision coverage ratio of the bank increased from 284.8% in 2007 to 307.4% in 2008 on account of higher provisioning made by the bank as a prudent measure in view of economic slowdown. In fact Mashreq Bank has one of the highest coverage ratios in the entire UAE banking industry.

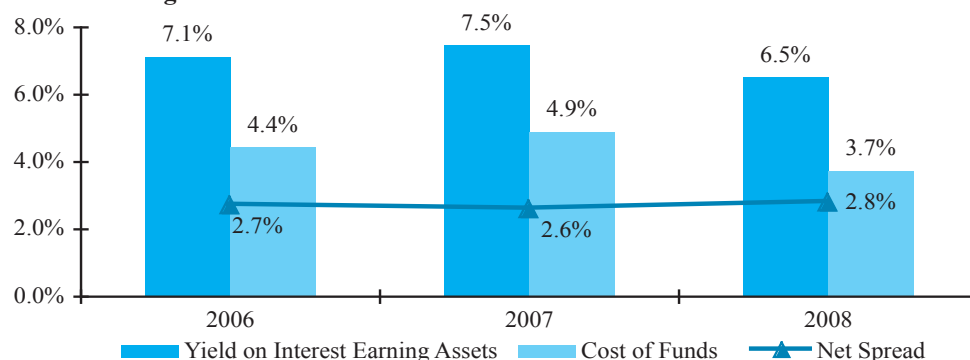
Investment portfolio

The investment portfolio of the bank stood at AED13.4bn at the end of 2008, down 9.2% from 2007. This mostly consists of non-trading investments (AED13.2bn) and trading investments (AED0.2bn). It is important to note that during the year the bank has reclassified securities worth more than AED8.5bn (as on 31st Dec 2008) in accordance with amendments to IAS 39 and IFRS 7. In view of the decline in the value of financial assets, Mashreq Bank witnessed investment losses during 2008. We expect the portfolio to sustain further losses on in 2009.

Interest Income

Total interest income of the bank (including Islamic) increased from AED4.0bn in 2007 to AED4.8bn in 2008, an increase of 18.9%. The growth in interest income was mainly driven by the growth in loan volume as yield on interest earning assets declined to 6.5% in 2008 from 7.5% in 2007. The decline in yield was expected in view of declining interest rate scenario. However bank's yield on interest earning assets is comparatively higher than its peers because of its greater focus on lucrative retail segment.

Total interest expense of the bank decreased from AED2.8bn in 2007 to AED2.7bn in 2008, a decrease of 4.3%. Cost of funds decreased from 4.9% in 2007 to 3.7% in 2008. Cost of funds of the bank is higher than some of the domestic peers since the share of low cost deposits is comparatively low and also due to lower share of government deposits. As the decline in cost of funds was sharper than the fall in yield on interest earning assets, Mashreq Bank's net spread increased from 2.6% in 2007 to 2.8% in 2008. In fact the net spread improved significantly during the fourth quarter of 2008 which we believe was mainly due to re-pricing of loans by the Mashreq Bank taking advantage of credit crunch.

Chart 6: Margins

Source: Mashreq Bank

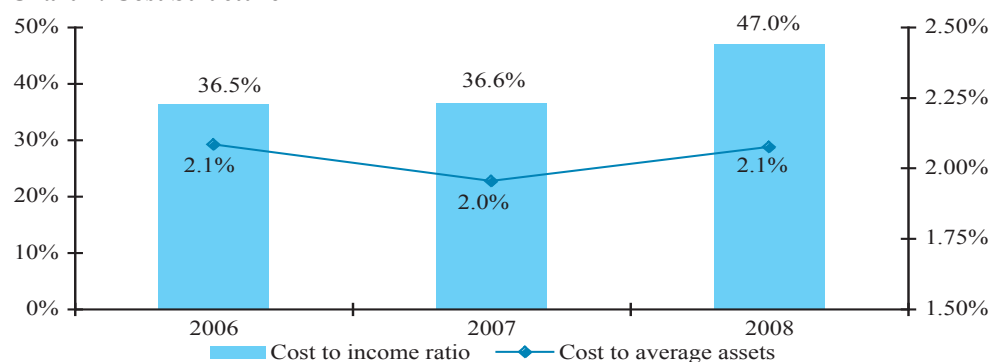
Non-interest income

Non-interest income of the bank declined by 28.3% during the year to reach AED1.9bn, down from AED2.7bn in 2007. Net fees and commission income increased from AED1.1bn in 2007 to AED1.3bn in 2008, a growth of 14.8%. We expect fee and commission income to decline in 2009 due to lower expected growth in loan book.

Bank made a net investment loss of AED218.0mn in 2008 compared to net investment gain of AED873.8mn in 2007. This was on account on account of significant corrections in assets witnessed during the year. In addition, losses to the tune of AED1.2bn from investment securities were reflected directly in the statement of equity. It is important to note that on account of reclassification securities in accordance with amendments to IAS 39 and IFRS 7, losses to the tune of AED428.5mn were not reflected in income statement.

Operating efficiency

During the year, total operating expense increased by 32.9% to reach AED1.9bn, up from AED1.4bn. This increased the cost to operating income ratio from 36.6% in 2007 to 47.0% in 2008. In fact Mashreq bank has one of the highest cost ratios in UAE banking sectors. This is due to bank's extensive presence in retail segment and consequent branch expansion. Staff expenses, which form around 60% of total operating expenses, was up 32.2% during the year. Total operating expense to average assets has gone up to 2.1% up from 2.0% in the previous year.

Chart 7: Cost Structure

Source: Mashreq Bank

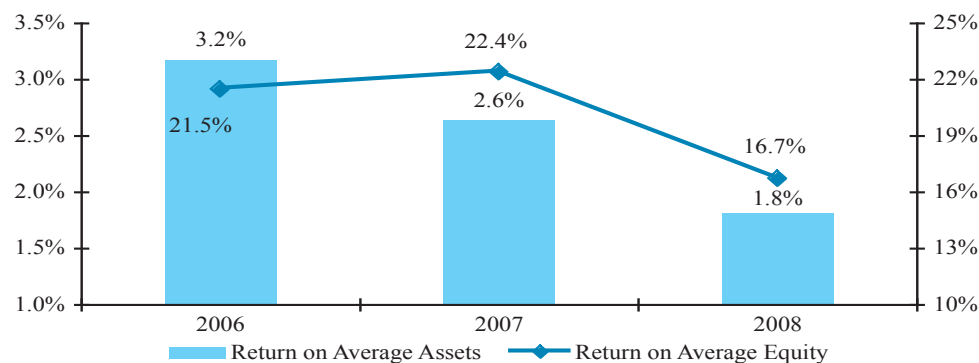
Provisions

The bank also increased its provisions during 2008. The total provision for the year was AED362.4mn in 2008, up 17.5% from 2007. However in view of decline in NPL level, the NPL coverage ratio of the bank increased from 284.8% in 2007 to 307.4% in 2008

Profitability

Mashreq Bank's net profit declined by 13.6% to reach AED1.6bn, down from AED1.9bn in 2007. Return on average equity decreased from 22.4% in 2007 to 16.7% in 2008. Similarly, return on average assets declined from 2.6% in 2007 to 1.8% in 2008.

Chart 8: Return Ratios

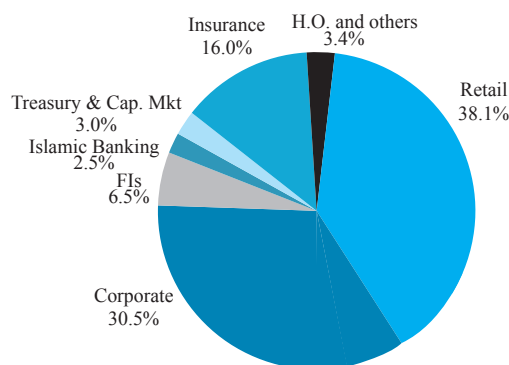


Source: Mashreq Bank

Segmental composition

Looking at the segmental composition, retail banking segment has the highest contribution to the total operating income. In fact, Mashreq Bank has higher contribution from retail segment compared to its peers in UAE banking sector. Operating income from the retail banking business increased by 24.6% to AED1.5bn in 2008 which represented around 38% of total operating income. The contribution of corporate banking business to the group profit was AED1.2bn, up 7.6% from the previous year.

Chart 9: Segmental Composition of Operating Income -2008



Source: Mashreq Bank

Capital adequacy

The capital adequacy ratio of the bank stood at 14.1% at the end of 2008 which was above Central Bank's requirement. For implementing current capital requirements, the Central Bank of UAE requires the group to maintain a prescribed minimum ratio of total capital to total risk-weighted assets of 10%. The capital adequacy ratio has declined from 17.8% at the end of 2007 on account of significant growth in risk-weighted assets. Out of total capital adequacy ratio of 14.1%, Tier I capital adequacy ratio was 12.9% at the end of 2008. As per Central Bank directives Tier I Capital need to be 11% from June 2009.

Analysis of Q1-2009 Performance

Balance sheet size of Mashreq Bank decreased by 2.8% as compared to 2008 to reach AED90.7bn at the end of March 2009. Customer deposits (including Islamic deposits) increased by 6.0% to AED54.5bn at end of March 2009 as compared with AED51.5bn at the end of year 2008. As a result, the contribution of customer deposits to the total liabilities and equities increased from 55.2% in 2008 to 60.2% at the end of Q1-2009. Due to banks was down 24.7% during the period to reach AED9.3bn.

Debt issued and other borrowed funds by the bank decreased to AED4.0bn at end of Q1-2009, down from AED5.2bn in 2008. There are no more remaining repayments for the rest of 2009 since bank repaid AED1.1bn during Q1-2009 which is an encouraging reflection of debt repaying capacity of the bank.

During Q1-2009, gross loan book reached AED55.2bn, an YTD decline of 1.8% from the year-end 2008. Net Loans decreased by 2.1% YTD to reach AED53.9bn in Q1-2009, down from AED55.0bn in 2008.

Gross non-performing loans (NPLs) increased from AED364.2mn in 2008 to AED483.6mn in Q1-2009, an increase of around 33%. Therefore NPL to gross loans ratio increased to 0.9% at the end of Q1-2009 up from 0.6% at the end of 2008. We expect NPL level to rise in the face of difficult economic scenario. The investment portfolio of the bank stood at AED12.5bn at the end of Q1-2009, down from AED13.4bn in 2008. The investment portfolio continued to witness losses during Q1-2009.

The total operating income of Mashreq Bank reached AED994.7mn in Q1-2009, a jump of 6.0% from the corresponding period in the previous year. Net interest income (including Islamic) reached AED581.0mn in Q1-2009 i.e. up 41.0% from AED412.1mn in Q1-2008. The improvement in net interest margin played a significant role in increase in net interest income as compared to previous year. Bank was able to re-price its loans during the period resulting in higher net interest margin.

Table 3: Income Statement Q1-2009

<i>(In AED '000)</i>	Q1-2008	Q1-2009	Change %
Interest Income	1,142,829	1,241,566	8.6%
Interest Expense	(744,181)	(707,617)	-4.9%
Net interest income	398,648	533,949	33.9%
Income from Islamic products	35,712	90,865	154.4%
Distributions to depositors - Islamic financing	(22,235)	(43,837)	97.2%
Net income from Islamic products	13,477	47,028	249.0%
Net interest income and income from Islamic products	412,125	580,977	41.0%
Net fee and commission income	319,175	338,668	6.1%
Investment income	174,967	(103,374)	-159.1%
Other income	147,680	410,526	178.0%
Provisions for Loan Losses	(115,726)	(232,061)	100.5%
Operating income	938,221	994,736	6.0%
Other operating expenses	(428,379)	(479,957)	12.0%
Operating profit	509,842	514,779	1.0%
Less: Provision for tax	(3,716)	(3,190)	-14.2%
Net Profit before minority interest	506,126	511,589	1.1%
Minority interest	(40,832)	(27,479)	-32.7%
Net Profit	465,294	484,110	4.0%

Source: Mashreq Bank

Net fee and commission income was up 6.1% YoY during the period to reach AED338.7mn as compared to corresponding period in the previous year. On account of decline in values of investments, bank made a net loss of AED103.4mn as opposed to gain of AED175.0mn in Q1-2008. In addition, losses to the tune of AED27.7mn from available-for-sale securities were reflected directly in the statement of equity. On account of reclassification of securities in accordance with amendments to IAS 39 and IFRS 7, losses to the tune of AED236.8mn were not reflected in income statement.

Other income of the bank was significantly up by around 178.0% YoY during the period. Keeping in view of the deterioration in economic conditions, the bank doubled its provision for NPLs to AED232.1mn, up from AED115.7mn in Q1-2008. However due to the sharper rise in NPL level, the coverage ratio of the bank declined from 307% in 2008 to around 264% in Q1-2009.

Total operating expenses for Q1-2009 was AED480.0mn, up 12.0% from AED428.4mn in Q1-2008. Cost to income ratio of the bank stood at 39.1% in Q1-2009, down from 40.6% in Q1-2008. The operating profit for the period reached AED514.8mn as compared to AED509.8mn in Q1-2008. Looking at the segmental composition of operating income, retail banking business was the biggest contributor to the bank's operating income at 36.0%. This was followed by corporate segment which contributed 26.7% of total operating income.

Net profit for the period AED484.1mn, up 4.0% from AED465.3mn in Q1-2008. Return on average equity (RoAE) was 19.0% for the period Q1-2009 whereas return on average assets (RoAA) was 2.1%.

Outlook

Given the deteriorating economic scenario and adverse credit environment over the past few quarters, the performance of Mashreq Bank during Q1-2009 was above our expectations. This was mainly due to improvement in net interest income on the back of widening net interest margin. The declining interest rate scenario during the first quarter of the year worked in favor of the bank resulting in higher net interest margin.

The bank's capital ratios stood at 14.3% at the end of Q1-2009 as compared to 14.1% in 2008. The bank has not yet converted Ministry of Finance's deposits to Tier II capital and has informed that the procedures for conversion are still in progress. As our estimation once conversion is complete, Tier II capital will increase by around 4 percentage points.

We expect the growth rate of the bank to slow down considerably in coming years in contrast with high growth rates achieved in the past years. This is not surprising given the slowdown witnessed across-the-board. Dubai has been highly impacted by this slowdown as it was depending mainly on non-oil sectors like real estate, construction, tourism, retail to drive growth. All of these non-oil sectors have experienced a significant slowdown in Dubai.

One of our key concerns areas is quality of assets which we project to deteriorate in coming quarters in view of the economic slowdown especially Dubai which is highly impacted as compared to other Emirates of UAE. We have started to see some impact as gross NPLs as a percentage of gross loans have gone up in 1Q-2009. Though Mashreq Bank has been conservative in its approach, we are a bit concerned about the high retail exposure of the bank in the current scenario. Dubai has witnessed significant job losses over the past few quarters and this might impact the retail portfolio of the bank.

We have started to see some signs of market stabilizing both internationally and regionally. Though it is very early to say that market will enter a high growth phase in near future, we believe that market might have found a bottom. However on the macroeconomic front, we still continue to witness adverse economic indicators. As per IMF forecast, UAE's economy is expected to contract by 0.6% in 2009. We believe it will take some more time before we see normal liquidity level in the banking system. However things have improved since 4Q-2008 when the liquidity dried up after speculative money betting on revaluation of Dirham went out of UAE banking system. Though Government has taken several positive steps to infuse liquidity into the system, it will take some time to show the impact.

In view of the difficult economic environment, we believe most of the banks including Mashreq Bank will focus on factors like monitoring of credit quality, setting up effective risk management systems and rationalizing cost bases etc. Mashreq Bank needs to rationalize its operating expenses which have grown at a higher pace in recent times. Therefore expansion plans are expected to take a back seat in 2009 and 2010.

Valuation & Recommendation

For arriving at the fair value of Mashreq Bank, we have used two valuation methods:

1. Cash flow approach represented by the Dividend Discounting Model.
2. P/BV target multiple approach using an adaptation of the Gordon Growth Model.

Dividend Discounting Model (DDM)

The DDM is based on a 4-year forecast of dividends as cash flows (2009-12). The dividends for the forecasted period and the terminal value are then discounted back at the cost of equity to arrive at the total equity value of the bank. In our calculations, we have made the following assumptions in order to arrive at the equity value of Mashreq Bank:

1. Cost of Equity derived using Capital Asset Pricing Model comes out to be 12.80% based on the following assumptions:
 - a. Risk free rate of 6.30%.
 - b. Market risk premium of 6.50%.
 - c. Beta of 1. The actual beta for the company is low, but to be more appropriate in reflecting the market risk we have taken it as 1.
2. Terminal growth rate of 3.00%.

Based on our future earnings projections and the above assumptions, the DDM value of Mashreq Bank is AED101.41 per share.

Table 4: DDM Valuation

(000' AED)	2009 F	2010 F	2011 F	2012 F	Terminal Value
Dividends Expected	1,046,667	1,288,206	1,529,744	1,771,283	18,616,543
PV of dividends expected	4,292,284				
PV of Terminal Value	12,037,605				
Estimated Fair Value of Equity	16,329,889				
No. of Outstanding Shares ('000)	161,026				
Fair Value Per Share (AED)	101.41				

Value in AED '000s unless otherwise mentioned

Source: Global Research

Sensitivity Analysis - DDM

A sensitivity analysis for different estimated long-run growth rates and cost of equity has been provided. The table provides estimated fair values for Mashreq Bank's shares based on a range of varying inputs. The shaded area at the center shows the most probable range of alternatives.

Table 5: DDM Valuation – Sensitivity Analysis

		Cost of Equity				
		10.80%	11.80%	12.80%	13.80%	14.80%
Terminal Growth Rate	1.00%	105.93	95.88	87.54	80.51	74.50
	2.00%	115.68	103.64	93.83	85.70	78.84
	3.00%	127.93	113.16	101.41	91.85	83.91
	4.00%	143.79	125.12	110.71	99.26	89.93
	5.00%	165.10	140.61	122.40	108.35	97.17

Source: *Global Research*

Gordon Growth Model (GGM)

The adaptation of the Gordon Growth Model uses the sustainable return on average equity (ROAE), cost of equity (COE) and expected growth in earnings (g) to calculate the target P/BV of the bank using the formula:

$$P/BV = (ROE - g) / (COE - g)$$

This P/BV is then multiplied with the BVPS of the bank at the next full year, in our case the BVPS at December 31, 2009 to arrive at the fair value of the bank over a medium term investment horizon.

In our calculations, we have made the following assumptions in order to arrive at the equity value of individual banks:

1. Sustainable ROE calculated as the average ROAE of the forecasted 4 years.
2. Cost of Equity derived using the same assumptions as in the DDM.
3. Terminal growth rate of 3.00%, similar to the DDM.

On the basis of Gordon Growth Model, the bank's stock value comes to AED101.94 per share.

Table 6: Gordon Growth Model

Sustainable ROE	17.28%
COE	12.80%
Terminal Growth Rate (g)	3.00%
P/BV target multiple (x)	1.46
2009: BV/share (AED)	69.95
GGM Value per share (AED)	101.94

Source: *Global Research*

Sensitivity Analysis - GGM

We have also prepared a sensitivity analysis for the estimated fair price based on various terminal growth rates and COE. The shaded area at the center shows the most probable range of alternatives.

Table 7: GGM Valuation – Sensitivity Analysis

		Cost of Equity				
		10.80%	11.80%	12.80%	13.80%	14.80%
Terminal Growth Rate	1.00%	116.21	105.45	96.52	88.97	82.53
	2.00%	121.47	109.07	98.98	90.59	83.51
	3.00%	128.07	113.52	101.94	92.50	84.66
	4.00%	136.62	119.11	105.57	94.80	86.02
	5.00%	148.12	126.34	110.14	97.62	87.66

Source: *Global Research*

The following table shows the movement in fair value as a consequence of different ROE and COE assumptions.

Table 8: GGM Valuation – Sensitivity Analysis

		Cost of Equity				
		10.80%	11.80%	12.80%	13.80%	14.80%
Return on Equity	15.28%	110.14	97.62	87.66	79.55	72.80
	16.28%	119.11	105.57	94.80	86.02	78.73
	17.28%	128.08	113.52	101.94	92.50	84.66
	18.28%	137.04	121.47	109.08	98.98	90.59
	19.28%	146.01	129.42	116.21	105.45	96.52

Source: *Global Research*

Weighted Average Share Value

To arrive at the weighted average share value, we have provided a higher 80% weightage to the value arrived at using the DDM method and 20% weightage to the value arrived at using the GGM method.

Table 9: Weighted Average Share Value (AED)

Method	Value	Weight	Weighted Value
DDM	101.41	80%	81.13
GGM	101.94	20%	20.39
Fair Value			101.52

Source: *Global Research*

Our estimated value for this banking scrip is worked out to be AED101.52 based on DDM (80%) and adaptation of the Gordon Growth Model (20%). According to our fair value the banking scrip offers a downside of 17.5% at the closing price of AED123.00 per share (as of May 27, 2009). We therefore recommend a **REDUCE** on Mashreq Bank at the current price level.

BALANCE SHEET

	MASHREQ BANK						
<i>(In AED '000)</i>	2006	2007	2008	2009E	2010E	2011E	2012E
Assets							
Cash balances	274,351	231,137	454,043	800,227	781,062	609,098	436,587
Balances with central bank for reg. purposes	1,179,871	1,597,378	2,425,276	2,769,522	3,119,562	3,518,362	3,973,765
Balances with central bank other than for reg. purposes	951,466	18,371,608	3,410,067	4,177,332	5,639,398	6,344,323	8,564,836
Deposits with banks	8,556,912	10,974,141	9,077,630	9,985,393	10,484,663	11,008,896	11,559,341
Trading Securities	10,094,456	10,023,141	219,776	192,304	197,112	211,895	227,787
Islamic financing and investment products	829,014	2,345,269	6,600,704	7,425,792	8,539,661	10,034,101	12,040,922
Net Loans and Advances	28,572,233	32,980,680	48,434,274	52,398,635	56,287,355	62,556,800	70,368,528
Other Assets	2,781,805	5,472,924	8,231,536	6,996,806	7,521,566	8,085,683	8,287,826
Non-trading Investments	2,840,993	4,749,018	13,189,058	12,859,332	13,180,815	13,510,335	13,848,094
Investment property	361,739	498,440	724,237	814,767	875,874	941,565	988,643
Net Fixed Assets	302,275	383,661	476,920	677,915	722,539	745,179	770,649
Total Assets	56,745,115	87,627,397	93,243,521	99,098,024	107,349,607	117,566,238	131,066,977
Liabilities							
Deposits from Banks	5,702,538	13,397,024	12,336,491	9,560,781	9,799,800	10,044,795	10,547,035
Deposits from Customers	33,908,235	46,133,514	48,435,538	58,122,646	65,387,976	73,561,473	82,756,658
Other Liabilities	3,356,871	5,857,323	7,568,835	7,001,172	7,176,202	7,893,822	9,077,895
Repurchase agreements with banks	1,285,612	3,834,313	5,129,883	3,975,659	3,776,876	3,588,033	3,408,631
Islamic customers' deposits	747,890	2,153,198	3,042,027	3,422,280	3,935,622	4,624,356	5,549,228
Insurance & life assurance funds	373,940	516,895	802,485	902,796	970,505	1,091,818	1,255,591
Long-term loans	23,541	16,707	11,838	8,287	5,801	4,060	2,842
Medium-term notes	3,397,525	5,234,025	5,234,025	4,132,125	2,938,400	1,836,500	1,836,500
Total Liabilities	48,796,152	77,142,999	82,561,122	87,125,745	93,991,183	102,644,858	114,434,379
Minority interest	571,395	870,546	617,706	708,925	825,048	963,738	1,123,414
Owner's Equity							
Paid-up equity capital	866,195	1,126,054	1,463,870	1,610,257	1,610,257	1,610,257	1,610,257
Statutory & legal reserves	469,453	599,009	740,734	805,129	805,129	805,129	805,129
General reserve	312,000	312,000	312,000	312,000	312,000	312,000	312,000
Cumulative translation adjustments	(11,449)	(2,155)	(33,932)	(38,437)	(38,437)	(38,437)	(38,437)
Retained earnings	5,557,149	7,068,366	8,231,655	9,553,766	10,502,304	11,597,050	12,810,833
Investment revaluation reserve	184,220	510,578	(649,634)	(979,360)	(657,877)	(328,357)	9,402
Total Shareholder's Equity	7,377,568	9,613,852	10,064,693	11,263,354	12,533,376	13,957,642	15,509,183
Total Liabilities & Owner's Equity	56,745,115	87,627,397	93,243,521	99,098,024	107,349,607	117,566,238	131,066,977

Source: Company Reports and Global Research

OPERATING STATEMENT

	2006	2007	2008	2009E	2010E	2011E	2012E
<i>(In AED '000)</i>							
Interest Income	2,642,553	3,949,981	4,563,103	4,639,853	4,837,409	5,506,760	6,354,973
Interest Expense	(1,763,923)	(2,788,349)	(2,632,701)	(2,474,129)	(2,576,457)	(3,091,833)	(3,721,125)
Net interest income	878,630	1,161,632	1,930,402	2,165,725	2,260,951	2,414,927	2,633,847
Income from Islamic products	32,052	81,508	228,889	358,878	408,487	498,440	619,993
Distributions to depositors - Islamic financing	(28,505)	(42,682)	(75,516)	(100,427)	(123,507)	(158,665)	(206,378)
Net income from Islamic products	3,547	38,826	153,373	258,450	284,980	339,775	413,615
Net interest income and income from Islamic products	882,177	1,200,458	2,083,775	2,424,175	2,545,931	2,754,703	3,047,462
Net fee and commission income	707,423	1,091,204	1,252,770	1,190,132	1,202,033	1,232,084	1,324,490
Investment income	768,407	873,759	(217,980)	(51,510)	(19,471)	10,225	10,992
Other operating income	469,431	685,065	865,373	1,124,985	1,136,235	1,147,597	1,176,287
Provisions for Loan Losses	(146,604)	(308,385)	(362,362)	(990,947)	(744,494)	(531,839)	(431,133)
Operating income	2,680,834	3,542,101	3,621,576	3,696,835	4,120,234	4,612,770	5,128,098
Staff costs	(605,226)	(828,036)	(1,094,258)	(1,109,050)	(1,153,666)	(1,199,320)	(1,282,024)
Other operating expenses	(372,295)	(514,351)	(696,977)	(702,399)	(721,041)	(738,043)	(769,215)
Depreciation	(53,949)	(67,400)	(82,727)	(98,998)	(112,872)	(128,294)	(144,331)
Total operating expenses	(1,031,470)	(1,409,787)	(1,873,962)	(1,910,447)	(1,987,579)	(2,065,657)	(2,195,570)
Operating profit	1,649,364	2,132,314	1,747,614	1,786,388	2,132,655	2,547,113	2,932,528
Less: Provision for tax	(6,622)	(6,319)	(15,545)	(15,890)	(21,327)	(25,471)	(29,325)
Net Profit before minority interest	1,642,742	2,125,995	1,732,069	1,770,498	2,111,329	2,521,641	2,903,203
Minority interest	(72,102)	(225,363)	(89,239)	(91,219)	(116,123)	(138,690)	(159,676)
Net Profit	1,570,640	1,900,632	1,642,830	1,679,279	1,995,206	2,382,951	2,743,527
P&L Appropriation Account:							
Op Balance of Retained Earnings	4,160,362	5,557,149	7,068,366	8,231,655	9,553,766	10,502,304	11,597,050
Net Profit for the year	1,570,640	1,900,632	1,642,830	1,679,279	1,995,206	2,382,951	2,743,527
Trfr to Statutory & legal reserves	(614)	(129,556)	(141,725)	(64,395)	-	-	-
Cash Dividend	(173,239)	-	-	(146,387)	(1,046,667)	(1,288,206)	(1,529,744)
Stock Dividends	-	(259,859)	(337,816)	(146,387)	-	-	-
CI Balance of Retained Earnings	5,557,149	7,068,366	8,231,655	9,553,766	10,502,304	11,597,050	12,810,833

Source: Company Reports and Global Research

CASH FLOW STATEMENT

	MASHREQ BANK						
(In AED '000)	2006	2007	2008	2009E	2010E	2011E	2012E
Operating							
Operating Activities							
Net Profit before minority interest	1,656,604	2,511,954	2,389,048	2,855,938	2,968,695	3,181,774	3,478,667
Depreciation	1,642,742	2,125,995	1,732,069	1,770,498	2,111,329	2,521,641	2,903,203
Fair value adjustments - trading investment	53,949	67,400	82,727	98,998	112,872	128,294	144,331
Fair value adjustments - trading investment	(63,283)	(136)	192,203	-	-	-	-
Forex adjustment	4,556	9,325	(31,778)	(4,505)	-	-	-
Impairment of loans & advances	83,124	462,035	500,174	990,947	744,494	531,839	431,133
Fair value adjustments - property investment	(64,157)	(152,732)	(152,467)	-	-	-	-
(Gain)/loss on sale of fixed assets	(327)	67	(57,730)	-	-	-	-
Others	-	-	123,850	-	-	-	-
Working capital							
Change in loans and advances	(1,899,476)	15,130,906	(11,042,158)	(1,972,844)	(1,722,589)	(1,848,909)	(1,904,555)
Change in Islamic products	(6,385,928)	(4,870,483)	(15,932,539)	(4,955,308)	(4,633,213)	(6,801,285)	(8,242,861)
Change in trading securities	(829,014)	(1,516,255)	(4,255,435)	(825,088)	(1,113,869)	(1,494,441)	(2,006,820)
Change in deposits with banks	(3,163,929)	71,451	5,638,460	27,472	(4,808)	(14,783)	(15,892)
Change in deposits with central bank	(623,716)	(3,792,028)	1,678,607	(907,763)	(499,270)	(524,233)	(550,445)
Change in repurchase agreements with banks	(217,136)	(417,507)	(827,898)	(1,111,511)	(1,812,107)	(1,103,725)	(2,675,916)
Change in other assets	918,312	2,548,701	1,295,570	(1,154,224)	(198,783)	(188,844)	(179,402)
Change in deposits from banks	(730,622)	(2,691,119)	(2,759,764)	1,234,730	(524,760)	(564,117)	(202,142)
Change in deposits from customers	2,569,607	7,694,486	(1,060,533)	(2,775,710)	239,020	244,995	502,240
Change in Islamic customer deposits	3,903,443	12,225,279	2,302,024	9,687,108	7,265,331	8,173,497	9,195,184
Change in insurance & life assurance funds	747,890	1,405,308	888,829	380,253	513,342	688,734	924,871
Change in long-term loans	113,492	142,955	285,590	100,311	67,710	121,313	163,773
Change in medium-term loans	(7,124)	(6,834)	(4,869)	(3,551)	(2,486)	(1,740)	(1,218)
Change in other liabilities	1,101,900	1,836,500	-	(1,101,900)	(1,193,725)	(1,101,900)	-
Total operating	(242,872)	17,642,860	(8,653,110)	883,094	1,246,106	1,332,865	1,574,112
Investing							
Additions to fixed assets, net of disposals	(162,807)	(149,880)	(181,922)	(299,993)	(157,496)	(150,934)	(169,801)
Sale of fixed assets	737	1,027	63,666.00	-	-	-	-
(Purchase)/Sale of non-trading investments	(327,556)	(1,416,114)	(6,130,414)	-	-	-	-
Investment property	-	-	-	(90,530)	(61,107)	(65,691)	(47,078)
Total investing	(489,626)	(1,564,967)	(6,248,670)	(390,522)	(218,604)	(216,624)	(216,879)
Financing							
Dividend paid to minority	(35,441)	(31,011)	(35,972)	-	-	-	-
Net capital withdrawn by minority	(8,504)	(44,753)	(422)	-	-	-	-
Dividend paid to shareholders	(173,239)	-	-	(146,387)	(1,046,667)	(1,288,206)	(1,529,744)
Total financing	(217,184)	(75,764)	(36,394)	(146,387)	(1,046,667)	(1,288,206)	(1,529,744)
Net change in cash balances	(949,682)	16,002,129	(14,938,174)	346,184	(19,165)	(171,965)	(172,511)
Net cash balances at beginning	9,050,093	8,100,411	24,102,540	454,043	800,227	781,062	609,098
Net cash balances at end	8,100,411	24,102,540	9,164,366	800,227	781,062	609,098	436,587

Source: Company Reports and Global Research

Fact Sheet

	MASHREQ BANK						
	2006	2007	2008	2009E	2010E	2011E	2012E
Profitability							
- Return on Average Assets	3.2%	2.6%	1.8%	1.7%	1.9%	2.1%	2.2%
- Return on Average Equity	21.5%	22.4%	16.7%	15.7%	16.8%	18.0%	18.6%
- Net interest income / Op. Income after Provisions for Loan Losses	27.4%	25.2%	47.5%	38.8%	43.7%	48.2%	51.0%
- Non-interest income / Op. Income after Provisions for Loan Losses	72.6%	74.8%	52.5%	61.2%	56.3%	51.8%	49.0%
Margins							
- Net income / Revenues	58.7%	47.1%	34.3%	33.6%	38.0%	39.7%	39.3%
- Operating profit / Revenues	61.7%	52.9%	36.5%	35.7%	40.7%	42.4%	42.0%
- Interest Expense to Interest Income	67.0%	70.2%	56.5%	51.5%	51.5%	54.1%	56.3%
- Yield on interest earning assets	7.1%	7.5%	6.5%	6.0%	5.8%	6.0%	6.3%
- Cost of interest bearing liabilities	4.4%	4.9%	3.7%	3.4%	3.3%	3.6%	4.0%
- Net Spread	2.7%	2.6%	2.8%	2.7%	2.5%	2.4%	2.3%
- Net Interest Margin	2.4%	2.2%	2.8%	2.9%	2.8%	2.8%	2.7%
Efficiency							
-Cost / Op. Income after Provisions for Loan Losses	38.5%	39.8%	51.7%	51.7%	48.2%	44.8%	42.8%
-Cost / Op. Income before Provisions for Loan Losses	36.5%	36.6%	47.0%	40.8%	40.9%	40.2%	39.5%
- Staff Expense / Op. Income after Provisions for Loan Losses	22.6%	23.4%	30.2%	30.0%	28.0%	26.0%	25.0%
- Staff Expense / Op. Income before Provisions for Loan Losses	21.4%	21.5%	27.5%	23.7%	23.7%	23.3%	23.1%
- Cost to Average Total Assets	2.1%	2.0%	2.1%	2.0%	1.9%	1.8%	1.8%
Liquidity							
- Loans to Interest Earning Assets	75.3%	53.8%	70.8%	71.6%	71.6%	72.8%	73.3%
- Loans to Customer Deposits	84.8%	73.2%	106.9%	97.2%	93.5%	92.8%	93.3%
- Customer Deposits to Equity	469.7%	502.3%	511.5%	546.4%	553.1%	560.2%	569.4%
- Due from Banks to Due to Banks	150.1%	81.9%	73.6%	104.4%	107.0%	109.6%	109.6%
Credit Quality							
- Provisions to Average Gross Loans	0.5%	0.9%	0.8%	1.7%	1.1%	0.7%	0.5%
- NPLs to Gross Loans	1.3%	1.1%	0.6%	1.4%	1.9%	2.1%	2.2%
- NPLs to (Equity + Loan Loss Reserve)	4.8%	3.6%	3.3%	6.3%	8.2%	9.1%	9.9%
- Loan Loss Reserve to Gross Loans	3.0%	3.0%	2.0%	3.4%	4.2%	4.5%	4.4%
- NPL Coverage	231.2%	284.8%	307.4%	250.0%	225.0%	215.0%	200.0%
Capital Adequacy							
- Equity to Total Assets	13.0%	11.0%	10.8%	11.4%	11.7%	11.9%	11.8%
- Equity to Gross Loans	24.3%	26.4%	17.9%	18.2%	18.5%	18.4%	18.0%
- Capital Adequacy Ratio (CAR)	17.5%	17.8%	14.1%				
Constitution of Total Income							
- Net commission income / Op. Income after Provisions for Loan Losses	26.4%	30.8%	34.6%	32.2%	29.2%	26.7%	25.8%
- Investment securities income / Op. Income after Provisions for Loan Losses	28.7%	24.7%	-6.0%	-1.4%	-0.5%	0.2%	0.2%
- Other operating income / Op. Income after Provisions for Loan Losses	17.5%	19.3%	23.9%	30.4%	27.6%	24.9%	22.9%
Operating Performance							
- Change in Net Interest Income after Provisions for Loan Losses	10.9%	21.3%	93.0%	-16.7%	25.7%	23.4%	17.7%
- Change in Other Income	-33.3%	45.9%	26.3%	30.0%	1.0%	1.0%	2.5%
Ratios Used for Valuation							
- EPS (AED)	9.75	11.80	10.20	10.43	12.39	14.80	17.04
- Book Value Per Share (AED)	45.82	59.70	62.50	69.95	77.83	86.68	96.31
- Market Price Year End (AED) *	145.24	215.38	240.00	123.00	123.00	123.00	123.00
- P/E (x)	14.89	18.25	23.52	11.79	9.93	8.31	7.22
- P/BV (x)	3.17	3.61	3.84	1.76	1.58	1.42	1.28
- Dividend yield (%)	1.1%	1.0%	0.8%	5.3%	6.5%	7.7%	8.9%
- Dividend pay-out ratio (%)	16.5%	17.8%	17.8%	62.3%	64.6%	64.2%	64.6%

* Market price for 2009 and subsequent years as per last closing price available on DFM as on May 27, 2009.

Source: Company Reports and Global Research

The following is a comprehensive list of disclosures which may or may not apply to all our researches. Only the relevant disclosures which apply to this particular research has been mentioned in the table below under the heading of disclosure.

Disclosure Checklist				
Company	Recommendation	Ticker	Price	Disclosure
Mashreq Bank	Reduce	MASQ.DU (Reuters) MASQ.UH (Bloomberg)	AED123.00	1, 10

1. Global Investment House did not receive and will not receive any compensation from the company or anyone else for the preparation of this report.
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Global Research: Equity Ratings Definitions

Global Rating	Definition
Buy	Fair value of the stock is >10% from the current market price
Hold	Fair value of the stock is between +10% and -10% from the current market price
Reduce	Fair value of the stock is between -10% and -20% from the current market price
Sell	Fair value of the stock is < -20% from the current market price

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