

UAE Banks

Improving risk/return profile

FGB is top pick, Upgrade UNB to BUY
BUY ENBD as a Dubai recovery play

3rd April 2013

Coverage Universe

FGB	
Recommendation	BUY
Target Price (LC)	16.30
UNB	
Recommendation	BUY
Target Price (LC)	5.40
ENBD	
Recommendation	BUY
Target Price (LC)	4.85
CBD	
Recommendation	HOLD
Target Price (LC)	4.00
DIB	
Recommendation	HOLD
Target Price (LC)	2.35
NBAD	
Recommendation	HOLD
Target Price (LC)	11.85
ADCB	
Recommendation	HOLD
Target Price (LC)	4.40
ADIB	
Recommendation	HOLD
Target Price (LC)	3.85

SECTOR OUTPERFORMING...PROFITABILITY GROWING AND ASSET QUALITY IMPROVING

The banking sector added 33% in the last twelve months and an impressive 17% YTD. Improving investor sentiment, growing profitability and receding credit cost risks have added to banks' ability to weather downside risks. Moreover, banks have pushed to optimize capital with increased cash dividend payout in 2012 a key part of this process. This also signals that managements are confident of easing risks and stronger growth outlook. The valuation gap between Abu Dhabi and Dubai banks has been closing significantly; YTD share performance of Dubai banks outpaced Abu Dhabi peers. UAE banks are trading at a median 2013E P/E of 7.7x, 1.1x book value and c. 6% dividend yield – unjustified discount to MENA banks (8.8x, 1.2x, 5%). The market is not fully pricing the better operating outlook for UAE banks, improving visibility on loans' quality outlook and potential for ROE re-rating.

FGB REMAINS TOP PICK; UPGRADE UNB TO BUY; ENBD IS OUR DUBAI RECOVERY PLAY

FGB remains our preferred stock in the UAE banking space as we believe the bank will be the most profitable in the sector and expect further markets share gains. We upgrade UNB from HOLD to BUY- the name is attractively priced at these levels, offering deep value and sizeable upside potential (42% upside). At current valuations (P/B 13E at 0.8x), we see asset quality concerns as exaggerated and the market ignoring operational improvement at the bank. Our positive view on the turnaround story within Dubai banks translates into upgrading ENBD to BUY from HOLD. The name is an attractively-priced play on Dubai's recovery at a 13E P/B of 0.7x. We downgrade our recommendation on NBAD from BUY to HOLD on the back of share price rally (29% since our initiation), leaving limited upside potential from these levels. Our HOLD recommendation on ADCB is based on the fact that provisioning against legacy assets is improving as is its capital position yet current valuations reflect these improvements (13E P/B at 1.1x, P/E at 8.8x, up 37% YTD). We introduce CBD as an attractive Dubai yield play (D.Y. at 7%) yet we believe its high-return profile (ROE 13E at 15%) is priced in at current levels (P/B 13E at 1.1) after recent share price rally (16% YTD, 34% TTM). We maintain our HOLD recommendation on ADIB and DIB, yet our preference changes to DIB as a play on the UAE Islamic banks. We view its valuation as cheaper (40% P/B discount), market pricing is harsher and we like its loan growth prospects and outlook (Tamweel acquisition and associated synergies).

KEY THEMES FOR UAE BANKING SECTOR IN 2013

We identify several key themes driving the banking sector in 2013: 1) credit growth recovery led by Dubai banks, 2) adequate funding and sector liquidity, 3) NIM stability, 4) fee income recovery, but not a game changer, 5) improving visibility on asset quality- the worst is over, 6) robust capitalization and capital release theme lifting dividend payouts, 7) improving profitability and greater room for ROE re-rating and 8) greater clarity on recent Central Bank regulations.



Sector Coverage

Taher Safieddine, CFA
+9714 3199 785
tsafieddine@shuaa.com

Asjad Yahya, CFA
+9714 3199 768
ayahya@shuaa.com

Company	Price (LC)	Recommendation	Target Price (LC)	%upside/(downside)
NBAD	11.05	HOLD	11.85	7%
FGB	13.60	BUY	16.30	20%
ADCB	4.15	HOLD	4.40	6%
UNB	3.83	BUY	5.40	42%
ADIB	3.70	HOLD	3.85	4%
ENBD	3.92	BUY	4.85	24%
DIB	2.02	HOLD	2.35	16%
CBD	3.47	HOLD	4.00	16%

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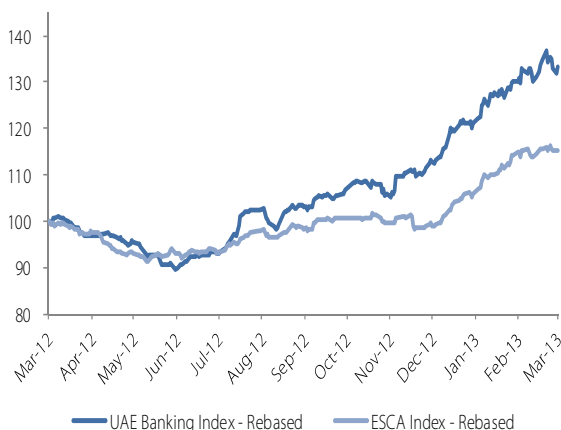
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Valuation

Strong outperformance...operational improvement and dividend surprises

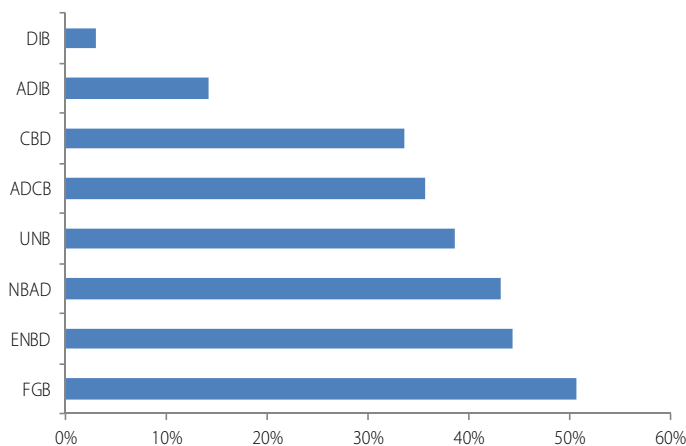
UAE banks had a stellar performance over the past few months, with some names climbing to highs not seen in a while. Despite the strong performance posted by market indices (ESCA up 13% TTM and 14% YTD), UAE banks have managed to outperform respective indices and other regional peers. The banking sector added 33% in the last twelve months and an impressive 17% YTD. We feel the general investor sentiment has improved towards UAE markets especially with strong signs of economic growth, ongoing restructuring efforts and new project announcements from both Dubai and Abu Dhabi over the period. More specifically, improving profitability and receding credit cost risks have added to banks' ability to weather any downside risks and grow profitability moving forward. Moreover, the major theme of the past few months was the push by banks to optimize capital, with increased cash dividend distribution a key part of this process. Payout ratio increased from an average of 39% in 2011 to 48% in 2012 (up 44% YoY). Top performers over the last twelve months include FGB (+51%), ENBD (+44%) and NBAD (+43%).

UAE banks outperforming



Source: Bloomberg, SHUAA Capital

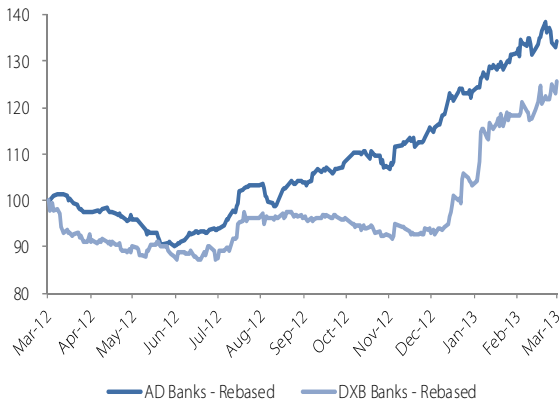
FGB and ENBD are top performers on TTM basis



Source: Bloomberg, SHUAA Capital

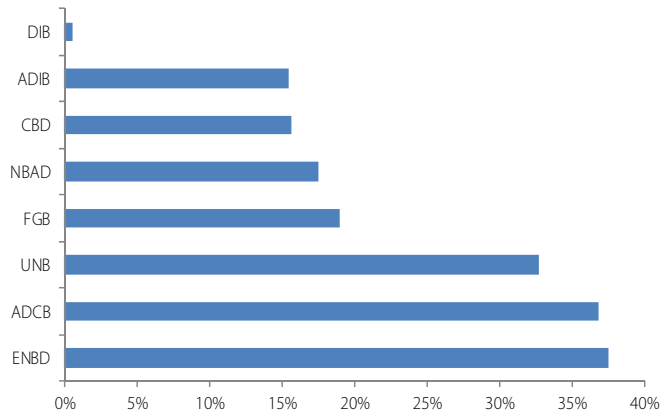
While we argued in our initiation report, dated September 2012 that there is a clear divergence between Dubai and Abu Dhabi banks' stock performance – Abu Dhabi banks outperforming Dubai peers, the story has changed significantly. We view that the gap between Abu Dhabi and Dubai banks has been closing significantly; TTM performance calculated at 34% for Abu Dhabi and 26% for Dubai. However, on YTD basis the picture looks quite different with Dubai peers outperforming Abu Dhabi counterparts (34% vs. 15%). The key driver behind this story is the improving confidence in Dubai's economy and corporates on one hand and the improving risk/reward profile offered by Dubai banks on the other hand. Banks like ENBD added 38% YTD while ADCB's share price appreciated by 37% YTD. Both names have announced higher-than-expected dividend payouts and are trading at attractive dividend yields. DIB lagged peers with muted gains of 1% YTD.

Dubai banks catching up



Source: Bloomberg, SHUAA Capital

YTD performance remains strong



Source: Bloomberg, SHUAA Capital

Valuation still attractive on relative scale

UAE banks are trading at a median 2013E P/E of 7.7x, 1.1x book value and c. 6% dividend yield – still at discount to MENA banks (8.8x, 1.2x, 5%). We view this discount as unjustified given UAE banks’ strong capitalization levels, strong structural profitability and receding asset quality risks. In our view, the market is not fully pricing the strong operating improvement for UAE banks, stronger visibility on loans’ quality outlook and potential for ROE re-rating. Despite recent share price appreciation, UAE banks continue to trade at discount valuations to Saudi peers (P/E at 9.4x, P/B at 1.2x) and Qatari (P/E at 9.6x, P/B at 1.4x) peers. The sector offers an attractive dividend yield of c. 6% yet RoAE levels remain below average (13E at 13% vs. 15% MENA median).

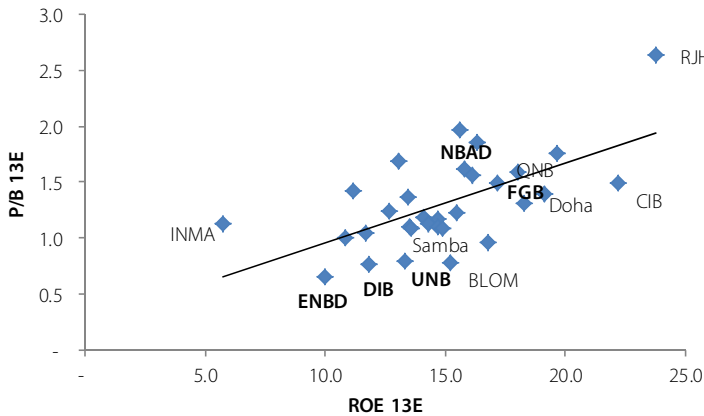
Comparative valuation

Company	Country	Market Cap (USDm)	P/E (x)		P/B (x)		D.Y (%)		RoAE (%)		RoAA (%)	
			2013	2014	2013	2014	2013	TTM	2013	TTM	2013	TTM
NBAD	UAE	12,953	10.7	9.0	1.6	1.5	3.0	15.1	15.2	1.6	1.5	
FGB	UAE	11,394	9.2	8.2	1.6	1.5	7.1	14.8	16.8	2.5	2.5	
ADCB	UAE	6,322	8.8	7.9	1.1	1.0	5.3	14.3	13.0	1.5	1.4	
UNB	UAE	2,732	6.0	6.0	0.8	0.7	5.4	11.9	12.4	1.9	1.9	
ADIB	UAE	2,382	7.6	6.9	1.2	1.1	5.7	11.3	12.7	1.5	1.4	
ENBD	UAE	5,901	7.8	6.3	0.7	0.6	5.7	7.2	9.0	0.9	0.9	
DIB	UAE	2,088	7.0	5.8	0.8	0.7	6.8	12.3	11.7	1.2	1.1	
CBD	UAE	1,926	7.4	6.8	1.1	1.0	6.8	13.0	15.0	2.2	2.4	
Rajhi	KSA	26,299	11.3	9.8	2.6	2.4	5.8	22.8	23.8	3.2	3.1	
Samba	KSA	10,679	8.3	7.6	1.2	1.1	4.5	14.5	14.7	2.2	2.3	
SABB	KSA	8,879	9.2	8.2	1.5	1.3	2.9	17.4	17.2	2.2	2.2	
ANB	KSA	6,052	8.8	7.7	1.2	1.1	4.3	13.8	14.1	1.9	1.9	
BSF	KSA	7,352	8.5	7.6	1.1	1.0	3.6	14.2	14.3	2.0	2.1	
SHB	KSA	2,921	8.5	7.5	1.2	1.1	3.6	15.9	15.5	2.0	1.9	
Riyad Bank	KSA	9,160	9.4	8.3	1.0	1.0	6.3	11.2	11.7	1.9	2.0	
Banl Albilad	KSA	2,664	13.8	11.3	2.0	1.7	1.1	24.2	15.6	3.3	2.3	
Alinma Bank	KSA	5,280	19.2	14.3	1.1	1.0	-	4.5	5.7	1.6	2.1	
Bank Al Jazira	KSA	2,144	13.1	11.0	1.4	1.3	2.3	10.3	11.1	1.1	1.2	
SAIB	KSA	2,611	9.9	8.4	1.0	0.9	3.5	10.2	10.8	1.6	1.7	
QNB	Qatar	25,675	9.6	8.3	1.8	1.6	4.1	18.7	19.7	2.5	2.5	
CBQ	Qatar	4,465	7.6	6.9	1.1	1.0	8.5	13.8	14.9	2.7	2.5	
QIB	Qatar	4,601	10.8	9.6	1.4	1.3	6.2	10.9	13.4	1.9	2.2	
Masraf Al rayan	Qatar	5,098	12.4	11.1	1.9	1.7	4.4	16.6	16.4	2.5	N/A	
Doha Bank	Qatar	3,342	8.3	7.4	1.3	1.2	8.0	17.8	18.3	2.4	2.4	
Bank Muscat	Oman	3,438	8.4	7.2	1.1	1.0	4.1	14.3	13.6	1.8	1.7	
Bank Audi	Lebanon	2,361	6.4	6.2	1.0	0.9	5.8	15.4	16.8	1.2	N/A	
Blom Bank	Lebanon	1,772	5.4	4.8	0.8	0.7	6.1	16.6	15.2	1.4	N/A	
NBK	Kuwait	14,415	12.3	11.7	1.7	1.7	4.0	12.8	13.1	2.0	2.0	
Burgan	Kuwait	2,923	9.8	8.9	1.6	1.5	2.8	11.9	16.1	1.1	1.4	
COMI	Egypt	2,631	7.2	6.3	1.5	1.3	4.5	22.8	22.2	2.5	2.4	
NSGB	Egypt	1,957	8.0	7.1	1.4	1.2	4.0	19.4	19.1	2.4	2.3	
UAE median			7.7	6.8	1.1	1.0	5.7	12.6	12.8	1.5	1.5	
KSA median			9.4	8.3	1.2	1.1	3.6	14.2	14.3	2.0	2.1	
Qatar median			9.6	8.3	1.4	1.3	6.2	16.6	16.4	2.5	2.5	
MENA median			8.8	7.7	1.2	1.1	4.5	14.3	14.9	1.9	2.0	

Source: Bloomberg, SHUAA Capital

UAE banks appear to offer an attractive return/valuation profile compared to peers. Names like ENBD, DIB and UNB are trading at sizeable discounts relative to peers. UNB remains a deep value play with 2013E ROE of 13.3%, yet cheap valuations with a P/B of 0.8x (UAE sector at 1.1x, MENA median at 1.2x). FGB offers a strong profitability profile with an above-average ROE of 18%, yet valuations remain attractive at a P/B 13E of 1.6x. The name continues to offer one of the best risk/reward combinations among UAE banks with more scope to release capital, grow ROE and improve dividend payouts in the future. NBAD's superior profitability and strong market position is reflected in its above-average valuation with 2013 P/B at 1.6x.

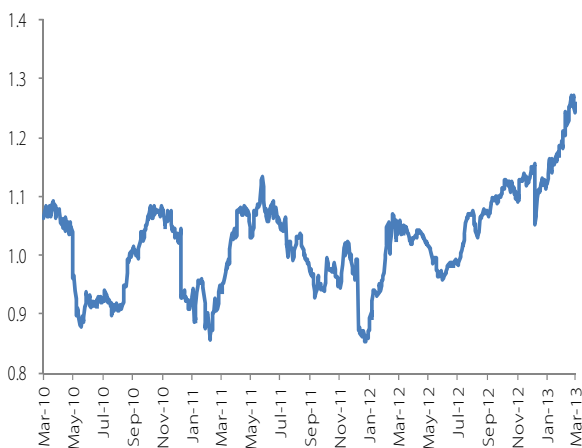
UAE banks attractively priced in MENA context



Source: Bloomberg, SHUAA Capital

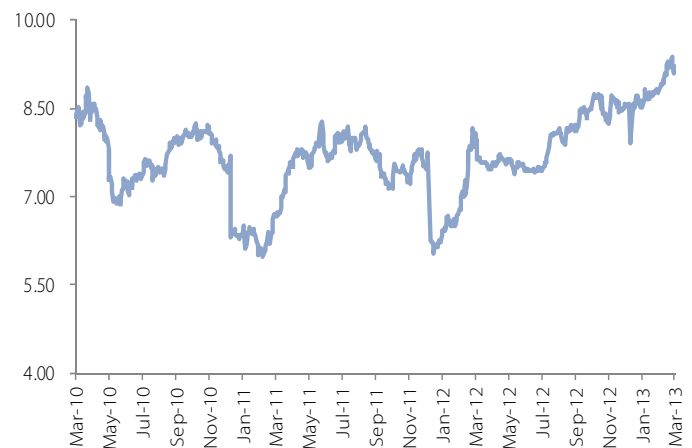
UAE banks' valuations have recovered from early 2012 lows, with a weighted 1-year forward P/B currently at 1.3x compared to lows of 0.9x in January 2012. The improving operational performance, receding asset quality risks, strong capitalization and increasing dividend payout all signal that UAE banks are past the worst. Despite this valuation pick-up, we still believe there is room for UAE banks to further re-rate as ROE picks up at lagging Abu Dhabi banks and main Dubai players. UAE banks are still trading at discounted valuations relative to MENA peers. The picture is similar on a P/E basis; UAE banks trading at a 1-year forward P/E of 9.0x, recovering from 2011 lows of 6.0x yet remain well below 2008 peaks. As profitability picks up in 2013 and thereafter, UAE names are expected to close the existing valuation gap with other MENA peers.

UAE banks 1-year forward P/B at 3-year highs



Source: Bloomberg, SHUAA Capital

Forward P/E recovering from 2011 lows



Source: Bloomberg, SHUAA Capital

Justified P/B valuation approach

Similar to our initiation report, we value UAE banks using the justified P/B valuation methodology, which is derived from the Gordon Growth model:

$$\text{Justified P/B multiple} = (\text{Sustainable ROE-g}) / (\text{CoE-g})$$

Our estimates of sustainable ROEs are based on the combination of current fundamentals, long-term outlook and consensus estimates of sustainable ROEs for the banks. The respective justified P/B multiple is applied to the 2013 forecast Book value per share (BVPS) of each bank to obtain our price targets. Our choice of justified P/B multiple as the preferred method of valuation is based on the following factors:

- 1) The methodology takes into account the long-term profitability of the bank (ROE) relative to its Cost of Equity (CoE).
- 2) It limits the number of assumptions required as the formula consists of only three inputs, namely sustainable ROE, Cost of Equity (CoE) and Terminal Growth rate (g).
- 3) The methodology is simple and easy to understand: it simply implies that banks that are able to generate returns for shareholders (ROE) above the Cost of Equity (CoE) deserve to trade at a premium to their book values, while those that fall short should trade at a discount.
- 4) We like the focus on a single-period model (2013 book value per share) in view of current lack of visibility at the macro level in particular.

Valuation inputs

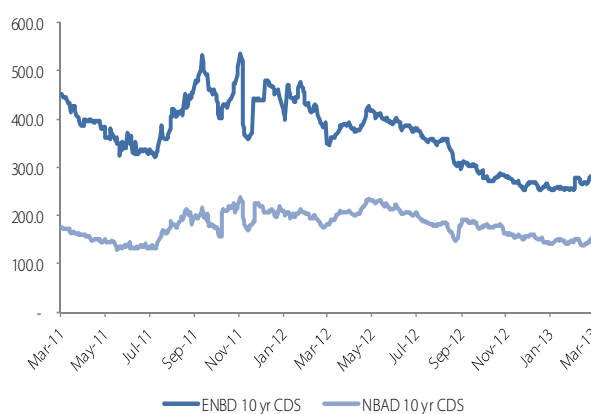
We have reduced our cost of equity assumptions for both Abu Dhabi and Dubai banks as we believe our estimates are conservative relative to market consensus and the overall risk associated with Dubai has receded. Our cost of equity assumptions for Dubai currently stand at 14% (15% previously) while that of Abu Dhabi is at 12.5% (13% previously). We believe this revision is justifiable given: 1) tangible positive economic development in general and in Dubai in particular, 2) successful restructuring of Dubai GREs and 3) healthy uptake in core sectors like retail, hospitality and trade. Dubai's default risk (CDS spread) has eased around 85bps in the past twelve months and 145bps since 2011-end. Moreover, the CDS differential between Dubai and Abu Dhabi has tightened significantly since peaking in 2011-end, currently at 190 bps vs. peaks of 400bps in October 2011. Dubai's government and GREs have demonstrated their ability to tap the debt market and refinance existing facilities at cheaper rates.

CDS spread differential narrowing between DXB and AD



Source: Bloomberg, SHUAA Capital

Tightening spread between ENBD and NBAD



Source: Bloomberg, SHUAA Capital

While we base our terminal growth projections (g) on existing level of credit penetration and long term inflation expectations, we have made allowances for market share winners and losers. Previously, we assigned a uniform growth rate of 2.5% for Dubai banks and 3.0% for Abu Dhabi banks. We have revised our growth rate assumptions for FGB and NBAD up to 3.5% as we are confident of their ability to grow above-average and gain further market share in the UAE banking universe. Growth rate assumptions remain unchanged for other banks.

We have revised our sustainable ROE assumptions depending on recent financial performance, growth outlook and market consensus. Our new assumptions are: 18.8% for NBAD, 20.5% for FGB, 14.5% for ADCB, 13.2% for UNB, 15.0% for ADIB, 13.0% for ENBD, 12.8% for DIB and 16.8% for CBD.

Snapshot of our valuation exercise

We present below a summary table with key inputs and results of the justified P/B valuation – including price targets and upside/downside potential from current levels.

UAE banks' valuation summary

Bank	NBAD	FGB	ADCB	UNB	ADIB	ENBD	DIB	CBD
BVPS 2013E (AED)	6.99	8.61	3.64	5.06	3.06	5.31	2.62	3.25
Sustainable ROE	18.8%	20.5%	14.5%	13.2%	15.0%	13.0%	12.8%	16.8%
Cost of equity (CoE)	12.5%	12.5%	12.5%	12.5%	12.5%	14.0%	14.0%	14.0%
Growth (g)	3.5%	3.5%	3.0%	3.0%	3.0%	2.5%	2.5%	2.5%
Implied P/B (x)	1.7	1.9	1.2	1.1	1.3	0.9	0.9	1.2
Target price (AED)	11.85	16.30	4.40	5.40	3.85	4.85	2.35	4.00
Current price (AED)	11.05	13.60	4.15	3.83	3.70	3.92	2.02	3.47
Upside (downside)	7%	20%	6%	42%	4%	24%	16%	16%
P/B 2013E at TP (x)	1.7	1.9	1.2	1.1	1.3	0.9	0.9	1.2
P/B 2013E at current (x)	1.6	1.6	1.1	0.8	1.2	0.7	0.8	1.1
P/E 2013E at TP (x)	11.4	11.0	9.4	8.5	7.9	9.6	8.1	8.6
P/E 2013E at current (x)	10.7	9.2	8.8	6.0	7.6	7.8	7.0	7.4

Source: Bloomberg, SHUAA Capital

At our new target prices, we see solid upside potential for FGB and UNB. Despite its recent re-rating and more modest upside potential than for ENBD and UNB, FGB remains our preferred stocks in the UAE banking space as we believe the bank will be the most profitable in the sector and expect further market share gains. We upgrade UNB from HOLD to BUY – the name is attractively priced at these levels, offering deep value and sizeable upside potential (42% upside). The company has seen strong improvement in operating performance and enjoys a very solid capital and liquidity position. At current valuations (P/B 13E at 0.8x), we see asset quality concerns as exaggerated and the market ignoring operational improvement at the bank. Our positive view on the turnaround story within Dubai banks translates into upgrading ENBD to BUY from HOLD. We believe Dubai's ongoing economic recovery is positive for ENBD's loan growth prospects and credit quality. The name is an attractively-priced play on Dubai's recovery at a 13E P/B of 0.7x. We downgrade our recommendation on NBAD from BUY to HOLD on the back of share price rally (29% since our initiation), leaving limited upside potential from these levels. Our HOLD recommendation on ADCB is based on the fact that provisioning against legacy assets is improving as is its capital position, yet current valuations reflect these improvements (13E P/B at 1.1x, P/E at 8.8x, up 37% YTD). We remain cautious on credit outlook for the bank. We introduce CBD as an attractive Dubai yield play (div. yield at 7%) yet we believe its high-return profile (ROE 13E at 15%) is priced in at current levels (P/B 13E at 1.1) after recent share price rally (16% YTD, 34% TTM). We maintain our HOLD recommendation on ADIB and DIB, yet our preference changes to DIB as a play on the UAE Islamic banks. We view its valuation as cheaper (40% P/B discount), market pricing is harsher and we like its loan growth prospects and outlook (Tamweel acquisition and associated synergies).

What is the market pricing?

We consider two alternative adjustments to our valuation model in order to assess what the market is currently pricing for UAE banks. For this purpose, we assess the market-implied ROEs as well as market-implied book values.

We conclude that the market is currently pricing an average ROE of 12.4% for Dubai banks vs. our sustainable ROE estimate of 14.2%. For Abu Dhabi banks, the effect is also pronounced as the market is pricing off an average ROE of 14.8% vs. SHUAA's estimate of 16.4%. On an individual basis, the largest mismatch is in our three BUY-rated stocks: FGB, UNB and ENBD. FGB is trading at a market-implied ROE of 17.7%, below 2012 levels of 18.2% and c. 280 bps below our sustainable ROE estimate of 20.5%. UNB is also deeply discounted by the market at these levels; implied ROE of 10.2% vs. our 13.2% projection.

Market-implied ROE

Bank	NBAD	FGB	ADCB	UNB	ADIB	ENBD	DIB	CBD
Sustainable ROE - LT	18.8%	20.5%	14.5%	13.2%	15.0%	13.0%	12.8%	16.8%
Implied ROE - current	17.7%	17.7%	13.8%	10.2%	14.5%	11.0%	11.4%	14.8%
<i>Difference (current - LT)</i>	-1.0%	-2.8%	-0.7%	-3.0%	-0.5%	-2.0%	-1.4%	-2.0%
ROE 12A*	16.8%	18.2%	14.5%	13.6%	12.0%	8.2%	12.8%	13.7%
<i>Difference (current - 2012)</i>	0.9%	-0.5%	-0.7%	-3.5%	2.5%	2.8%	-1.4%	1.1%

Source: SHUAA Capital, Company reports

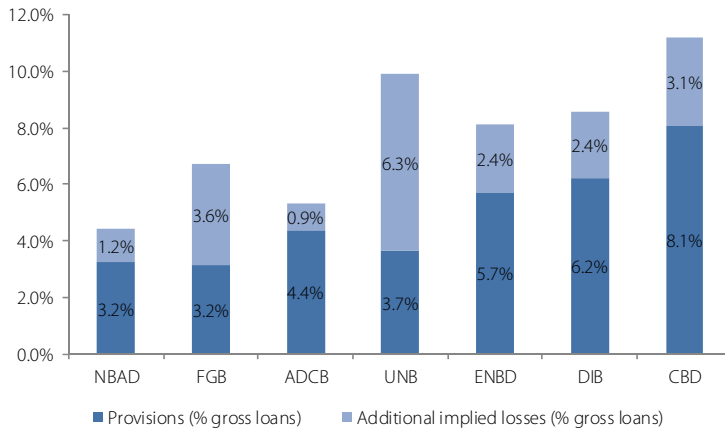
* adjusted for Tier 1 notes and proposed 2012 dividends

In our second approach, we maintain our assumptions and use justified P/B multiple to calculate book values implied by current share price. Our calculations suggest the market is pricing a capital erosion of 14% for the UAE banks, with UNB the most affected (30% erosion) followed by ENBD (19%) and FGB (16%). Again, our top three picks are undervalued by book value standards, which further support our buy case on these names. We also present this capital erosion as a percentage of gross loans; market is pricing in a 6% erosion of UNB's gross loan book, 4% for FGB and c. 2% for ENBD and DIB.

Market-implied book value

Bank	NBAD	FGB	ADCB	UNB	ADIB	ENBD	DIB	CBD
BVPS 2013E (AED)	6.99	8.61	3.64	5.06	3.06	5.31	2.62	3.25
P/B 2013E – target (x)	1.7	1.9	1.2	1.1	1.3	0.9	0.9	1.2
Current price (AED)	11.05	13.60	4.15	3.83	3.70	3.92	2.02	3.47
Implied BVPS 13E (AED) - current	6.52	7.20	3.43	3.57	2.93	4.29	2.26	2.80
<i>Difference (implied - 13E)</i>	-7%	-16%	-6%	-30%	-4%	-19%	-14%	-14%
Capital erosion (AED mn)	2,018	4,218	1,197	3,726	311	5,675	1,395	909
<i>% of current gross loans</i>	1.2%	3.6%	0.9%	6.3%	0.6%	2.4%	2.4%	3.1%

Source: SHUAA Capital, Bloomberg

Capital erosion as % of gross loans


Source: Company reports, SHUAA Capital

Stock summaries

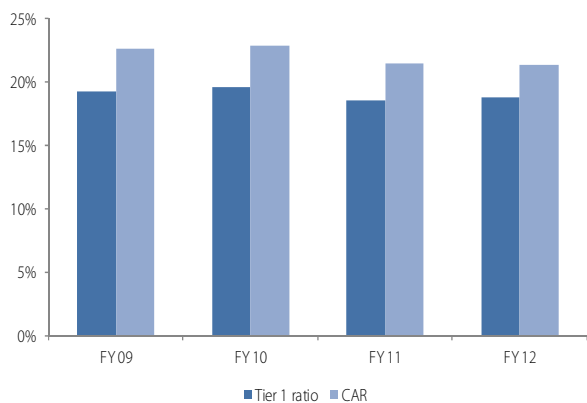
FGB: Top pick, superior profitability and growing yield

(FGB UH/FGB.AD, BUY, TP: AED 16.30, CP: AED 13.60)

Healthy capitalization... more room for dividend hikes

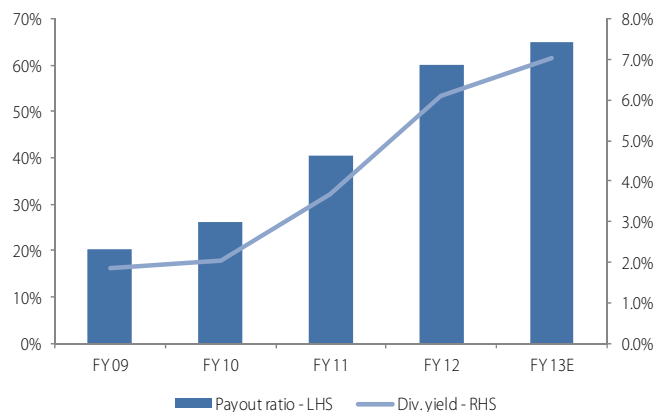
With the UAE central bank allowing FGB to raise its payout ratio to c. 60% of earnings (vs. 50% CB cap and 40% payout in 2011), we believe the precedent is set on payouts over 50% so long as capitalization remains at healthy levels and asset quality risks are manageable. We believe management has further room to hike dividends given robust capitalization (Tier 1 ratio at 19% in FY 12) and potential for loan growth. This is in line with management guidance on releasing capital to shareholders. We now expect the payout to rise to 65% of profits for 2013E supporting 16% growth in the dividend. This capital release should also support expansion in ROEs from 2012 levels of 18.2% (our sustainable ROE estimate at 20.5%).

Robust capitalization levels



Source: Company reports, SHUAA Capital

Rising payout, compelling yield

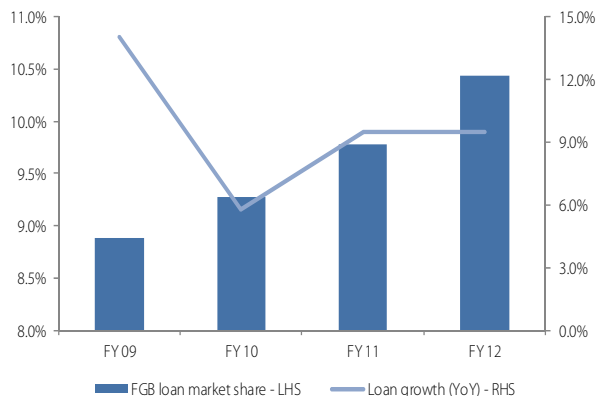


Source: Company reports, SHUAA Capital

Profitability advantage vs. peers... market share gains, superior NIMS and efficiency

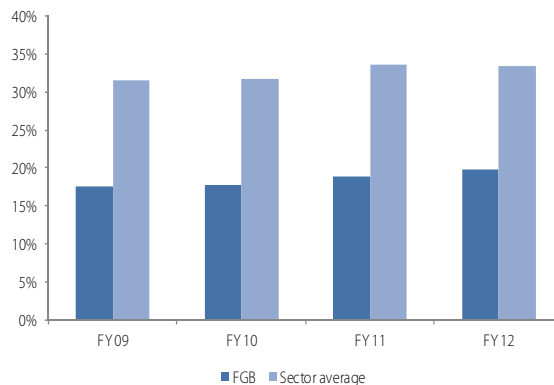
FGB maintained strong loan book growth of 9.5% YoY in 2012 (sector avg. at 5%), driven by increased lending to the government and public sector (+23% YoY). We expect FGB will enjoy above-average volume growth (c. 9-10% in FY 13) and continue to gain market share driven by Abu Dhabi public sector lending. FGB is in a good position to win business from the Abu Dhabi government and related commercial entities in the future; the bank has not traditionally been active in this space (government lending share at 9% of total loan book), and this is also an area where other banks may need to shed market share to comply with potential regulations limiting exposure to local government/ GREs.

Strong loan growth and market share gains



Source: Company reports, SHUAA Capital

Best cost efficiency in the UAE (Cost/Income ratio)



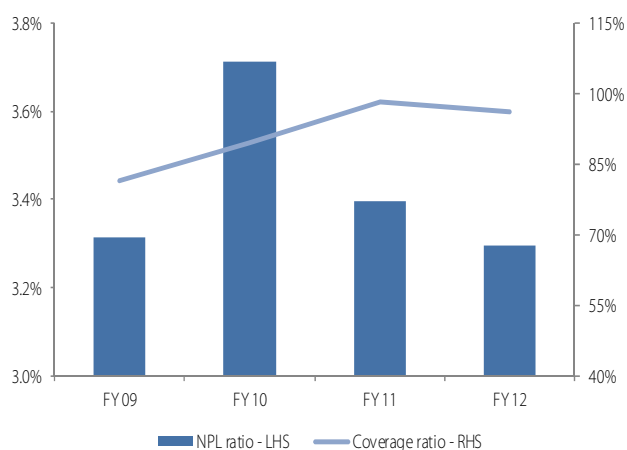
Source: Company reports, SHUAA Capital

The bank also enjoys superior asset yields and net interest margins, reflecting a loan mix with greater exposure to retail customers. FGB has the best cost efficiency in the UAE with a cost/income ratio of 20% in FY 12 (sector average at 33%) on the back of its agent-driven distribution model. Pre-provision profits grew 10% YoY last year (sector avg. at 7%) and we expect this growth trend to continue moving forward.

Sound asset quality... strong provisioning buffer

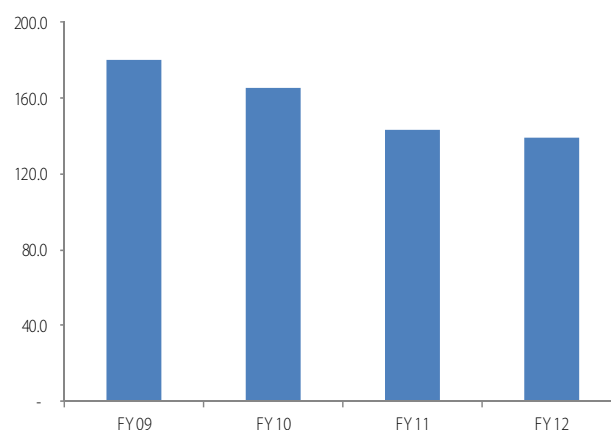
FGB enjoys sound asset quality with NPL ratio standing at 3.3% in FY 12 vs. an average of 6.1% for our UAE banks coverage; provision coverage remains comfortable at the 96% level in 2012 compared to 76% for peer group. Management is positive regarding asset quality and expects gradual improvement in the future. We expect the bank to focus on building its general provision reserve to bring it in line with central bank's requirement at 1.5% by FY 14 (FY 12 at c. 1.1%). Cost of risk reached 139bps in FY 12, down marginally YoY and c. 40bps from 2009 peaks. The bank's robust profitability metrics and healthy capitalization should provide a strong cushion against asset quality headwinds (provisioning costs of c. 400bps before impacting the bank's book value). According to our calculations, the market is currently pricing a 16% erosion in FGB's book value, translating into a high 4% of gross loan book. We believe this is a highly unlikely scenario.

Credit quality at healthy levels



Source: Company reports, SHUAA Capital

Easing cost of risk (in bps)



Source: Company reports, SHUAA Capital

Valuation re-rated, but attractive upside remains

FGB trades at 9.2x and 1.6x 2013E P/E and P/B respectively, along with 19% ROE. While FGB has already re-rated from deep value levels (up 51% TTM), and currently trades at a premium to sector multiples (7.7x P/E, 1.1x P/B), we believe this premium should widen given its stable balance sheet, superior profitability and compelling and growing dividend yield (D.Y at 7% in FY 13). At our target price, FGB trades at 11.0x 2013E P/E and 1.9x book value. The name remains mispriced by the market as reflected by the difference between projected sustainable ROE of 20.5% and 17.7% long term ROE implied by current price. We retain FGB as our top pick in the UAE banking sector with a target price of AED 16.30/share and a 20% upside potential.

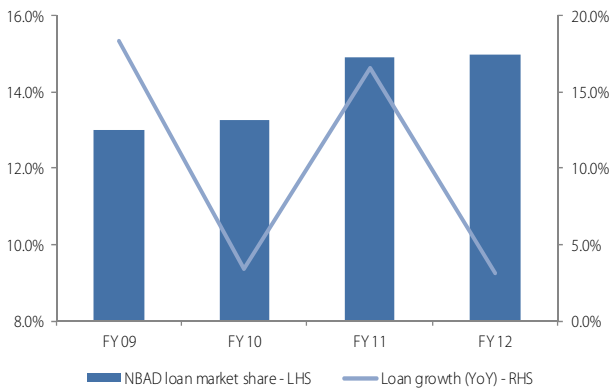
NBAD: Superior fundamentals priced in

(NBAD UH/NBAD.AD, HOLD, TP: AED 11.85, CP: AED 11.05)

Credit growth to pick up, high exposure to government lending

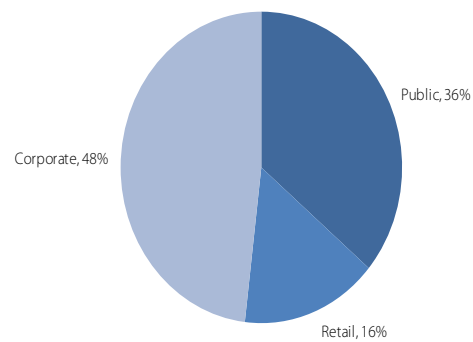
NBAD's loan growth disappointed in 2012, up 3% YoY compared to 17% the year before. This slowdown has been the result of re-payments from borrowers in the public sector. We expect loan book growth to pick up to high single digits this year on the back of growing international operations and short term lending to banks. NBAD has traditionally benefited from its close ties to the Abu Dhabi government, which has enabled the bank to secure business in terms of loans origination and deposits inflow. However, the UAE Central Bank could potentially introduce rules limiting the amount of credit exposure banks can have to local governments and GREs. Close to 36% of NBAD's loan book is directed towards government and public sector. We believe NBAD's total exposure to the Abu Dhabi sovereign and GREs are both likely to be above the 100% of regulatory capital limit that was originally proposed by the UAE Central Bank. Even if lending caps are renegotiated at a more manageable level, NBAD could find itself losing market share with this customer segment.

Loan growth disappointed in 2012



Source: Company reports, SHUAA Capital

Public lending makes 36% of NBAD's loan book

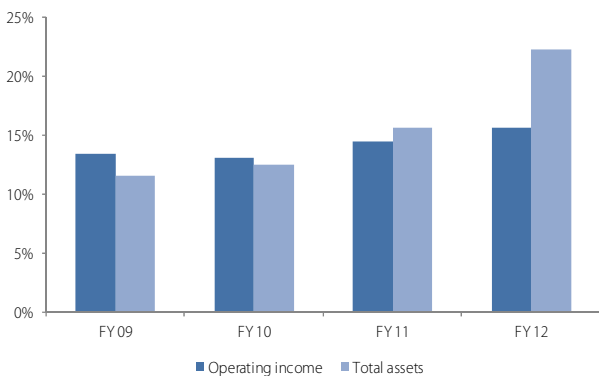


Source: Company reports, SHUAA Capital

Strong international diversification

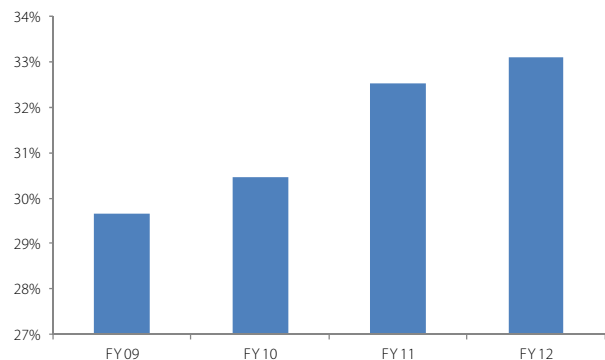
NBAD currently generates 16% of its operating income from international operations, up from 13% in 2009. Its total asset base is becoming more diversified: 22% is generated from non-UAE business. These figures are much higher than other UAE banks. NBAD has indicated its aim to expand its operations to 41 countries by 2021, from 14 currently. While this international expansion makes sense given the bank's top tier status in the UAE and the mature nature of the banking system (credit/GDP at c. 100%), this growth in new markets will come at a price. NBAD will not enjoy cheap funding access and preferential government support in new geographies as that in the UAE. The bank's cost/income has been rising steadily (at 33% in 2012) and return on equity (2012A adj. ROE at 16.8%) continues to lag the bank's internal targets of 20%.

International diversification gathering pace (As % of total)



Source: Company reports, SHUAA Capital

Efficiency deteriorating on expansions (Cost/Income)

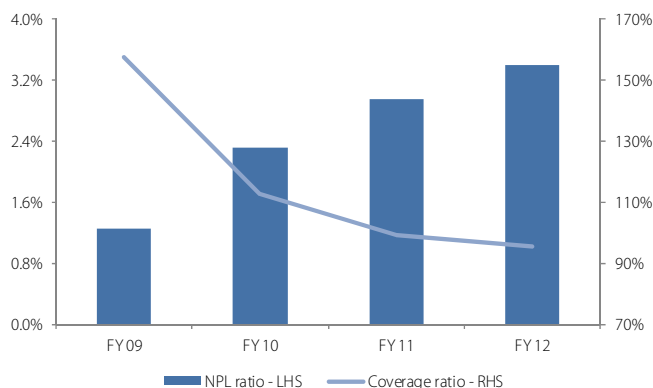


Source: Company reports, SHUAA Capital

Unmatched credit quality metrics

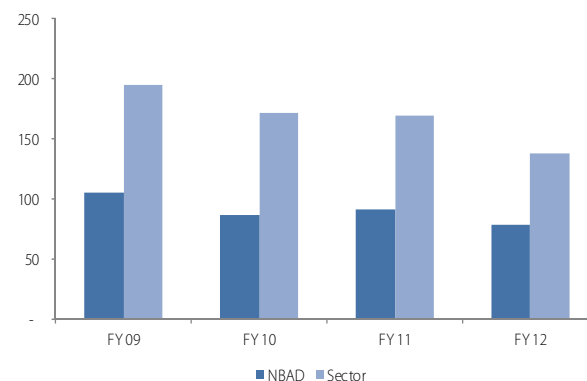
NBAD's asset quality metrics remain the healthiest in the UAE banking sector with NPL ratio of 3.4% and a coverage ratio at 96% in FY 12. The bank has consistently enjoyed superior loan quality and lower risk costs than peers as a result of its close links to the Abu Dhabi government (major shareholder at 70%). Management is guiding towards a gradual drop in provisions as the bank reaches peak delinquency levels; NPLs to peak below 3.75% of performing loans (currently at 3.40%). NBAD's cost of risk has been easing over the years, down to 78 bps in 2012 from peak levels of 105 bps in 2009. These levels remain the lowest in the UAE banking sector, owing to NBAD's robust credit quality metrics.

Best asset quality metrics in the UAE



Source: Company reports, SHUAA Capital

Lowest cost of risk (bps) in the sector



Source: Company reports, SHUAA Capital

Premium valuations are fair... downgrade to neutral

We are downgrading NBAD to HOLD from BUY despite raising our target price to AED 11.85, after a strong run up in the share price (43% within the last year and 18% YTD) - leaving us with limited upside potential of 7%. We prefer to play a further recovery in the UAE through FGB which we believe has better risk/reward combination and offer a more attractive capital release story. NBAD trades at a 2013E P/E of 10.7x and 1.6x P/B with 18.8% sustained ROE. Valuations are now at a premium to its historical average and 45% premium to UAE average. While we believe the bank deserves its premium to the sector given its best of breed status, substantial capital base and stable ROE, we believe it is close its fair value and see limited further upside. At our target price, NBAD trades at 11.4x 2013 PE and 1.7x book value. We could turn more positive on NBAD if we see more of a capital release theme that would produce higher dividend yields; the bank currently has self-imposed cap on payout (c. 33%) limiting its dividend. Another potential upside would be renegotiated lending caps on government and GRE exposures.

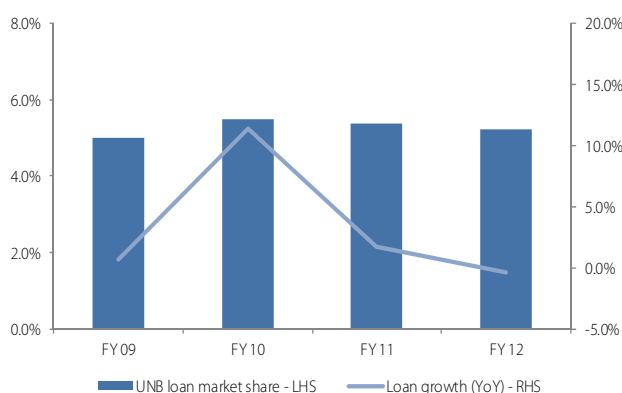
UNB: Deep value play with an improving performance

(UNB UH/UNB.AD, BUY, TP: AED 5.40, CP: AED 3.83)

Credit growth has room to increase, robust capital position

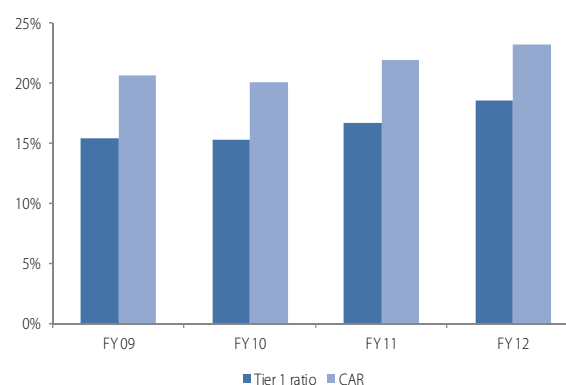
UNB's loan growth disappointed in 2012, with flat YoY growth after a muted 1.8% growth in 2011. The bank slightly lost its loan market share to 5.2%, underperforming sector growth for two years in a row. We believe the bank has adequate room to accelerate lending in the future, with robust capitalization position and adequate capital headroom. UNB enjoys one of the healthiest capital ratios in the sector with a Tier 1 ratio of 19% and a CAR at 23%. Moving forward, we expect lending to pick up (5-6% YoY in 2013) as the bank scales up its SME lending and pushes its drive into the retail segment. The bank enjoys a strong liquidity position with a loans-to-deposits ratio at a low 90% in FY 12 (sector average at 95%). The muted loan growth witnessed over the past two years has been outpaced by a stronger pick-up in deposits inflow; up 4% and 5% YoY in 2011 and 2012 respectively.

Loan growth remains muted



Source: Company reports, SHUAA Capital

Robust capital position

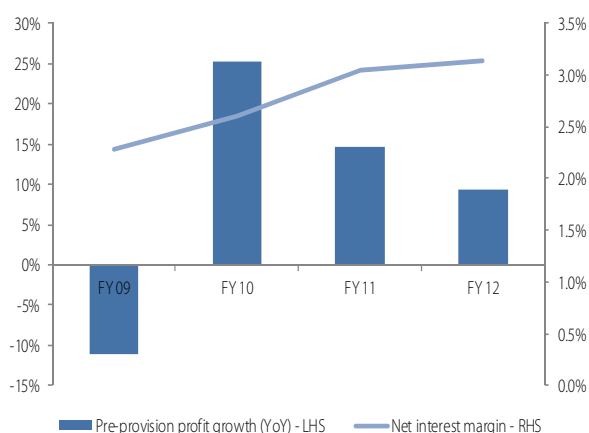


Source: Company reports, SHUAA Capital

Operational improvement...improving margins and higher efficiency

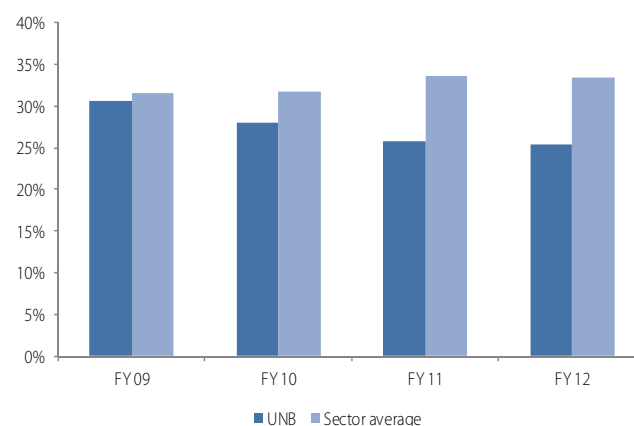
UNB has staged strong operational recovery despite the muted credit growth. Over the past three years, the bank has managed to grow its pre-provision profits at an average growth rate of 16% per annum. This was driven by stronger margins and better efficiency. UNB has managed to shed some expensive deposits and focus on growing the share of current and savings deposits in efforts to lower funding costs. Moreover, UNB's strict cost controls paid off; the bank is one of the most cost efficient banks in the sector, second only to FGB. Cost/income ratio has been trending down from the 31% level in FY 09 to 25% by FY 12-end. Moving forward, we believe a pick-up in loan growth coupled with sustained margins and cost efficiency will translate into a strong growth in pre-provision profits.

Operational recovery underway



Source: Company reports, SHUAA Capital

Improving cost efficiency – among best in sector

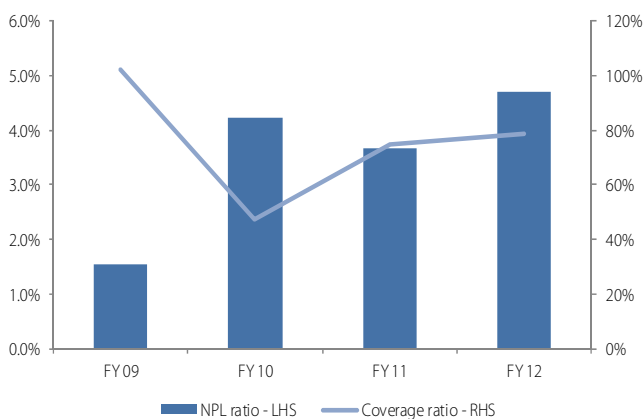


Source: Company reports, SHUAA Capital

Cautious outlook on asset quality...concerns are exaggerated

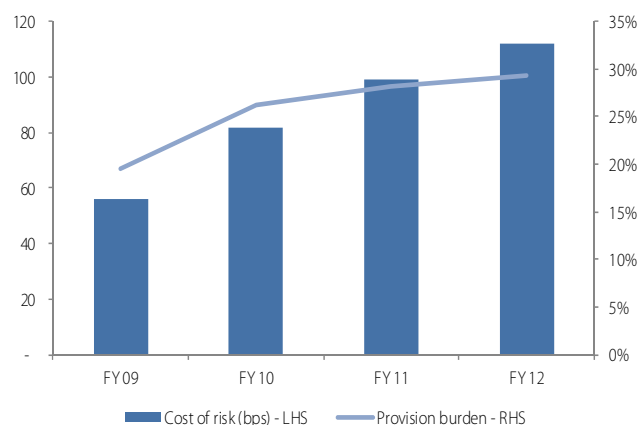
UNB has seen deterioration in its asset quality metrics over the past two years. NPL ratio increased from 3.7% in FY 11 to 4.7% in 2012 while coverage ratios slightly recovered to 79% in FY 12 after dipping to lows of 48% in 2010. We maintain a cautious outlook on provisioning for UNB as its credit quality metrics remain weak relative to other Abu Dhabi banks and UNB will need to grow its general provisioning reserve to comply with the CB's requirements (currently at 1.4% vs. 1.5% requirement by FY 14). However, UNB has a robust operational profitability that allows it to absorb costs of risks up to 380 bps before impacting its book value. We believe the market is exaggerating the bank's loan quality concerns; current price implies a 30% erosion in UNB's capital base, equating to a staggering 6% of its gross loan book. We believe this is a highly unlikely scenario and hence our preference for the name as a recovery play in Abu Dhabi.

Asset quality metrics remain weak



Source: Company reports, SHUAA Capital

Cost of risk is elevated, but under control



Source: Company reports, SHUAA Capital

A deep value play...upgrade to BUY

UNB is trading at a compelling set of valuations; P/B 13E at 0.8x (27% discount to sector) and P/E of 6.0x on 2013 profits (22% discount to sector) despite robust profitability and 2013E ROE of 13%. We believe that asset quality concerns are exaggerated and the market is ignoring the bank's operational improvement. Investors have been disappointed with credit growth and low dividend payouts in 2012 (16% vs. sector avg. at 48%) despite the strong capital position. We view UNB as a deep value play and upgrade our recommendation to BUY with a target price of AED 5.40/share and a 42% upside potential. The name remains mispriced by the market as reflected by the difference between projected sustainable ROE of 13.2% and 10.2% long term ROE implied by current price. UNB is our recovery play within the Abu Dhabi banking universe.

ENBD: A compelling play on Dubai's recovery, prefer over CBD

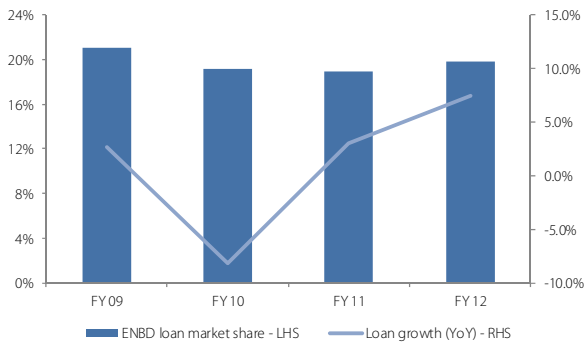
(EMIRATES UH/ENBD.DU, BUY, TP: AED 4.85, CP: AED 3.92)

(CBD UH/CBD.DU, HOLD, TP: AED 4.00, CP: AED 3.47)

Credit growth returning, geared to Dubai recovery

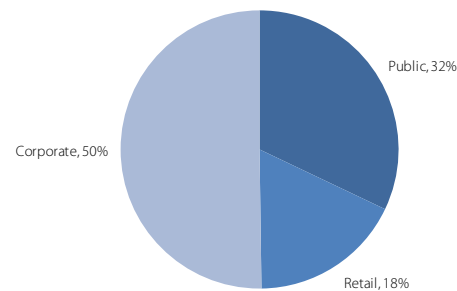
Despite experiencing sluggish volume growth over 2009-2011, ENBD has the largest balance sheet in the UAE banking system with a market share of total loans standing at 20% in FY 12. The ongoing recovery within Dubai's economy is positive for ENBD, a key lender to Dubai Govt. and its related entities (61% ownership). The bank has regained its risk appetite after a period of balance sheet deleveraging; loan growth picked up to 7% YoY in 2012, outpacing our coverage growth of 5%. This was mainly driven by lending to the government and the public sector (+28% YoY). Moving forward, the bank is focusing on the retail segment to drive credit growth. The acquisition of BNP Paribas operations in Egypt is a step in this direction. We believe the bank needs to diversify its loan base to mitigate the high exposure to Dubai GREs and comply with the new large exposure rules introduced by the UAE CB. The bank's total exposure to the government and related GREs is in excess of 100% of regulatory capital and hence the need to look out for new credit sources. We expect loan growth to reach 5-6% in FY 13, driven by the retail segment and the ongoing recovery within Dubai's economy.

Credit growth gathers pace



Source: Company reports, SHUAA Capital

Loan book heavily geared to public sector

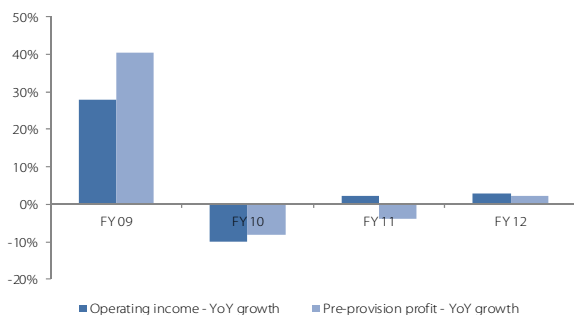


Source: Company reports, SHUAA Capital

Operational performance turning the corner

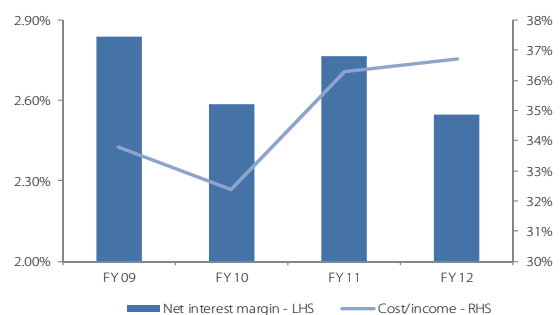
ENBD's operational performance is recovering, with the bank posting profits in each quarter since the crisis in 2009. Operating income grew 3% YoY in FY 12, supported by a pick-up in non-interest income (+24% YoY) while pre-provision profit growth has rebounded after two consecutive years of negative growth; up 2% YoY in 2012. Pre-provision profits lagged on growing cost/income ratio (up to 37% in FY 12 from 32% in 2010). Moving forward, we expect this operational recovery to gather pace on the back of: 1) sustained net interest margins as loan spreads stabilize and low-cost deposits translate into low cost of funding, 2) strong loan growth supporting net interest generation and fee income and 3) cost optimization initiatives to drop C/I back to the 34%-35% range.

Operational performance recovering



Source: Company reports, SHUAA Capital

NIMs to stabilize, cost efficiency needs control

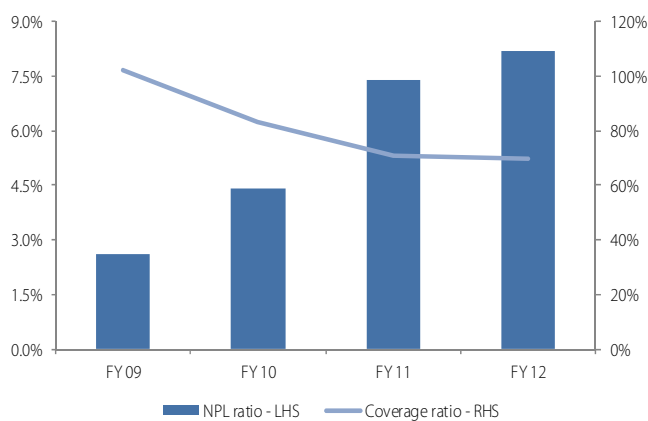


Source: Company reports, SHUAA Capital

Loan quality lags peers, yet we are past the worst

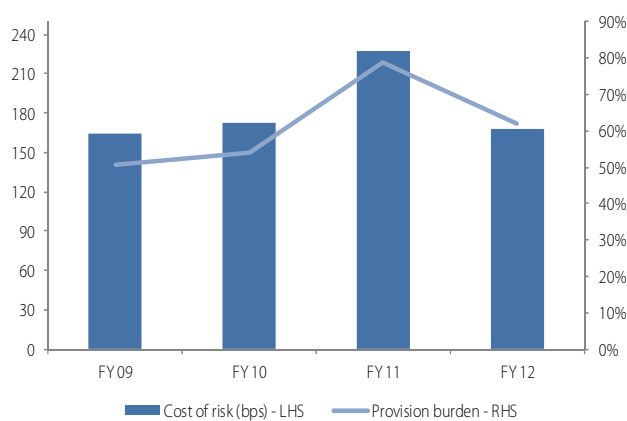
ENBD's NPL ratio stands at 8.2% with provisions coverage of 70% as of FY 12-end. These ratios lag other UAE banking peers, in a large part reflecting ENBD's role as the key lender to Dubai sovereign and related entities. ENBD's credit quality is showing some signs of stabilization: 1) NPL ratio eased 10bps QoQ in Q4 12, the first time in more than 3 years, 2) cost of risk sliding from 2011 peaks to 169 bps (- 60 bps YoY) and 3) provisioning burden dropping to 62% from 2011 highs of 79%. While we view these signs as positive, management remains cautious and retains its guidance for loan quality and provisions coverage; NPL ratio will rise by 1% point in 2013 and provisions coverage up to 80- 85% of NPLs. This implies that provision costs will remain elevated in 2013 as the bank builds up its coverage yet also indicates that we are past the worst. Starting 2014, we believe cost of risk will normalize, NPLs will peak and coverage ratio targets will be met. This implies that ENBD stands to benefit from a strong profitability recovery and ROE re-rating. We expect the bank's ROE to rebound from the 8-8.5% level in 2012 to the 12% level by FY 14.

Asset quality remains challenging



Source: Company reports, SHUAA Capital

Cost of risk peaking, provision burden easing



Source: Company reports, SHUAA Capital

Compelling valuations...buy a recovery story at a discount

While we believe that most of the asset quality concerns are behind us, ENBD's shares continue to trade at a 40% discount to UAE banks on a P/B basis. Given recent improvements in economic activity levels in the Dubai economy, we believe that such a steep discount is no longer warranted. While the bank has re-rated from deep values (up 44% TTM and 38% YTD), we believe there exists further room for upside. The name is trading at a compelling set of multiples: 2013 P/B at 0.7x, P/E at 7.8x and an attractive dividend yield of 6%. We view the recent hike in dividend payout (from 44% in FY 11 to 54% in FY 12) as a signal from management that loan quality concerns are behind us and growth prospects look positive. We view ENBD as the best way to play the Dubai recovery story and hence our preference over CBD (cheaper multiples, more geared to Dubai's recovery despite weaker asset quality metrics). Therefore, we increase our target price to AED 4.85/share and upgrade our recommendation from HOLD to BUY (24% upside potential).

DIB: Our preference in Islamic banking universe

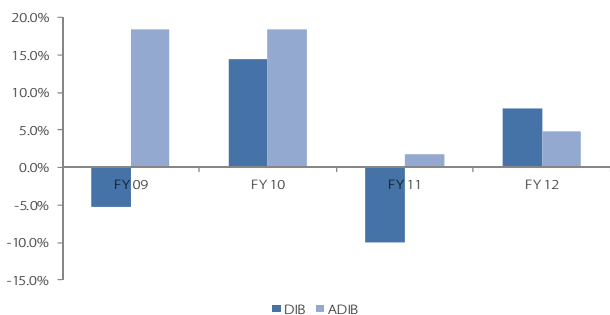
(DIB UH/DIB.DU, HOLD, TP: AED 2.35, CP: AED 2.02)

(ADIB UH/ADIB.AD, HOLD, TP: AED 3.85, CP: AED 3.70)

Capital boost, recent loan growth trend is encouraging for DIB

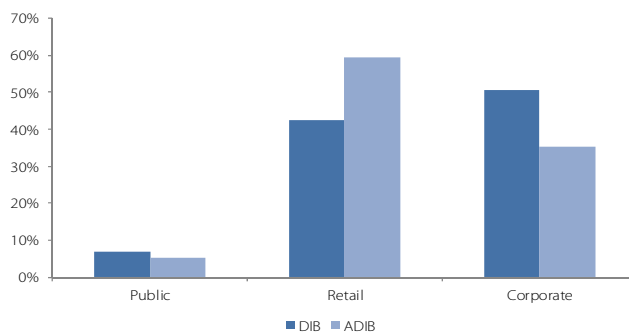
The two major Islamic banks in the UAE have tapped the debt market over the past few months; demand was high and the issues were successful (c. 14-15x oversubscribed). Both DIB and ADIB managed to raise Tier 1 notes in efforts to boost their capital positions (Tier 1 ratio to reach c. 18-19% after these issuances) and increase capacity for loan growth. DIB's recent loan growth trend has been encouraging; up 8% YoY in 2012 after a sharp 10% YoY drop in 2011. This rebound has been geared by growing lending to the public sector and a recovery in corporate credit. Going forward, we expect this recovery to sustain with a loan book growth to the tune of 5% in 2013 – driven by: 1) management's focus to leverage on the bank's strong retail franchise and 2) ongoing recovery in Dubai's overall economy and key sectors. While ADIB's loan book growth outpaced that of DIB over 2009-2011, the picture in 2012 was different with ADIB's loan book lagging at 5% YoY. We believe ADIB has the ability to grow its loan book in the future yet it risks losing market share in the retail segment (54% share) on growing competition. We like the more balanced mix between retail and corporate segments within DIB's loan portfolio vs. that of ADIB.

Loan growth comparison: DIB outperforms in 2012



Source: Company reports, SHUAA Capital

DIB's loan book is more balanced

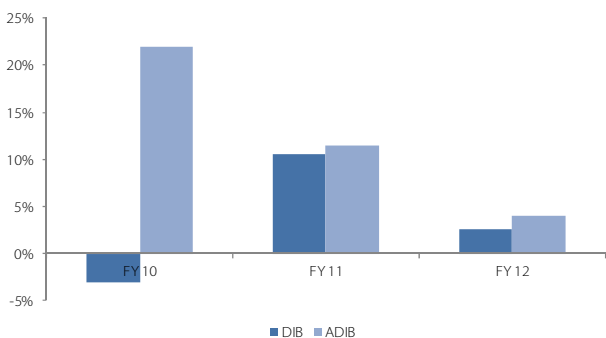


Source: Company reports, SHUAA Capital

Growth prospects at DIB are more appealing; Tamweel acquisition

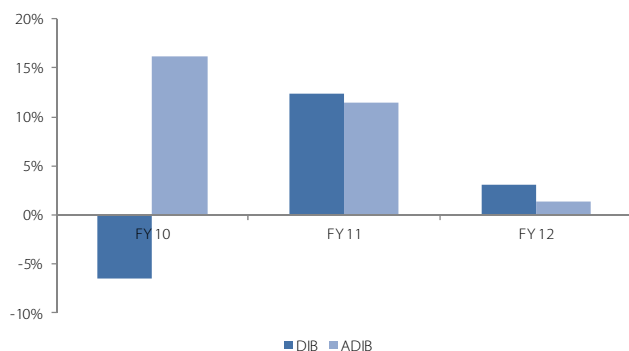
In January 2013, DIB announced that it would seek to take full control of its 58%-owned subsidiary, mortgage lender Tamweel. The investment is a non-cash transaction and will be carried out through a share exchange. We expect this acquisition to be value accretive for DIB on the back of scope for significant funding cost synergies. DIB is one of the most liquid banks in the UAE, with a loans/ deposits ratio of 83%. As of FY 12, its cost of funds was c. 1.40% in contrast to that of Tamweel at 3.40% as the latter is not able to access customer deposits directly. By taking full ownership of the mortgage lender, we believe DIB could utilize its strong deposit franchise to lower Tamweel's funding costs.

Operating income YoY growth: a comparison



Source: Company reports, SHUAA Capital

Pre-provision profit growth: DIB beats



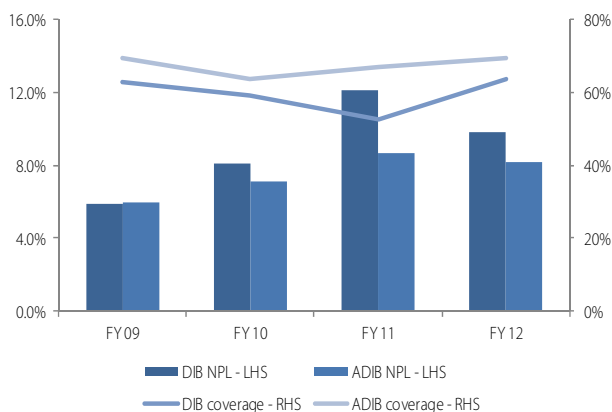
Source: Company reports, SHUAA Capital

DIB has been lagging ADIB in terms of operational performance and profitability. In 2012, DIB managed to close this gap; operating income up 3% YoY vs. 4% for ADIB. Pre-provision profits grew at 3% in FY 12 for DIB vs. 1% for ADIB on the back of a stricter cost control. Cost efficiency at DIB stood at 41% vs. 44% for ADIB in 2012. Our main concern for DIB remains the large exposure to real estate assets; around 35% of its total assets are linked to real estate (loans, associate, and investment properties). While the risk of this portfolio has reduced significantly following the recovery of real estate prices in Dubai, it remains an area of concern for investors in terms of valuation, earnings quality and visibility.

Asset quality: DIB lagging, but improving

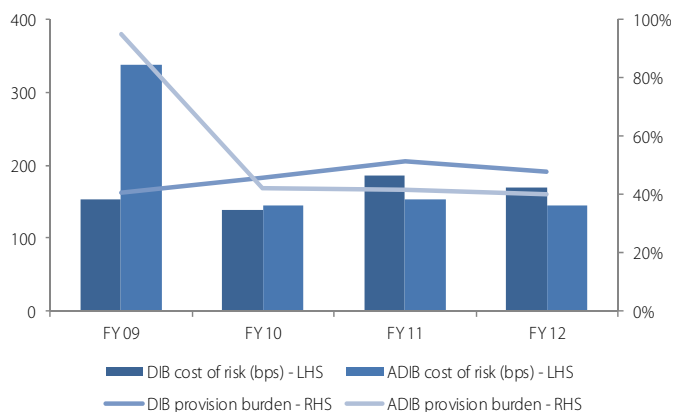
While DIB's credit quality lags the UAE banking sector in general and ADIB in specific, these metrics improved in 2012. NPL ratio dropped from 12.1% to 9.8% during the course of 2012, while provision coverage increased from 53% to 64%. In terms of cost of risk, both banks have seen some easing in 2012 on the back of slower NPL formation yet the impact was more pronounced at DIB. We view this improvement as a positive and expect DIB to continue building up its coverage levels in 2013 to more appropriate levels vs. peers. In summary, we believe we are past the worst in terms of credit quality and investors should prepare for a period of lower provisions, easing cost of risk, slower NPL formation and more valuation re-rating.

Asset quality metrics: ADIB leading yet DIB recovering



Source: Company reports, SHUAA Capital

Cost of risk easing, provision burden drops



Source: Company reports, SHUAA Capital

Prefer DIB to ADIB – valuations are cheaper and market pricing is more harsh

We prefer DIB to ADIB as a play on the Islamic banking theme within the UAE banking sector. We are more positive on DIB's growth prospects with Tamweel's acquisition on the table and associated synergies coupled with the strong uptake in credit growth seen in 2012. We also believe DIB is key beneficiary of improved credit quality and receding asset quality risks on the back of higher cost of risk and provision burden on existing books. Both names have announced decent dividend payouts (c. 50%) which translated into attractive dividend yields (c. 6-7%). However, valuation looks more compelling for DIB as the name trades at an unjustified discount of 40% to ADIB on a P/B basis. While we acknowledge that investors would demand a discount on DIB given its heavier real estate exposure and weaker credit quality metrics, we think the market is not pricing an improvement in credit quality, operational performance and ROE re-rating. DIB shares are trading at a 13E P/B of 0.8x and P/E of 7.0x (sector at 1.1x P/B and 7.7x P/E). Our preference for DIB is further supported by current implied valuations: implied ROE of 11.4% vs. our sustainable ROE estimate of 12.8% while ADIB's implied ROE is close to our sustainable ROE assumption of 15%. Current price levels are also pricing a 14% erosion in DIB's book value vs. 4% for ADIB. This translates into a 2.4% share of gross loans for DIB, a highly unlikely scenario in our view. We maintain our HOLD rating on both names; raise TP on DIB to AED 2.35 (16% upside potential) and ADIB to AED 3.85 (4% upside potential).

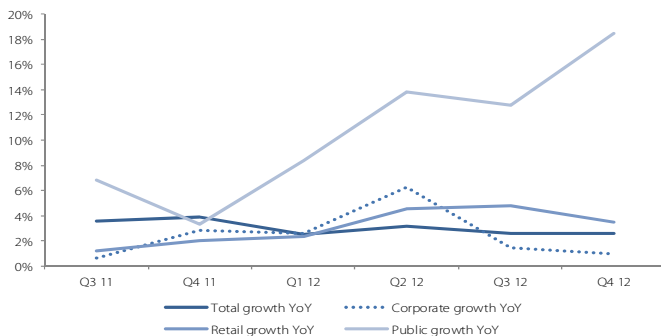
Key Themes

For the purpose of identifying key trends for the UAE banking sector, we have relied on data from the UAE Central Bank, when applicable in addition to a compilation of data from nine banks: the 5 largest banks in Abu Dhabi (NBAD, FGB, ADCB, UNB and ADIB) and 4 largest banks in Dubai (ENBD, DIB, Mashreq and CBD). This universe covers 75% of total assets in sector, 78% of net loans and 77% of total deposits. As such, we feel this pool serves as a good gauge for the sector.

Credit growth: Recovering with changing trends

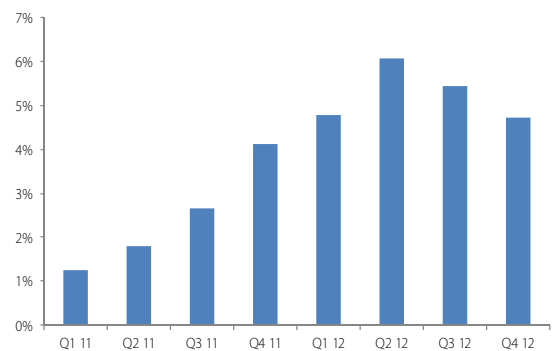
The year 2012 saw a pick in appetite for credit in the UAE; our coverage grew their loan books by 5% YoY, accelerating from 4% in FY 11 and a mere 1% in FY 10. Dubai's recovery has been gaining momentum backed by growing confidence, real estate recovery and pick-up in key sectors like trade, tourism and hospitality. Meanwhile, Abu Dhabi has seen a gradual pick-up in investment spending. Moving forward, we expect credit growth to remain in mid-single digit despite the underlying recovery given high penetration rates (credit/GDP at c.100%) and expectations of new regulations that could constrain growth.

Public lending is the key driver



Source: UAE CB, SHUAA Capital

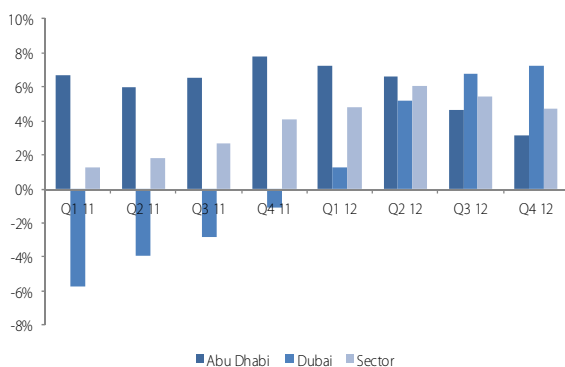
Quarterly loan growth for our coverage



Source: Company financials, SHUAA Capital

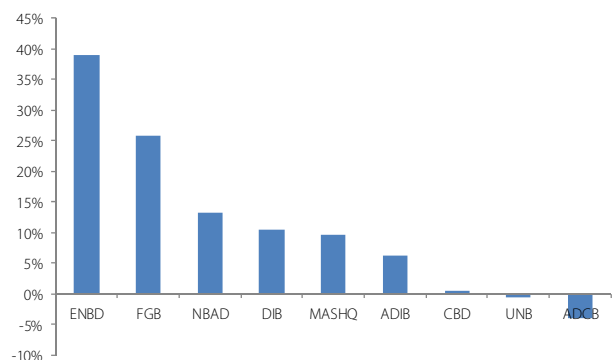
We highlight some key trend observed in 2012 loan book expansion. First, government loans remain the key driver behind this growth; up 13% YoY on average in 2012. Corporate credit remains muted (up 3% YoY) as major restructuring is still under way, especially in Dubai, coupled with remaining uncertainty and risk aversion. Moreover, loan growth for covered Dubai banks outpaced Abu Dhabi peers in Q3 12 and Q4 12 for the first time since the crisis. Numbers indicate that Dubai credit growth came in at 7% in H2 12 compared to 4% in Abu Dhabi. Emirates NBD and DIB led this expansion driven mainly by the public sector (ENBD) and corporate credit recovery (DIB). In Abu Dhabi, FGB led the pack with 9% YoY growth in loan book while NBAD lagged at 3%. UNB and ADCB lagged the overall sector as they were impacted by continued risk aversion by the former and repayments by the latter.

Shifting gears: Dubai loan growth picking up



Source: Company financials, SHUAA Capital

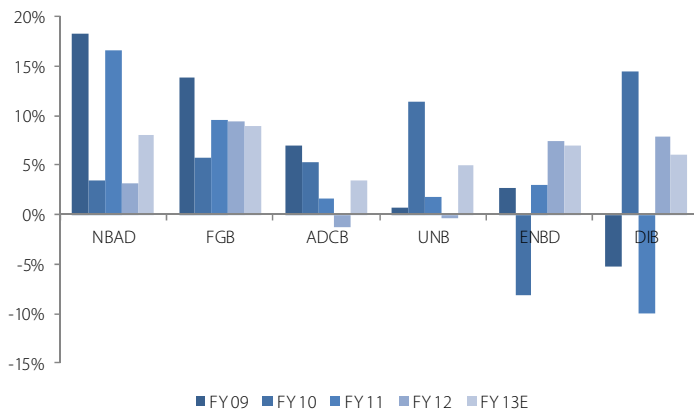
Net loan origination 2012 – market share by bank



Source: Company financials, SHUAA Capital

Moving forward, we expect FGB to continue growing its lending market share, growing its loan book at above-average rates. The bank is expected to continue the healthy trend depicted in 2012, growing at 9-10% YoY in 2013, driven by Abu Dhabi public sector lending (public lending up 23% YoY in 2012). On the other hand, we see NBAD's credit growth reversing 2012 disappointment (up 3% YoY), picking up to the 8-9% level in 2013 as repayments to borrowers subside on one hand and the UAE central bank lending caps on GREs renegotiated at a more manageable levels. UNB has adequate capital headroom (Tier 1 ratio of 18.5%) to accelerate lending in 2013 (5-6%) after a disappointing 2012 (flat YoY). The bank is planning to scale up SME lending and retail credit. ENBD's strong credit appetite that we saw in 2012 (7% YoY growth) is projected to continue in 2013 as the bank increase focus on the underpenetrated retail segment. The bank plays a key role in the Dubai economy and remains a key beneficiary of the recent pick-up in economic activity across the emirate. DIB's loan growth recovered in 2012 to 8% driven by the corporate segment. Going forward, management is focusing on leveraging the bank's strong retail franchise to grow its retail loan book (total loan growth at c. 5-6% in FY 13). The recent issuance of the USD1 billion Tier 1 note should address the bank's relatively weak Tier 1 ratio of 14% and increase capacity for loan growth.

Loan growth for covered banks: FGB and NBAD lead the pack

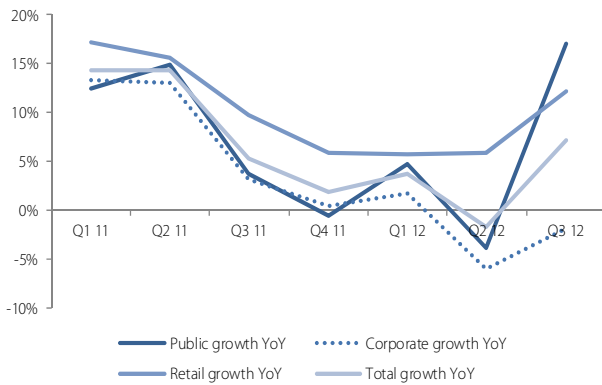


Source: Bloomberg, Company financials, SHUAA Capital

Funding: Adequate, mix changing

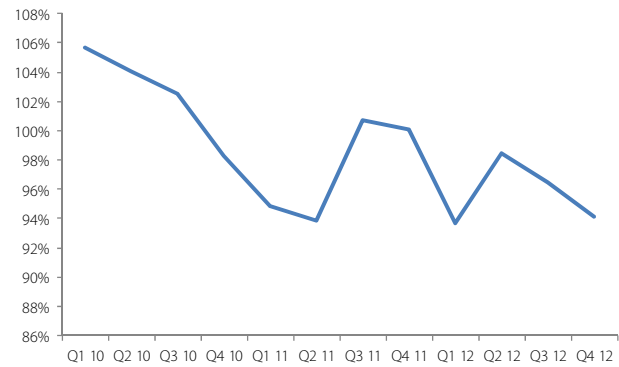
Deposits in the UAE banking system have witnessed strong growth in 2012, up 11% YoY and recovering from the 3% growth in 2011. This expansion validates managements' emphasis on chasing liquidity and attracting deposits. The main drivers behind this growth have been retail and government deposits while corporate funding lagged. As loan growth did not keep up with funding expansion, liquidity levels eased with system's loans/deposits ratio at 94% in Q4 12 vs. 100% a year earlier. Having said that, we do not believe funding constraints will restrict loan growth in the future as liquidity remains adequate and funding base can support further credit expansion.

Retail and government funding driving growth



Source: UAE CB, SHUAA Capital

Loans/deposits at comfortable levels



Source: UAE CB, SHUAA Capital

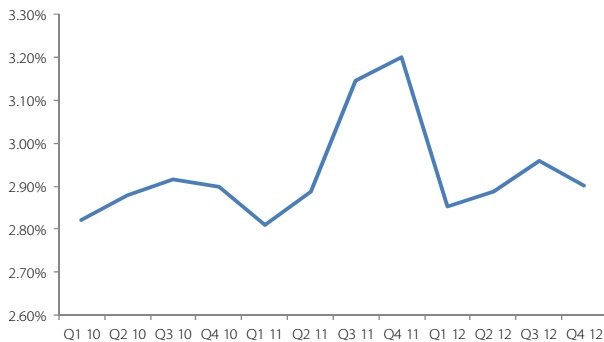
More interestingly, UAE banks have focused on improving their funding mix through targeting a higher portion of low and liquid demand deposits. For instance, demand deposit grew their share of the total mix from 33% in FY 10 to 40% by FY 12. Time deposits dropped from 63% to 56% over the same period. ENBD, ADCB and ADIB were the most successful in changing their funding mix in 2012.

Notably, almost all banks demonstrated strong ability to raise financing through debt over the past twelve months in efforts to diversify sources of funding, extend debt maturities and benefit from the global low interest rate environment. NBAD raised a total of USD 1.5bn in 2012 while FGB managed to raise USD 2bn in three tranches (sukuk, loan and conventional borrowing). Dubai banks were also active in the bond market; ENBD raised USD 1.5bn and DIB tapped the market with USD 500mn sukuk in 2012. Year-to-date, the trend continued with names like ADIB, ADCB, DIB and ENBD tapping the bond market successfully.

NIMs: limited downside from current levels

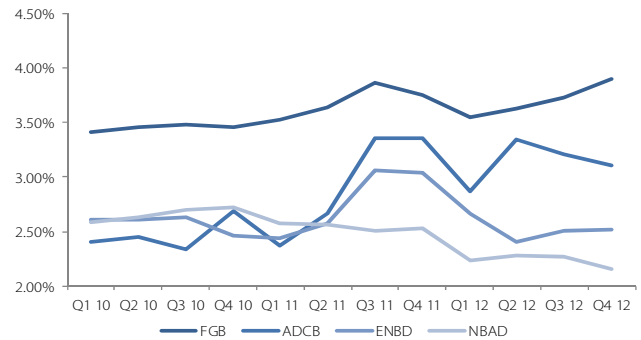
On a sector-wide basis, we expect net interest margins (NIMs) to stabilize despite the fact that competition is forcing yields on loans to drop. While some might argue that asset yields should remain under pressure, given the low interest rate environment, we believe that margin erosion should be limited as funding costs should also decline. We believe the pace of deterioration has been easing for most banks and we do not expect much further deterioration for the year as loan growth is starting to eat into excess liquidity and downward yield re-pricing due to lower global benchmark rates has already filtered through.

Quarterly trend for NIMs



Source: Company financials, SHUAA Capital

FGB enjoys highest net interest margins among peers



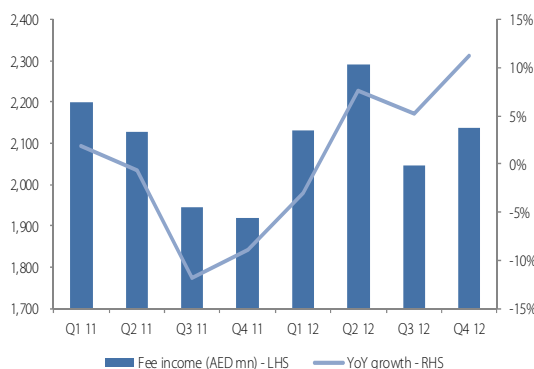
Source: Company financials, SHUAA Capital

FGB continues to enjoy the highest NIMs among peers, with margins showing strong resilience in H2 12 vs. prior year. ADCB managed to control its NIMs through lower funding costs despite pressure on asset yields. On the other hand, NBAD and ENBD saw a drop in NIMs on the back of a downward re-pricing in loans.

Fee income: recovering, positive driver

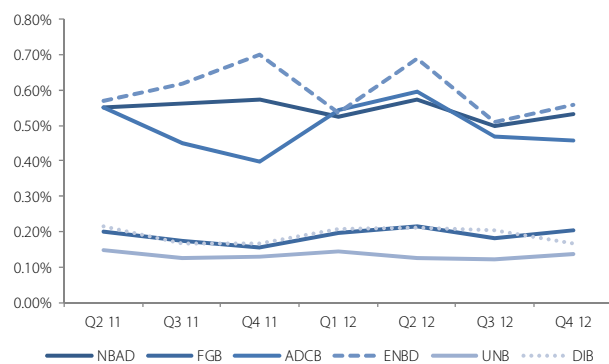
Banks have staged a decent recovery in fee income in 2012 after a drop in 2011 as a result of retail regulations introduced by the CB. Fee income expanded by 5% YoY in 2012, reversing the 5% decline seen in 2011. FGB, NBAD and ADCB succeeded in boosting their fee income, driven mainly by corporate segment at ADCB and growing commissions at FGB. While we positively view this fee growth story, other banks are still suffering on the back of fee-constraining regulations. We believe fee income should benefit from accelerated credit growth moving forward, increased economic activity and growing activity within capital markets. However, this should not act as a game changer for the overall sector in light of active regulatory push from the CB to cap fees.

Fee income growth rebounding YoY



Source: Company financials, SHUAA Capital

Broad-based recovery in fee yields

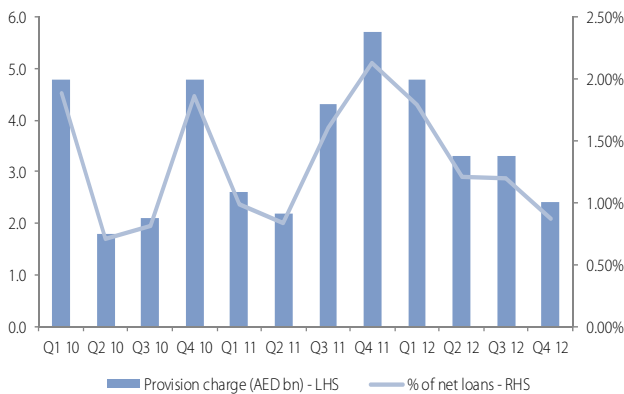


Source: Company financials, SHUAA Capital

Asset quality: Improving visibility, worst is over

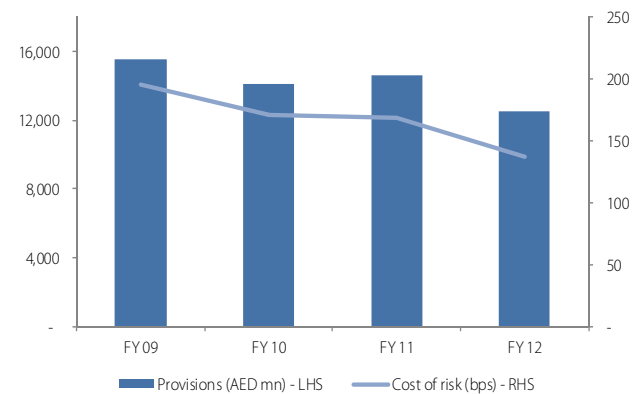
Generally, we believe the operating environment for UAE banks has improved substantially since 2008-2009 period. Loan quality trends for the large UAE banks points towards some degree of stabilization. NBAD and FGB are both signaling that NPL ratios are close to their peaks while ENBD has guided for a 1% annual increase in NPL ratio over 2013-2014. DIB has turned a corner with improvement in its credit quality metrics; NPL ratio dropped from 12% to 10% over 2011-2012. Central bank data showed that outstanding provisions for bad loans fell in October 2012 for the first time since the crisis in 2008, which further adds credence to easing of new NPL formation.

System provisions cooling down



Source: UAE CB, SHUAA Capital

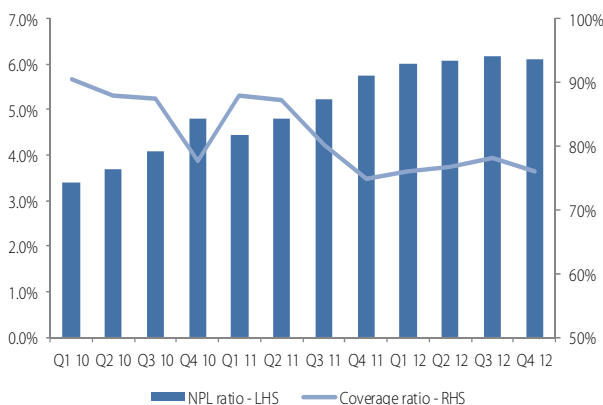
Cost of risk on a downward trend



Source: Company financials, SHUAA Capital

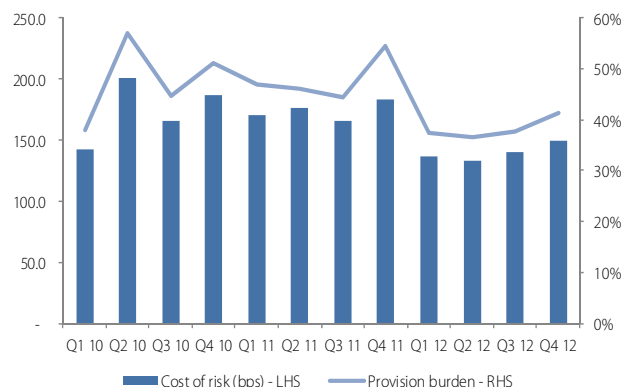
Having said that, we see a number of reasons to believe that we are past the worst in terms of asset quality. This year presents the fourth straight year of economic expansion (started 2010) in the UAE with average GDP growth of c. 3-3.5% per annum. In addition, refinancing conditions have improved, especially for Dubai-based entities. These entities are through with their restructuring drives, financing costs have dropped and ability to access capital markets has been restored. In light of the above, we can assert that credit quality is stabilizing and credit costs should start to decline moving forward. This will mainly result in lower provisioning costs and improved profitability and earnings outlook for the sector in general.

NPL formation slowing, coverage needs build-up



Source: Company financials, SHUAA Capital

Cost of risk peaked, provision burden at manageable levels

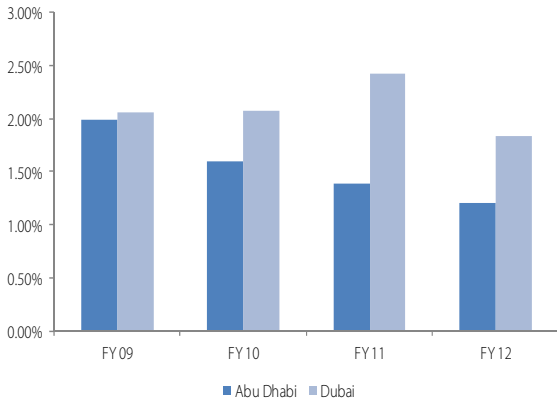


Source: Company financials, SHUAA Capital

For UAE banks under our coverage, NPL ratio stood at 6.1% in 2012 while coverage ratio reached 76% over the same period. With NPL formation slowing down (up 11% YoY in 2012 vs. 25% in 2011 and 44% in 2010) and recoveries gradually picking up, we believe banks will focus on rebuilding their coverage levels in 2013 especially Dubai banks. While we do expect cost of risk to remain one of the highest in MENA region, it is expected to ease from 2012 levels further supporting profitability.

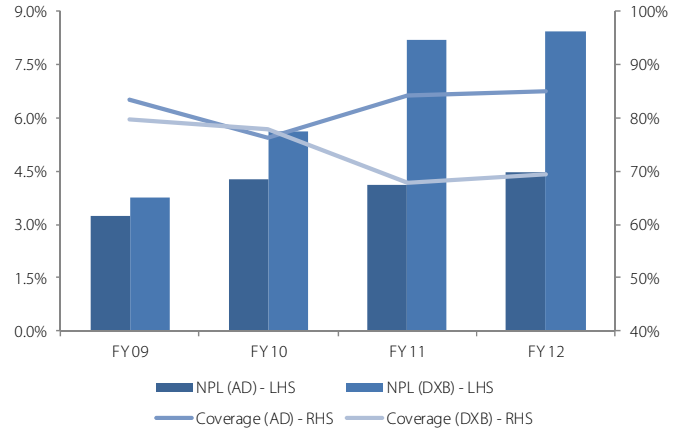
Provisioning burden (provisions/pre-provision profits) has dropped from highs of 57% in Q2 10 to an average of 38% in 2012.

Credit costs/net loans: Dubai turning the corner



Source: Company financials, SHUAA Capital

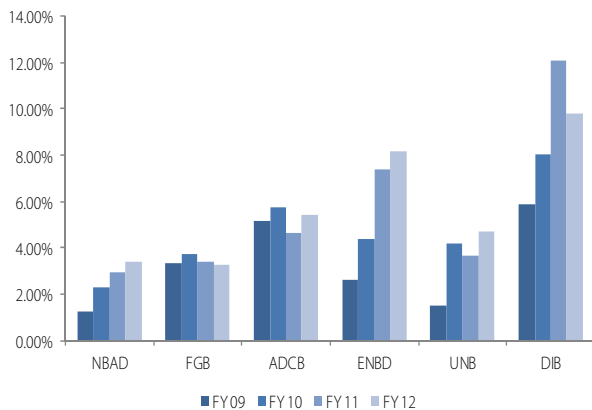
Slow NPL formation, Dubai to focus on building coverage



Source: Company financials, SHUAA Capital

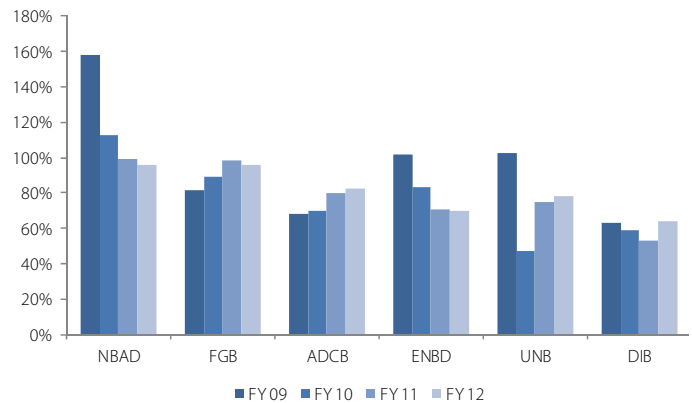
More specifically, Abu Dhabi banks have witnessed two consecutive years of declining credit costs in 2011 and 2012 (% of net loans), currently standing at 121bps (down c. 39bps from 2010 peaks). On the other hand, Dubai banks are placed differently in the cycle, peak costs at 242 bps in 2011 and dropping c. 60 bps in 2012. These numbers validate our assertion that credit costs have peaked and will stage a downward trend moving forward. This will allow banks to focus more on improving coverage levels, especially Dubai banks (coverage ratio at 69% vs. 85% for Abu Dhabi).

NBAD and FGB stand out on NPLs, DIB turning around



Source: Company financials, SHUAA Capital

Abu Dhabi banks well covered, Dubai lags



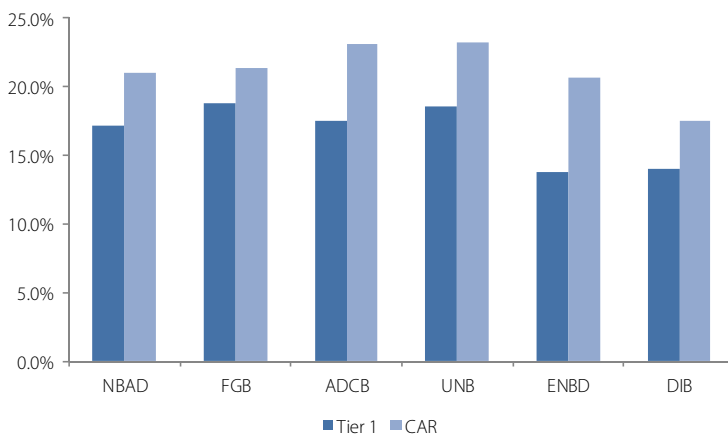
Source: Company financials, SHUAA Capital

As of December 2012, NBAD had the best loan quality metrics with NPL ratio at 3.4% and provision coverage at 95% followed by FGB (NPL at 3.3%, coverage at 96%). While Dubai banks have inferior loan quality and provision coverage compared to Abu Dhabi peers, they have staged a decent recovery over the past year. DIB's NPL ratio dropped from 12.1% in 2011 to 9.8% in 2012 while coverage improved from 53% to 64% over the same period. ENBD saw its NPL formation ease down with NPL ratio growing to 8.2% in 2012 (+ 80bps vs. 300 bps in 2011). Coverage ratio hovered around the 70% level by year-end.

Strong capitalization... dividend surprises

UAE banks continue to enjoy high solvency ratios and robust capitalization levels, making them well placed in context of existing capital adequacy requirements by Central Bank and upcoming Basel III requirements. Capitalization levels have become more robust over the past three years as result of high retention ratios, strong operating profitability, subdued loan growth and capital injections by the government. Abu Dhabi banks remain the best capitalized among peers with Tier 1 ratio ranging from 17.2% at NBAD to 18.8% at FGB. CAR stands at highs of 23% at UNB and ADCB compared to 21% at FGB and NBAD. Dubai banks enjoy lower capitalization ratios, Tier 1 ratio at 14% for ENBD and DIB while CAR ranges from 17.5% at DIB to 20.6% at ENBD. However, it is worth noting that DIB recently issued a USD 1bn hybrid Tier 1 note that will boost its Tier 1 ratio to the 19% level. All in all, UAE banks remain one of the best capitalized in the world and hence their ability to absorb any negative shocks and any severe downturn in asset quality, which we believe is highly unlikely.

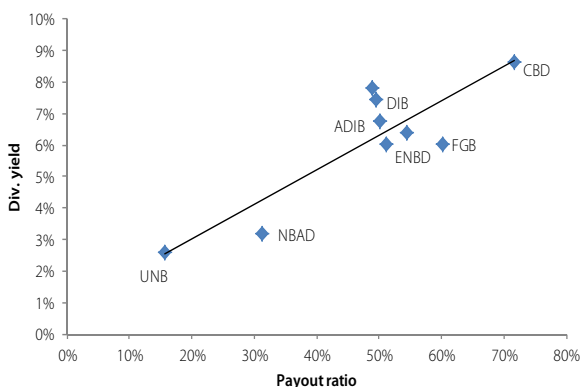
UAE banks are well capitalized



Source: Company financials, SHUAA Capital

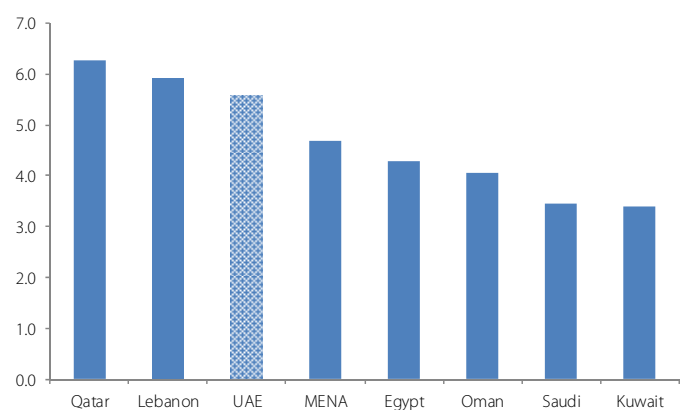
Recently, many UAE banks have executed repayments of Ministry of Finance subordinated loans (form of Tier 2 notes). ADCB and UNB partially repaid their loans while FGB has fully repaid its AED 4.5bn Tier 2 notes to the government. NBAD announced last week that it will fully repay its Tier 2 notes to the government in tranches by Q2 13-end. These repayments support our view of improved liquidity coverage and solid capitalization levels across the banks we cover. These banks are finding cheaper financing elsewhere, benefiting from low EIBOR rates and global interest rates. This repayment should also support profitability in annual savings on interest expense.

Impressive dividend yields and high payouts



Source: Company financials, SHUAA Capital

Dividend yield compares well in regional context



Source: Bloomberg, SHUAA Capital

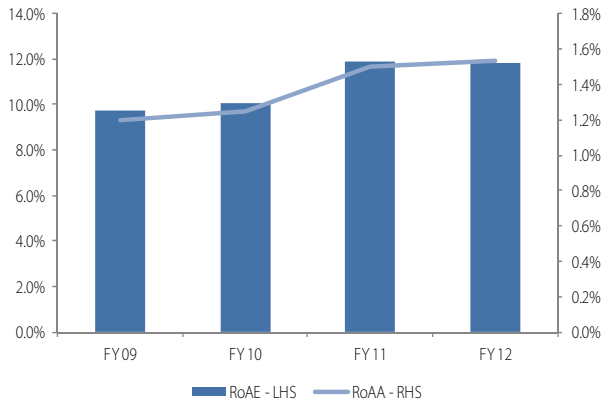
In 2012, we believe UAE banks focused on optimizing capitalization as growing confidence on asset quality, limited credit growth and robust capitalization levels opened up the room to return capital to shareholders. The average dividend payout increased to 48% in FY 12 vs. 39% in FY 11. Most UAE banks surprised positively on dividends with payouts at FGB (60%) and CBD (72%) coming well ahead of previous maximum payouts allowed by UAE banks. NBAD came in line with management guidance while UNB disappointed the market with a 16% payout ratio despite being one of the best capitalized banks in the sector.

As we expect credit costs to ease in light of slow NPL formations and higher recoveries, and profitability to increase, we believe UAE banks have no major reason to build up their capital ratios further. Therefore, we argue for UAE banks as play on capital release theme, namely through cash dividends and share buybacks. We expect the momentum seen in 2012 to sustain moving forward. UAE banks are trading at an attractive dividend yield of c. 6.0%. These levels compare favorably with MENA peers' average of 4.7% and developed markets at 3.0%.

Profitability improving... Room for ROE re-rating

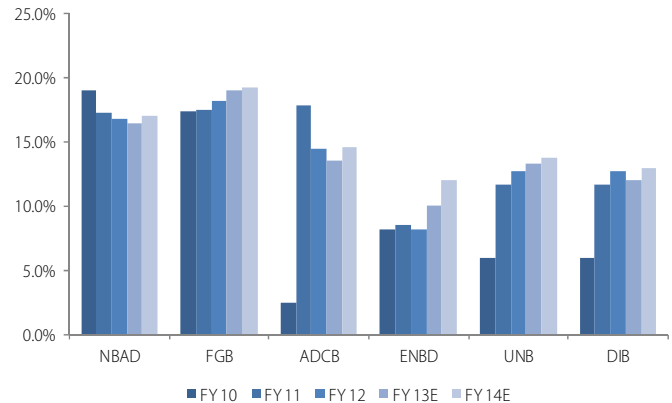
UAE banks have managed to improve capitalization levels (median Tier 1 ratio at 17%) and operating profitability (pre-provision ROA at 2.4%) which provide strong buffers against any erosion in book values. Moreover, banks continue to employ strong cost controls (average cost/income at 33%) and break-even provisioning levels are robust in our view (386bps in FY 12). With a greater visibility on the asset quality outlook and expected easing in credit costs, we believe sector profitability is set to improve despite the weak loan growth prospects.

System ROE recovering from 2010 lows



Source: Company financials, SHUAA Capital

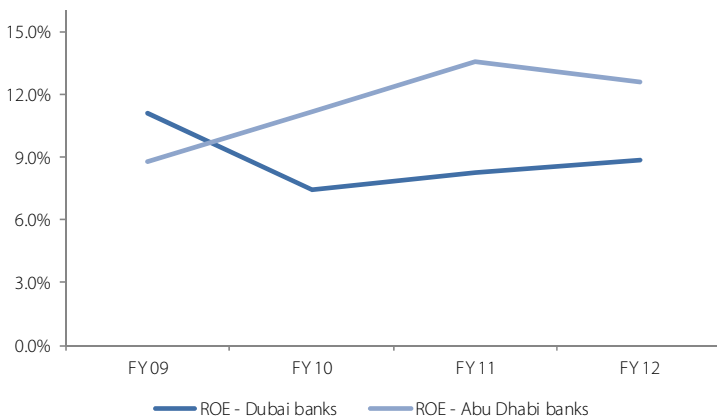
Room for ROE* re-rating: Dubai has greater upside potential



Source: Company financials, SHUAA Capital
*excludes Tier 1 notes and adjusts for 2012 proposed dividends

Robust capitalization levels should help banks release some capital and return it to shareholders, namely in the form of dividends. This will help ROE to re-rate in the near future. The trend looks encouraging for Dubai banks, which have a higher scope for re-rating as they are coming off a low base. Our Dubai coverage posted an ROE (reported) of 8.9% in 2012, after bottoming out at 7.4% in 2010. ENBD and DIB have a large room to improve their profitability as provisioning costs ease off, profitability picks up and dividend payouts grow. On the other hand, Abu Dhabi banks continue to post higher ROEs than Dubai peers, supported by stronger structural profitability and lower provisioning. The ROE trend for Abu Dhabi banks remains on the upward trend, mainly driven by healthy loan prospects and profitability.

Reported ROE at Dubai banks recovering, Abu Dhabi remains healthy



Source: Company financials, SHUAA Capital

Regulations: expect more clarity this year

In the past 12-18 months, the UAE Central Bank has introduced tighter regulations for the retail banking business (Feb-11) and introduced limits on the amount of credit exposure that banks can take against their largest customers (Apr-12). This large exposure regulation deadline was initially set by September 2012, yet the deadline has been postponed pending feedback from industry participants. Moreover, a new liquidity framework has been introduced lately to guide the sector to a full transition into Basel III liquidity metrics by January 2018 yet the deadlines have now been postponed from the initial January 2013 timeline.

Regulation	Implementation	Description
Retail lending	Feb-11	Mandates that installments for retail loans should not exceed 50% of gross salary, repayment periods for personal loans must not exceed 48 months and maximum loans capped at 20x annual income.
Large exposure rules*	Sep-12	Loans to local UAE governments limited at 100% of bank's capital. A similar loan cap applies for loans to GREs.
Liquid Assets Ratio*	Jan-13	At least 10% of liabilities to be held in readily liquid assets
Uses of Funds to Stable Resources (USSR)*	Jan-13	Replaces the current Advances/Stable resources ratio. USSR maintained below 100%
Retail Mortgages*	Dec-12	LTV ceiling for retail mortgages; 50% for expats and 70% for UAE nationals on first home.

Source: SHUAA Capital, UAE CB

*deadlines have been postponed but new dates have yet to be announced

In response to the sharp rise in activity in the Dubai real estate market in 2012, the UAE Central Bank issued new mortgage rules on 31 December 2012, limiting LTVs for expatriates to 50% for the first home and 40% for subsequent properties, compared to 80-85% LTV typically available prior to the revised rules. Loan limits for UAE citizens have similarly been revised downwards to 70% for first homes and 60% for subsequent homes. After a period of delays and lack of clarity, we expect 2013 to provide conclusions on proposed lending caps, mortgage LTVs and Basel III implementation.

Large exposure rule: NBAD and ENBD most affected

In April 2012, the UAE Central Bank introduced amended banking rules governing large exposures of commercial banks. Aggregate credit exposure to local governments is limited to 100% of a bank's capital. A similar 100% cap exists on aggregate bank loans to government-owned commercial entities. No such limits existed before this new circular. While the September 2012 deadline has now been postponed, pending feedback from industry participants (which may include the proposed 100% limit being relaxed), the long-term goal of these regulations to reduce concentration risk across banking sectors and manage risk more properly is sound, in our view. ENBD and NBAD are estimated to have the highest sovereign and quasi-sovereign (commercial entities) exposure in the UAE banking sector. There might be a number of other UAE banks that are in breach of other aspects of the new circular. In general, we await further details from the banks to assess the impact of this new regulation and its implementation.

New liquidity framework: should not be a problem

The UAE Central Bank has introduced a new liquidity framework that will help guide the sector to a full transition to Basel III liquidity metrics by 1 January 2018. While the initial deadline for implementation was expected by early January 2013, it has now been postponed. While an aggressively implemented compliance with these new liquidity rules could have generated significant market distortions, this new framework is likely to lead UAE banks to improve their liquidity profiles, a positive long-term development in our opinion. The UAE Central Bank introduced two new ratios that will be used to monitor liquidity until the full Basel III liquidity framework is implemented. The Liquid Assets Ratio (LAR) is the volume of liquid assets as a proportion of total liabilities; the minimum threshold is set at 10%. The USRR is an amended version of the Advances to Stable Resources Ratio (ASRR) by which the UAE banks are already monitored, and will also have a ceiling of 100%. We believe banks are generally comfortable in complying with these new liquidity requirements when they come into effect.

New mortgage rules: Impact should not be pronounced

In response to the sharp rise in activity in the Dubai real estate market in 2012, the UAE Central Bank issued new mortgage rules on 31 December 2012, limiting LTVs for expatriates to 50% for the first home and 40% for subsequent properties, compared to 80-85% LTV typically available prior to the revised rules. Loan limits for UAE citizens have similarly been revised downwards to 70% for first homes and 60% for subsequent homes. While we feel that the Central Bank's intervention to control the heating real estate market in Dubai was justifiable, the new mortgage limits are likely to prove too restrictive. Instead, a limit of 70% LTV for first mortgages and 60% for subsequent loans for both locals and expatriates is likely to prove a good "midway" solution. While this regulation is undergoing discussions, a recent proposal submitted by the Emirates Banks Association to the Central Bank asks for an upward revision to 70% LTV for first mortgages.

In our view, the impact of such regulations should be relatively subdued. Other than DIB (22% of loans) and ADCB (9% of loans), retail mortgages form a small part of the UAE bank lending exposure. Moreover, we believe most property transactions are conducted on a cash basis; our discussion with various industry sources suggests that mortgages account for 15-25% of transactions.

Research

Asjad Yahya, CFA
+9714 3199 768
ayahya@shuaa.com

Taher Safieddine, CFA
+9714 3199 785
tsafieddine@shuaa.com

Client Services:

800 SHUAA (74822) - UAE only
+971 (4) 319-9777 – International
clientservices@shuaa.com

Sales Trading Desk:

+971 (4) 319-9700
tradingdesk@shuaa.com

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