



شركة وثيقة المالية

Watheeqa Capital Company

A thematic study on Egyptian Banks: *“Moving towards higher sustainable ROE”*



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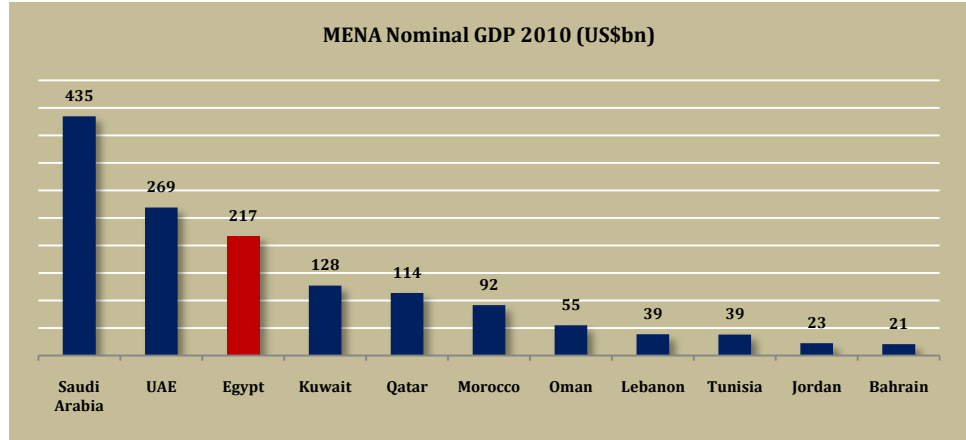
A thematic study on Egyptian Banks: “Moving towards higher sustainable ROE”

The recent uprising witnessed in Egypt might usher in a new regime that would pave for enhanced economic growth in the medium-to-long-term keeping a keen eye on fair and equitable distribution of income. Having said that, the uprising, undoubtedly, had blemished the near-term growth prospects of the Egyptian economy (*at least in FY2010-11*). International Monetary Fund (*IMF*) in its latest “World Economic Outlook” had revised its FY2010-11 real GDP growth forecast down to 1.0% - this is 400bps lower than the growth witnessed in FY2009-10 and 600bps lower than the real GDP growth during Egypt’s golden era that lasted through FY2005-2008. It is, however, pertinent to note that real GDP is expected to be back on growth trajectory from FY2011-12 onwards.

A corollary of lower economic growth is lower business growth for the domestic banking sector as well. Quite naturally, we have seen earnings estimates of the banking stocks being pruned down in the range of 10-12% for the next three financial years (*FY2011-FY2013*). The banking index (*EGXBANK Index*) is down by 34% year-to-date – much worse than the 26% decline in the EGX30 index and 17% in EGX70 index.

We broadly remain in sync with the consensus over the near term prospects of the Egyptian banking sector given the current political uncertainty. However, we believe that the medium-to-long term prospects of the banking sector are intact given the strong structural tailwinds like favorable demographics and significant under penetration of financial products. Consider this - Egypt is the most populous nation in the MENA region (*11 countries consisting of Bahrain, Egypt, Jordan, Kuwait, Lebanon, Morocco, Oman, Qatar, Saudi Arabia, Tunisia & United Arab Emirates*) accounting for nearly half of the total population in the region. Egypt is the third largest country in GDP (*nominal*) terms in the MENA region. It accounted for 15% of MENA’s nominal GDP in FY2010. Egypt’s loan-to-GDP ratio stood at 38% at the end of FY2010 (*end-June*) – this is nearly one-third that of UAE and half that of Bahrain and Qatar. Retail loan penetration (*as % of GDP*) remained in single digits; at nearly a third of UAE, Kuwait and Bahrain. System liquidity, as measured by the loan-to-deposit ratio (*lower the better*), stood at 48% at the end of December FY2010 – this is nearly half of the average witnessed in the GCC countries.

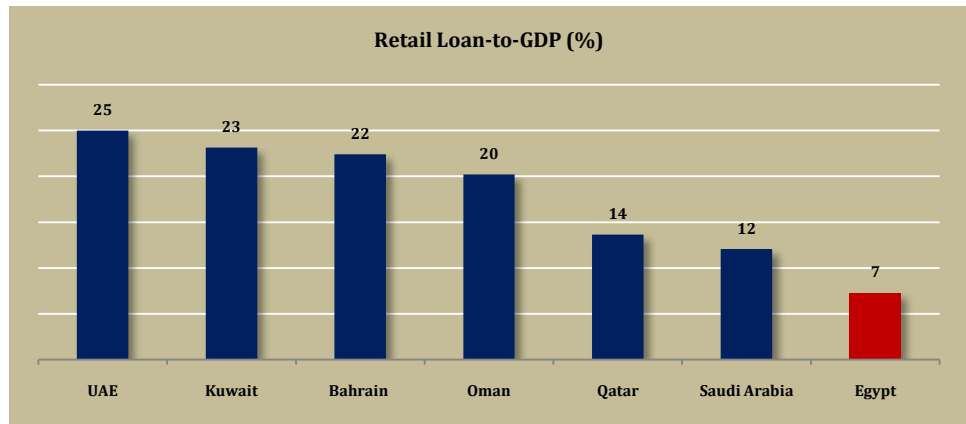
Chart 1. Egypt is the 3rd largest country in the MENA region



Source: EIU, Watheeqa

Note: Figure for Egypt pertains to June-2010; all other figures pertain to December-2010.

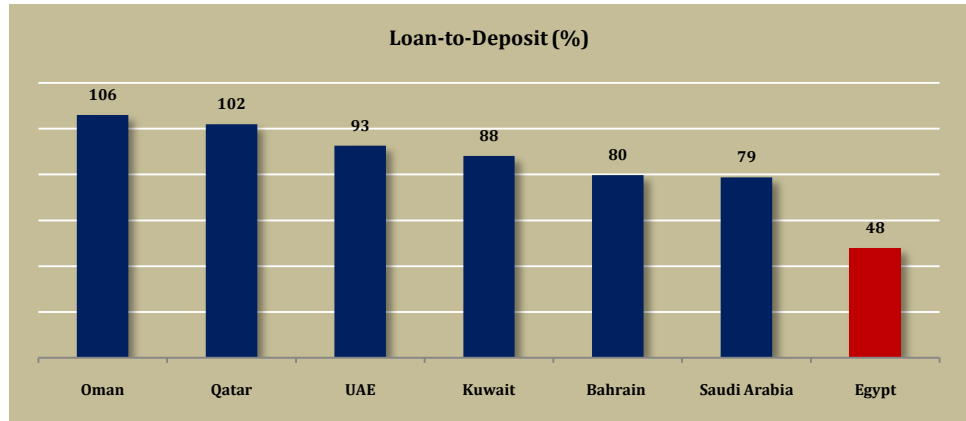
Chart 2. Egypt remains relatively underpenetrated vis-à-vis its GCC peers



Source: Central Banks, EIU, Watheeqa

Note: Figure for Egypt pertains to June-2010; all other figures pertain to December-2010.

Chart 3. Systemic liquidity remains healthy



Source: Central Banks, Watheeqa

Although we remain skeptical in the near-term, we opine that medium-to-long term sector valuations would warrant a re-rating in the event of a structural shift towards higher sustainable return on equity (ROEs) owing to the anticipated expansion in the retail sector loans. Our thematic study examines how the retail book expansion might improve the banking sector ROEs, thereby resulting in a probable sector re-rating.

To begin with, we looked at “IFRS 8 Operating segments” (*replacing IAS 14 Segment Reporting*) that is mandatory for annual financial statements for periods beginning on or after January 1, 2009. However, the Egyptian banks follow Egyptian Accounting Standards (EAS) and not International Accounting Standards (IAS). Nevertheless, the domestic banks have started providing details of the operating segments in their recent financial results, broadly in line with the IAS. Commercial International Bank (COMI), the largest private sector bank in Egypt, provided details for FY2009 and FY2010, whereas National Societe Generale Bank (NSGB), the second largest private sector bank, provided details for FY2010.

Further, we looked at National Bank of Kuwait (NBK) - Kuwait, Ahli United Bank (AUB) - Bahrain & Riyad Bank (RIBL) - Saudi Arabia to study the profitability of the retail segments in the respective countries. All these banks follow IAS and thereby have IFRS 8 disclosures in their financial statements. The rationale for inclusion of Kuwait & Bahrain in our analysis is to examine the profitability of the retail segment in relatively mature markets compared to Egypt. (*Note: Our selection of banks is based on the availability of segment disclosure in the best possible manner.*)

Retail operations in Kuwait are the most profitable (*Exhibit 1*). Profitability of retail operations in Bahrain (*Exhibit 2*) and Saudi Arabia (*Exhibit 3*) are higher than the non-retail segments. **In Egypt, for the banks under study, COMI & NSGB, the retail operations generate significantly superior ROEs in a nascent retail market (*Exhibit 4*). However, we feel these high ROEs would decline with growing competition. Share of retail assets are still in single-digits for Egypt whereas retail’s share in total assets varies between 10%-20% in the other three mentioned countries.**

Exhibit 1: National Bank of Kuwait, Kuwait : Retail segment profitability

Fig. in KD'000.	FY2008	FY2009	FY2010
Retail PAT	104,115	103,344	104,062
Retail Assets	2,621,467	2,790,653	2,799,344
Retail PAT as % of Total PAT	40%	39%	34%
Retail Assets as % of Total Assets	22%	22%	22%

Source: Company, Watheeqa

Exhibit 2: Ahli United Bank, Bahrain: Retail segment profitability

Fig. in USD'000.	FY2008	FY2009	FY2010
Retail PAT	59,578	47,977	44,711
Retail Assets	3,357,446	3,076,821	2,793,495
Retail PAT as % of Total PAT	19%	21%	15%
Retail Assets as % of Total Assets	15%	13%	11%

Source: Company, Watheeqa

Exhibit 3: Riyad Bank, Saudi Arabia: Retail segment profitability

Fig. in SAR mn.	FY2008	FY2009	FY2010
Retail PAT	814	535	452
Retail Assets	16,535	18,790	21,877
Retail PAT as % of Total PAT	31%	18%	16%
Retail Assets as % of Total Assets	10%	11%	13%

Source: Company, Watheeqa

Exhibit 4: Egyptian Banks: Retail segment profitability

Fig. in EGP mn.	FY2010
Commercial International Bank	
Retail PAT	583
Retail Assets	5,039
Retail PAT as % of Total PAT	29%
Retail Assets as % of Total Assets	7%
National Societe General Bank	
Retail PAT	242
Retail Assets	5,296
Retail PAT as % of Total PAT	18%
Retail Assets as % of Total Assets	9%

Source: Companies, Watheeqa

However, one might argue that capital requirements (*calculated as % of risk-weighted assets*) for retail assets would be higher than the wholesale (*corporate loans & off-balance sheet exposures*) assets put together. Basel II specifies a risk weight of 75% for claims on retail products. However, risk-weight is lower at 35% with respect to claims secured by residential mortgages, provided the loan-to-value ratio is within 80%. **To keep it simple, we have assumed 100% risk-weight for all retail assets' exposure (1.0x) for purpose of calculating risk-adjusted ROE.**

The implied risk-weighted assets for wholesale assets are well below 1.0x. Intuitively speaking, this is a reasonable outcome as retail loans tend to be riskier than corporate loans. Refer to Exhibits 5-8 for detailed calculations. (Note: We have applied the same principle for all the banks to arrive at risk-weighted assets and thereby the allocated capital for each segment. Further, the actual risk weighted assets reported by respective banks are lower than our calculated figures.)

Exhibit 5: National Bank of Kuwait, Kuwait : Risk-weighted assets, capital & risk-adjusted ROE

Fig. in KD'000.	FY2008	FY2009	FY2010
(A) Shareholders' Equity	1,568,566	1,838,663	2,230,503
(B) Tier -1 capital (%)	14.7%	14.5%	18.2%
(C) Risk-Weighted Assets (A/B)	10,670,517	12,680,434	12,255,511
(D) Risk-Weighted Assets - Retail @ 1.0x	2,621,467	2,790,653	2,799,344
(E) Risk-Weighted Assets - Non-Retail (C-D)	8,049,050	9,889,781	9,456,167
(F) Total Assets - Non-Retail	11,504,257	12,122,529	12,200,726
(G) Implied Risk-Weighted Assets (x) - Non-Retail (E/F)	0.70	0.82	0.78
(H) Capital - Non-retail (E*B)	1,183,210	1,434,018	1,721,022
(I) Capital - Retail Assets (A-H)	385,356	404,645	509,481
(J) PAT - Retail	104,115	103,344	104,062
(K) PAT - Total	257,577	266,636	302,917
(L) PAT - Non-Retail (J-K)	153,462	163,292	198,855
(M) Risk-adjusted ROE - Non-Retail (L/H)	13.0%	11.4%	11.6%
(N) Risk-adjusted ROE - Retail (J/I)	27.0%	25.5%	20.4%
(O) Risk-adjusted ROE - Overall (K/A)	16.4%	14.5%	13.6%

Source: Company, Watheeqa

Exhibit 6: Ahli United Bank, Bahrain: Risk-weighted assets, capital & risk-adjusted ROE

Fig. in USD'000.	FY2008	FY2009	FY2010
(A) Shareholders' Equity	2,394,777	2,581,431	2,752,175
(B) Tier -1 capital (%)	9.0%	10.9%	10.6%
(C) Risk-Weighted Assets (A/B)	26,608,633	23,682,853	25,963,915
(D) Risk-Weighted Assets - Retail @ 1.0x	3,357,446	3,076,821	2,793,495
(E) Risk-Weighted Assets - Non-Retail (C-D)	23,251,187	20,606,032	23,170,420
(F) Total Assets - Non-Retail	20,916,009	22,186,355	25,554,963
(G) Implied Risk-Weighted Assets (x) - Non-Retail (E/F)	1.11	0.93	0.91
(H) Capital - Non-retail (E*B)	2,092,607	2,246,058	2,456,065
(I) Capital - Retail Assets (A-H)	302,170	335,373	296,110
(J) PAT - Retail	59,578	47,977	44,711
(K) PAT - Total	309,742	226,086	291,199
(L) PAT - Non-Retail (J-K)	250,164	178,109	247,488
(M) Risk-adjusted ROE - Non-Retail (L/H)	12.0%	7.9%	10.1%
(N) Risk-adjusted ROE - Retail (J/I)	19.7%	14.3%	15.1%
(O) Risk-adjusted ROE - Overall (K/A)	12.9%	8.8%	10.6%

Source: Company, Watheeqa

Exhibit 7: Riyad Bank, Saudi Arabia: Risk-weighted assets, capital & risk-adjusted ROE

Fig. in SAR mn.	FY2008	FY2009	FY2010
(A) Shareholders' Equity	25,690	28,235	29,233
(B) Tier -1 capital (%)	15.5%	15.7%	16.0%
(C) Risk-Weighted Assets (A/B)	165,745	179,844	182,707
(D) Risk-Weighted Assets - Retail @ 1.0x	16,535	18,790	21,877
(E) Risk-Weighted Assets - Non-Retail (C-D)	149,209	161,054	160,830
(F) Total Assets - Non-Retail	202,303	220,129	224,898
(G) Implied Risk-Weighted Assets (x) - Non-Retail (E/F)	0.74	0.73	0.72
(H) Capital - Non-retail (E*B)	23,127	25,285	25,733
(I) Capital - Retail Assets (A-H)	2,563	2,950	3,500
(J) PAT - Retail	814	535	452
(K) PAT - Total	2,639	3,030	2,825
(L) PAT - Non-Retail (J-K)	1,825	2,496	2,373
(M) Risk-adjusted ROE - Non-Retail (L/H)	7.9%	9.9%	9.2%
(N) Risk-adjusted ROE - Retail (J/I)	31.8%	18.1%	12.9%
(O) Risk-adjusted ROE - Overall (K/A)	10.3%	10.7%	9.7%

Source: Company, Watheeqa

Exhibit 8A : Commercial International Bank, Egypt: Risk-weighted assets, capital & risk-adjusted ROE

Fig. in EGP mn.	FY2010
(A) Shareholders' Equity	8,619
(B) Tier -1 capital (%)	13.2%
(C) Risk-Weighted Assets (A/B)	65,521
(D) Risk-Weighted Assets - Retail @ 1.0x	5,039
(E) Risk-Weighted Assets - Non-Retail (C-D)	60,482
(F) Total Assets - Non-Retail	82,266
(G) Implied Risk-Weighted Assets (x) - Non-Retail (E/F)	0.74
(H) Capital - Non-retail (E*B)	7,956
(I) Capital - Retail Assets (A-H)	663
(J) PAT - Retail	583
(K) PAT - Total	2,007
(L) PAT - Non-Retail (J-K)	1,423
(M) Risk-adjusted ROE - Non-Retail (L/H)	17.9%
(N) Risk-adjusted ROE - Retail (J/I)	88.0%
(O) Risk-adjusted ROE - Overall (K/A)	23.3%

Source: Company, Watheeqa

Exhibit 8B : National Societe General Bank, Egypt: Risk-weighted assets, capital & risk-adjusted ROE

Fig. in EGP mn.	FY2010
(A) Shareholders' Equity	6,621
(B) Tier -1 capital (%)	12.7%
(C) Risk-Weighted Assets (A/B)	52,051
(D) Risk-Weighted Assets - Retail @ 1.0x	5,296
(E) Risk-Weighted Assets - Non-Retail (C-D)	46,755
(F) Total Assets - Non-Retail	70,149
(G) Implied Risk-Weighted Assets (x) - Non-Retail (E/F)	0.67
(H) Capital - Non-retail (E*B)	5,948
(I) Capital - Retail Assets (A-H)	674
(J) PAT - Retail	242
(K) PAT - Total	1,338
(L) PAT - Non-Retail (J-K)	1,096
(M) Risk-adjusted ROE - Non-Retail (L/H)	18.4%
(N) Risk-adjusted ROE - Retail (J/I)	35.9%
(O) Risk-adjusted ROE - Overall (K/A)	20.2%

Source: Company, Watheeqa

We notice that implied leverage for retail banking operations in Egypt are much lower than all the other countries. Leverage for retail operations should be at/close to par with non-retail operations (*as is evident in NBK – Refer to Exhibit 9*) or higher than non-retail operations (*as is evident in AUB/RIBL- Refer to Exhibits 10-11*). **Hypothetically, ROEs for Egyptian banks would have been higher assuming current ROAs and at par leverage with non-retail operations. ROE for COMI would have been higher by 110bps and NSGB by 70bps under the specified assumption (Refer to Exhibit 13A & 13B).**

Exhibit 9: National Bank of Kuwait, Kuwait : Segment wise implied leverage

Fig. in KD'000.	FY2008	FY2009	FY2010
Retail segment			
Assets	2,621,467	2,790,653	2,799,344
Equity	385,356	404,645	509,481
ROE	27.0%	25.5%	20.4%
ROA	4.0%	3.7%	3.7%
Implied Leverage	6.8	6.9	5.5
Non-Retail segment			
PAT	153,462	163,292	198,855
Assets	9,351,855	10,116,603	10,099,600
Equity	1,183,210	1,434,018	1,721,022
ROE	13.0%	11.4%	11.6%
ROA	1.6%	1.6%	2.0%
Implied Leverage	7.9	7.1	5.9

Source: Company, Watheeqa

Exhibit 10: Ahli United Bank, Bahrain: Segment wise implied leverage

Fig. in USD'000.	FY2008	FY2009	FY2010
Retail segment			
PAT	59,578	47,977	44,711
Assets	3,357,446	3,076,821	2,793,495
Equity	302,170	335,373	296,110
ROE	19.7%	14.3%	15.1%
ROA	1.8%	1.6%	1.6%
Implied Leverage	11.1	9.2	9.4
Non-Retail segment			
PAT	250,164	178,109	247,488
Assets	18,391,469	20,497,162	23,663,966
Equity	2,092,607	2,246,058	2,456,065
ROE	12.0%	7.9%	10.1%
ROA	1.4%	0.9%	1.0%
Implied Leverage	8.8	9.1	9.6

Source: Company, Watheeqa

Exhibit 11: Riyadh Bank, Saudi Arabia: Segment wise implied leverage

Fig. in SAR mn.	FY2008	FY2009	FY2010
Retail segment			
PAT	814	535	452
Assets	16,535	18,790	21,877
Equity	2,563	2,950	3,500
ROE	31.8%	18.1%	12.9%
ROA	4.9%	2.8%	2.1%
Implied Leverage	6.5	6.4	6.3
Non-Retail segment			
PAT	1,825	2,496	2,373
Assets	143,117	157,610	151,679
Equity	23,127	25,285	25,733
ROE	7.9%	9.9%	9.2%
ROA	1.3%	1.6%	1.6%
Implied Leverage	6.2	6.2	5.9

Source: Company, Watheeqa

Exhibit 12A: Commercial International Bank: Segment wise implied leverage

Fig. in EGP mn.	FY2010
Retail segment	
PAT	583
Assets	5,039
Equity	663
ROE	88.0%
ROA	11.6%
Implied Leverage	7.6
Non-Retail segment	
PAT	1,423
Assets	70,386
Equity	7,956
ROE	17.9%
ROA	2.0%
Implied Leverage	8.8

Source: Company, Watheeqa

Exhibit 12B: National Societe General Bank: Segment wise implied leverage

Fig. in EGP mn.	FY2010
Retail segment	
PAT	242
Assets	5,296
Equity	674
ROE	35.9%
ROA	4.6%
Implied Leverage	7.9
Non-Retail segment	
PAT	1,096
Assets	55,589
Equity	5,948
ROE	18.4%
ROA	2.0%
Implied Leverage	9.3

Source: Company, Watheeqa

Exhibit 13A: Commercial International Bank: Hypothetical ROE improvement with increase in leverage

Scenario Analysis - Leverage at par with non-retail segment	Existing	Scenario I	Scenario II	Scenario III
<i>Leverage</i>	7.6	8.0	8.5	9.0
ROA	11.6%	11.6%	11.6%	11.6%
ROE	88.0%	92.6%	98.4%	104.2%
Equity	663	663	663	663
PAT	583	614	652	691
ROE - Total	23.3%	23.6%	24.1%	24.5%
Incremental ROE - Total		0.4%	0.8%	1.2%

Source: Company, Watheeqa

Exhibit 13B: National Societe General Bank: Hypothetical ROE improvement with increase in leverage

Scenario Analysis - Leverage at par with non-retail segment	Existing	Scenario I	Scenario II	Scenario III
<i>Leverage</i>	7.9	8.5	9.0	9.5
ROA	4.6%	4.6%	4.6%	4.6%
ROE	35.9%	38.8%	41.1%	43.3%
Capital - Retail	674	674	674	674
PAT - Retail	242	261	277	292
ROE - Total	20.2%	20.5%	20.7%	21.0%
Incremental ROE - Total		0.3%	0.5%	0.8%

Source: Company, Watheeqa

Conclusion: As discussed earlier - ROAs for retail operations in Egyptian banks are unsustainable at the current levels as newer players enter the market. To arrive at the sustainable ROA level for Egyptian banks, we have considered retail ROAs at c.1.25x the ROA for non-retail assets (3-year average ROA for retail assets exceeding 2.0x the ROA for non-retail segment for NBK & RIBL and 3-year average ROA for retail assets @ 1.5x the ROA for non-retail segment for AUB). We noticed that both the banks are adequately capitalized (with Tier-I capital ratios of c.13%) and thereby factored in higher leverage than the current levels (in line with long-term historical medians though). The sustainable ROE for Egyptian banks are calculated with share of retail assets doubling and the above-mentioned inputs. ROE for COMI would improve by 340bps and ROE for NSGB would be higher by 410bps from the current levels based on our analysis. (Refer to Exhibit 14A & 14B) Going forward, as ROEs expand, we expect - both these Egyptian banks; COMI and NSGB to command higher valuations.

Exhibit 14A: Commercial International Bank: Sustainable ROE

	Current	Doubling of retail assets	
<i>Non-retail assets as % of total assets</i>	93%	87%	
ROA - Non retail assets	2.0%	2.6%	Median ROA for past 6 years
<i>Retail assets as % of total assets</i>	7%	13%	
ROA - Retail assets	11.6%	3.3%	Retail ROA @ 1.25x non-retail ROA
ROA - Combined	2.7%	2.7%	
Leverage - Non-retail assets	8.8	10.0	
Leverage - Retail assets	7.6	9.0	
Leverage - Total	8.8	9.9	
ROE - Total	23.3%	26.7%	
Incremental ROE - Total		3.4%	

Source: Company, Bloomberg, Watheeqa

Exhibit 14B: National Societe General Bank: Sustainable ROE

	Current	Doubling of retail assets	
<i>Non-retail assets as % of total assets</i>	91%	83%	
ROA - Non retail assets	2.0%	2.4%	Median ROA for past 5 years
<i>Retail assets as % of total assets</i>	9%	17%	
ROA - Retail assets	4.6%	3.0%	Retail ROA @ 1.25x non-retail ROA
ROA - Combined	2.2%	2.5%	
Leverage - Non-retail assets	9.3	10.0	
Leverage - Retail assets	7.9	9.0	
Leverage - Total	9.2	9.8	
ROE - Total	20.3%	24.3%	
Incremental ROE - Total		4.1%	

Source: Company, Bloomberg, Watheeqa

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