Banking industry 2013: an analysis of activity performance, risk profile and return indicators

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General Operating Environment

Within the context of the recent cross border expansion of Lebanon's banks, the analysis of the performance of Lebanese banking in terms of activity growth, risk profile and return indicators, has to be read in conjunction with the overall operating environment in the different regions where they are actually operating. The operating conditions of Lebanese banks over the past year were actually atypical in their different markets of presence, i.e. in Lebanon, in the MENA region and even outside it.

The global economy witnessed a tough albeit slightly better year in 2013, with activity strengthening in the second half of the year and global trade volumes picking up some steam. Macroeconomic conditions saw some improvement relative to the previous year, as the global economy recovered further from one of the worst crises in recent history. While still constraining aggregate demand, fiscal consolidation has started easing after years of tough policy measures. Private consumption demand is gaining a firmer footing though witnessing a slow recovery on the overall, dented by persistently high unemployment. Private investment spending continues to be affected by still weak growth prospects and investors' wait-and-see attitude amid high debt levels in some countries, despite some improvement in global business sentiment notably towards year-end. Within this context, the global economy continued to record a modest performance with real growth at an estimated 3.0% in the full-year 2013, as per the latest International Monetary Fund statistics.

Amid slightly improving albeit modest global economic performances, financial conditions across the world eased in relative terms, noting that the global banking system is phasing in stronger regulatory standards, which has been having some positive spillovers on confidence and contributed to reducing uncertainties. Market conditions nonetheless witnessed some volatility during the year, mostly as a result of speculation on a gradual reduction of monetary stimulus on behalf of the US Federal Reserve and its impact on emerging market economies and capital flows to the latter. While the improvement in the overall macroeconomic backdrop over the course of 2013 lately prompted the US Fed to begin reducing its support to the economy, the global monetary stance remained widely accommodative. The US Fed continued, along with the world's largest central banks, to follow loose monetary policies in an environment of slow recovery and subdued inflationary pressures, by maintaining interest rates at ultra-low levels in an aim to prop up economic conditions at large.

The near-term economic performance for the Middle East and North Africa region has weakened. Growth in the MENA region is set to have declined to 2.2 percent last year as per the IMF estimates. With respect to MENA's oil importers, the economic recovery in those countries has once again been delayed. Heightened security concerns, rising political uncertainty, and delays in reforms continue to weigh on confidence, preventing a recovery in investment and economic activity in many countries. The devastating civil war in Syria has sparked concerns about regional spillovers, further complicating economic management. While there are nascent signs of improvement in tourism, exports, and foreign direct investment in some countries, the economic recovery in the MENA oil importers remains sluggish, with growth of about 2.7 percent in 2013, significantly below the growth rates necessary to reduce persistent unemployment and improve living standards.

With respect to MENA's oil exporters, domestic oil supply disruptions and lower global demand are set to markedly reduce growth in MENA oil exporters to about 2 percent this year after several years of strong performance. Renewed oil output disruptions in Iraq and Libya, falling oil exports in Iran, and a modest fall in oil production in Saudi Arabia reflecting a still amply supplied global oil market entailed a fall in regional oil production last year, for the first time since the global crisis. By contrast, the non-oil economy continues to expand at a solid pace in most countries, supported by high levels of public spending and a gradual recovery of private sector credit growth.

At the banking level, the MENA region has been reporting an acceptable 10.9% annual growth in deposits and 9.2% annual growth in loans in 2013. But the sound banking sector growth in 2013 in the MENA region is mainly driven by oil exporters while oil importers barely saw their deposit and loan bases grow. Not less importantly, the latter's net banking profitability remained under pressure within the context of relatively tough operating conditions in their respective economies underlined by narrowing net interest margins, growing provisioning requirements and slow fee income growth generation at large.

Banking sectors' assets in the Arab MENA region

in US$ billion	Dec-12	Dec-13	Var 13	Var 12
Algeria	122.6	132.1	9.5	2.9
Bahrain	71.5	75.1	3.6	4.3
Egypt	226.6	242.2	15.7	9.8
Jordan	55.4	60.4	5.0	2.2
Kuwait	167.5	182.4	14.8	9.3
Lebanon	181.5	199.0	17.5	14.3
Libya	66.9	79.7	12.8	10.5
Morocco	133.5	142.8	9.3	11.5
Oman	54.4	58.1	3.6	6.7
Qatar	224.3	250.0	25.7	33.6
Saudi Arabia	462.4	504.9	42.4	50.6
Sudan	15.2	13.6	-1.6	-2.2
Tunisia	43.5	45.7	2.2	1.3
United Arab Emirates	488.6	529.6	41.0	35.2
Yemen	10.6	12.9	2.3	2.3
Arab MENA	**2,324.6**	**2,528.6**	**203.9**	**192.2**

Sources: Central Banks, Bloomberg.

Banking sectors' deposits in the Arab MENA region

in US$ billion	Dec-12	Dec-13	Var 13	Var 12
Algeria	102.4	110.4	8.1	4.5
Bahrain	34.4	39.6	5.2	2.7
Egypt	171.5	189.2	17.8	7.5
Jordan	35.3	39.0	3.8	0.9
Kuwait	119.1	128.6	9.6	9.2
Lebanon	150.0	164.3	14.3	12.0
Libya	53.0	67.7	14.7	6.5
Morocco	99.6	106.6	7.0	5.6
Oman	36.8	40.5	3.7	4.2
Qatar	125.8	150.7	24.8	25.9
Saudi Arabia	336.2	373.9	37.7	41.9
Sudan	9.1	7.8	-1.2	-1.4
Tunisia	25.2	25.1	-0.1	1.8
United Arab Emirates	318.0	348.2	30.2	26.7
Yemen	8.4	10.4	2.0	2.1
Arab MENA	**1,624.6**	**1,802.1**	**177.5**	**150.0**

Banking sectors' loans in the Arab MENA region

in US$ billion	Dec-12	Dec-13	Var 13	Var 12
Algeria	28.5	34.8	6.3	2.2
Bahrain	18.2	19.0	0.9	1.1
Egypt	81.2	79.1	-2.1	0.1
Jordan	25.1	26.7	1.6	2.8
Kuwait	103.1	110.3	7.1	1.7
Lebanon	53.8	62.0	8.2	5.5
Libya	12.6	14.8	2.2	2.4
Morocco	89.5	95.5	6.1	5.5
Oman	32.2	34.5	2.2	4.2
Qatar	139.7	158.1	18.3	28.9
Saudi Arabia	256.1	287.0	30.9	36.2
Sudan	6.9	6.6	-0.3	-1.6
Tunisia	30.7	31.1	0.4	1.4
United Arab Emirates	279.4	303.6	24.2	9.1
Yemen	1.7	2.4	0.6	0.0
Arab MENA	**1,159.0**	**1,265.5**	**106.5**	**99.4**

Sources: Central Banks, Bloomberg.

In Lebanon, the year 2013 has extended Lebanon's economic sluggishness witnessed since the beginning of the regional turmoil. A continuing economic slowdown is being reported within the context of the adverse spillover effects of the Syrian conflict on investment, tourism and foreign trade. Real GDP has displayed a low though positive growth for the third consecutive year, estimated at between 1.5% and 2.5% by the IMF and the Central Bank of Lebanon, amidst continuing regional tensions and lingering domestic uncertainties.

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The performance of Lebanon's real sector indicators was mixed throughout the past year. Among indicators that witnessed progressions in 2013, we mention electricity production (+10.3%), delivery of cement (+9.8%), merchandise at the Port (+14.4%), new car sales (+1.8%) and passengers at the Airport (+5.7%). Among indicators that witnessed regressions over the year, we mention construction permits (-10.9%), value of property sales (-2.4%) and number of tourists (-6.7%).

The quantity theory of money confirms the sluggishness in economic growth. The annual increase in money supply (+6.3%) was offset by a contracting velocity of money by 6.1% and an average price inflation of 2.6%. The contracting velocity is the result of a tiny growth in cleared checks of 1.9% within the context of an increase in average deposits by 8.4% in 2013. The moderation of inflation is technically tied to the fact that the Lebanese economy is operating at the flat Keynesian side of the Aggregate Supply curve amidst excess capacity and large output gap.

At the external level, exports dropped by 12.2% in 2013, as exports through Syria declined by 21.3% year-on-year amid the insecurity of shipping routes for Lebanon's land exports. Imports almost maintained their previous year's figure within the context of a lingering economic slowdown. While inflows were up by 5.9% in 2013, the balance of payments has reported a deficit of US$ 1.1 billion, following a deficit of US$ 1.5 billion during the previous year.

At the fiscal level, the latest released public finance figures underline a 7.5% increase in the public finance deficit over the first twelve months of 2013, amidst a mild rise in revenues of 0.3% and a rise in expenditures of 2.4%. And while debt service barely moved between the two periods, the rise in the public finance deficit was accompanied by a shift to a primary deficit of US$ 240 million. This has generated a net deterioration in public debt to GDP from 135.7% in 2012 to 143.2% in 2013.

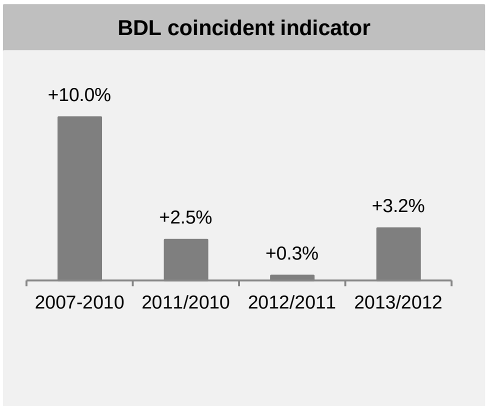
At the monetary level, the situation has been reporting considerable resilience, with no pressures on the currency, and with BDL foreign currency assets growing to US$ 35.3 billion by end-December 2013. At the current level of BDL foreign assets, equivalent to 78.3% of LP Money Supply and 20 months of imports, the Central Bank is in a comfortable position to defend the currency peg should conversion pressures arise.

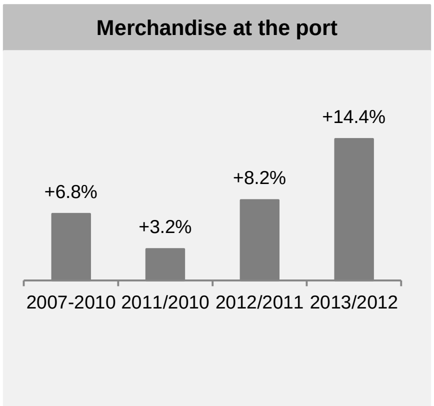
At the level of capital markets, activity was rather sluggish. As a matter of fact, a sluggish mood reigned over the equity market. The total trading value amounted to US$ 345 million, its lowest level since 2004, while the price index declined by 3.1% and the turnover ratio was quoted at 3.4%, its lowest level ever. On the bond market, papers came under some selling pressures, especially from foreigners, amidst domestic and regional concerns, in addition to rising speculation of the US Federal Reserve tapering its bond-buying program. Still, the average bond spread contracted by circa 42 bps to 297 bps, and the five-year CDS spreads shrank by circa 58 bps to 393 bps.

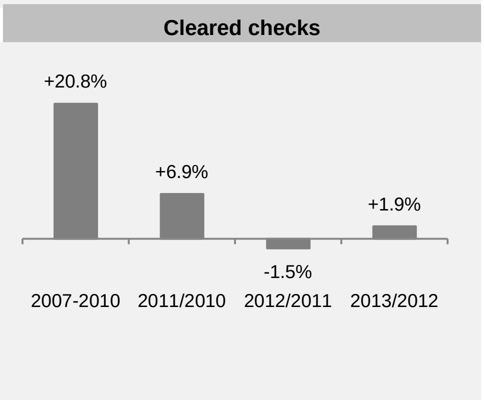
Lebanon's major economic indicators

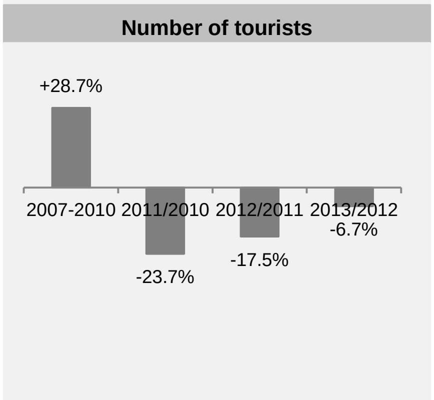
US$ million	2012	2013	Var 13/12
Macroeconomy			
GDP	42,519	44,318	4.2%
Real GDP growth (%)	2.5%	1.5%	-1.0%
GDP per capita (US$)	9,609	9,920	3.2%
Monetary sector			
Var M3	6,780	7,147	5.4%
Velocity	0.59	0.55	-6.1%
Average CPI inflation (%)	5.7%	2.6%	-3.1%
Public sector			
Gross domestic debt	33,300	37,349	12.2%
Foreign debt	24,387	26,113	7.1%
Total gross debt	57,687	63,462	10.0%
Gross debt/GDP (%)	136%	143%	7.5%
Deficit	3,925	4,220	7.5%
Deficit/GDP (%)	9.2%	9.5%	0.3%
External sector			
Imports	21,280	21,228	-0.2%
Exports	4,483	3,936	-12.2%
Trade deficit	16,797	17,292	2.9%
Gross financial inflows	15,260	16,164	5.9%
Balance of payments	-1,537	-1,128	-26.6%

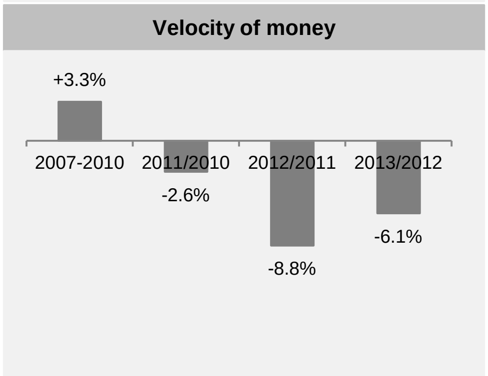
Sources: Lebanon Ministry of Finance, BDL & concerned public & private entities.

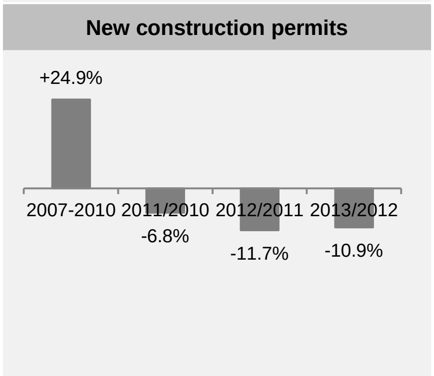












Lebanese banks activity

Within such an atypical global, regional and domestic environment, Lebanese banks have fared well the adverse operating conditions that have been prevailing in their different markets of presence, maintaining their adequate financial standing and continuing to grow at relatively lower but still satisfactory levels. The past years' deteriorating operating environment in the countries where Lebanese banks are present actually constitutes another proof of the strong foundation and the sound practices of Lebanese banks and added to the various episodes of resilience that Lebanese banking has born witness of over the past decades.

The in-depth analysis of the various types of risk represents henceforth tangible evidence that Lebanese banks continue to be well placed to face unforeseen contingencies. Following is a thorough analysis of banks operating conditions, profitability and risk metrics in 2013. It starts with the analysis of the pace and type of activity growth in 2013, to move to the analysis of liquidity and sovereign exposure, followed by lending quality and provisioning, then capital adequacy and solvency, profitability and efficiency and finally with investment considerations at large.

Consolidated activity growth

The Lebanese banking sector witnessed a relatively strong activity growth during the year 2013, in an overall tough operating environment characterized by sluggish domestic economic conditions. Total sector activity, measured by the aggregation of assets of banks operating in Lebanon, progressed by 9.7% over the covered period to reach US$ 199.0 billion at year-end 2013. When adding off balance sheet items, total footings of the Lebanese banking sector reached US$ 242.0 billion, growing by 10.6% during the year 2013.

Banking sector activity remains driven primarily by customer deposits, which rose by 9.5% in the year 2013, its highest growth in the past 3 years. The US$ 14.3 billion increase in deposits further reinforces the banks' funding base, with deposits accounting for 82.6% of the aggregate balance sheet, and 19% higher than the deposit growth recorded over the year 2012, which is a satisfactory performance given the domestic economic sluggishness and politico-security tensions.

The breakdown of deposits reveals that the growth recorded in the year 2013 is mostly owed to foreign currency deposits, which were responsible for about 84% of total growth in the sector. The growth in FX deposits was significant at US$ 12.0 billion in 2013. In parallel, local currency deposits continue to grow at a relatively good pace, with the equivalent of US$ 2.3 billion in new deposits during 2013. This has generated a rise in the share of foreign currency deposits to total deposits from 68.6% in 2012 to 69.9% in 2013.

It is worth mentioning that following the standstill in the share of foreign entities in the past years due to consolidation strategies, mainly in the region, such shares reported a relative rise in 2013. The share of foreign entities assets to total assets rose from 16.7% in 2012 to 17.0% in 2013, while that of foreign entities deposits to total deposits increased from 14.5% to 15.0% and that of foreign entities loans to total loans surged from 21.2% to 25.4%. Those rises are mainly driven by the recent expansion of the largest bank in the sector to the Turkish market.

The analysis by group of banks according to their size shows that growth was realized at different paces by the different bank groups. Bilanbanques divides the banking sector into four groups by size, the first being the Alpha Group (Banks with customer deposits above US$ 2 billion), then the Beta Group (Banks with customer deposits between US$ 500 million and US$ 2 billion), then the Gamma Group (Banks with customer deposits between US$ 200 million and US$ 500 million) and finally the Delta Group (Banks with customer deposits below US$ 200 million). The fastest activity growth in 2013 was realized by the Alpha group of banks, displaying a growth rate of 10.1% and the Beta Group reporting a growth of 6.6%, while the Delta Group grew by 5.3% and the Gamma Group rose by 5.2%. But banking activity continues to be significantly concentrated, with no major changes in the shares of the different bank groups. The Alpha Group's share remains highly dominant at 88.6% of the sector's assets in 2013 (88.2% in 2012), followed by the Beta Group with 8.6% (8.8% in 2012), the Gamma Group with 1.6% (1.6% in 2012) and the Delta Group with 1.3% (1.3% in 2012).

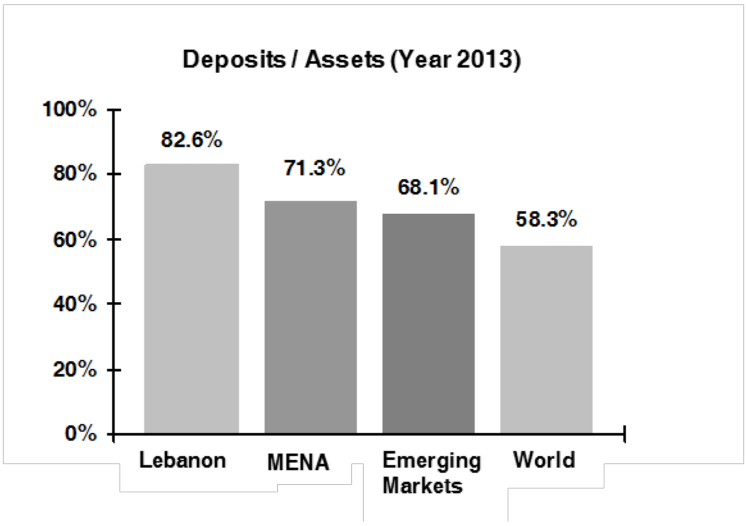
The analysis of Lebanese banks' groups by dollarization ratios suggests that the Delta goup of banks is the most dollarized in terms of deposits and the least dollarized in terms of loans. Deposit dollarization stands at 73.1% for the Delta Group, followed by 70.2% for the Alpha Group, 68.7% for the Gamma Group and 67.7% for the Beta Group. The Group that witnessed the highest pace of conversions in relative terms in 2013 was the Alpha Group with foreign currency deposits to total deposits rising from 68.6% in 2012 to 70.2% in 2013. On the other hand, loan dollarization is the largest for the Gamma Group with 87.0%, followed by 82.8% for the Alpha Group, 79.1% for the Beta Group and 42.4% for the Delta Group.

Growth rates of banking aggregates

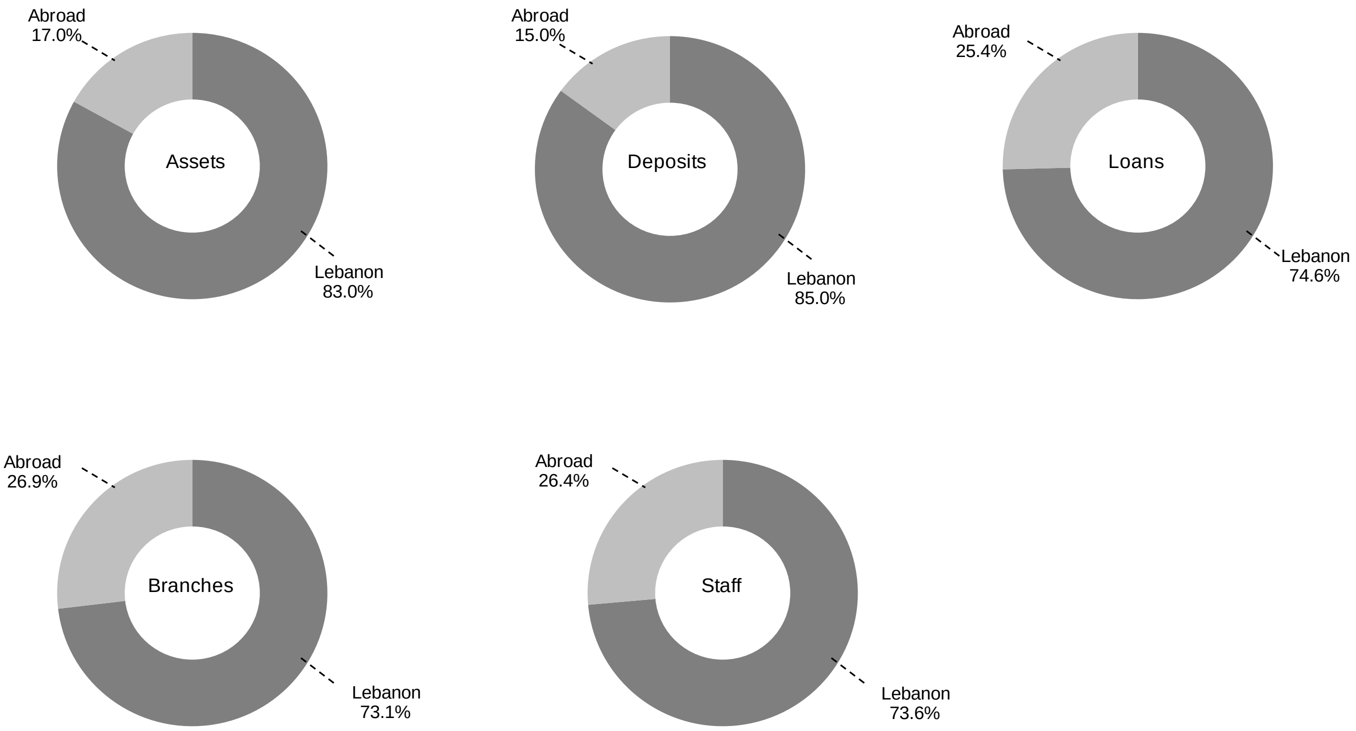
	2008	2009	2010	2011	2012	2013	Var 13/12
Assets	12.8%	21.7%	11.9%	7.9%	8.4%	9.7%	1.3%
Loans to customers	24.9%	15.6%	25.2%	13.6%	11.4%	15.2%	3.8%
Deposits from customers	13.9%	23.4%	12.4%	7.4%	8.8%	9.5%	0.7%
Shareholders' equity	14.7%	24.0%	15.9%	1.9%	13.4%	8.6%	-4.8%
Total L/C openings of the year	55.2%	-21.4%	31.2%	-8.4%	-5.3%	-6.2%	-1.0%
Net profit for the year	26.6%	17.4%	28.6%	-4.7%	7.6%	0.5%	-7.1%

Growth Rates of Lebanese Banks' Groups (Year 2013)

	Alpha	Beta	Gamma	Delta
Assets	10.1%	6.6%	5.2%	5.3%
Loans to customers	15.6%	14.6%	14.3%	-0.4%
Deposits from customers	9.9%	6.7%	2.2%	20.9%
Shareholders' equity	8.8%	7.3%	11.3%	4.5%
Total L/C openings of the year	-4.6%	-23.1%	29.6%	-23.6%
Net profit for the year	0.1%	11.8%	-10.1%	-4.2%



Geographic Concentration (Year 2013)



Liquidity and sovereign exposure

The Lebanese banking sector remains highly liquid by all standards. Net primary liquidity as a percentage of total deposits reported a sound level of 30.7% in 2013, though relatively declining when compared to 2012. It actually reported 20% in Lebanese Pounds and 35.3% in foreign currency. The mirror image of banks liquidity is the loans to deposits ratio of banks which reported 37.7% in 2013, against a regional average of 70.2%, an emerging markets' average of 77.1% and a global average of 83.1%.

Solid liquidity is a result of high BDL reserve requirements, which are currently set at 25% for local currency sight deposits and 15% on all other deposits (local and foreign currency). It is also worth mentioning that Lebanese banks continue to benefit from a stable and growing deposit base which makes up the bulk of the sector's liabilities, with minimal reliance on market funding.

The analysis of liquidity by Lebanese banks' groups in 2013 shows that the most liquid Group is the Gamma Group with a net primary liquidity to deposits ratio of 32.8%, followed by the Alpha Group with a ratio of 31.4%, the Beta Group with a ratio of 24.5% and the Delta Group with a low ratio of 7.5% as it holds a significantly large amount of government paper amid its asset base.

Beyond abundant liquidity, the sector has been witnessing over the past year a rising exposure on the sovereign. While the exposure is high on the Lebanese Pound side, which does not hold genuine default risk, it is quite bearable on the foreign currency side which is generally more risky. The ratio of Lebanese Treasury bills in LL to deposits in LL rose from 39.6% in 2012 to 41.5% in 2013. Notwithstanding certificates of deposits in LL that recorded 32.1% of customer deposits in LL. In parallel, the ratio of Lebanese sovereign eurobonds to deposits in foreign currency increased from 13.4% in 2012 to 15.7% in 2013. As a percentage of shareholders' equity, Lebanese sovereign eurobonds reached 101.2% in 2013, against 84.3% in 2012.

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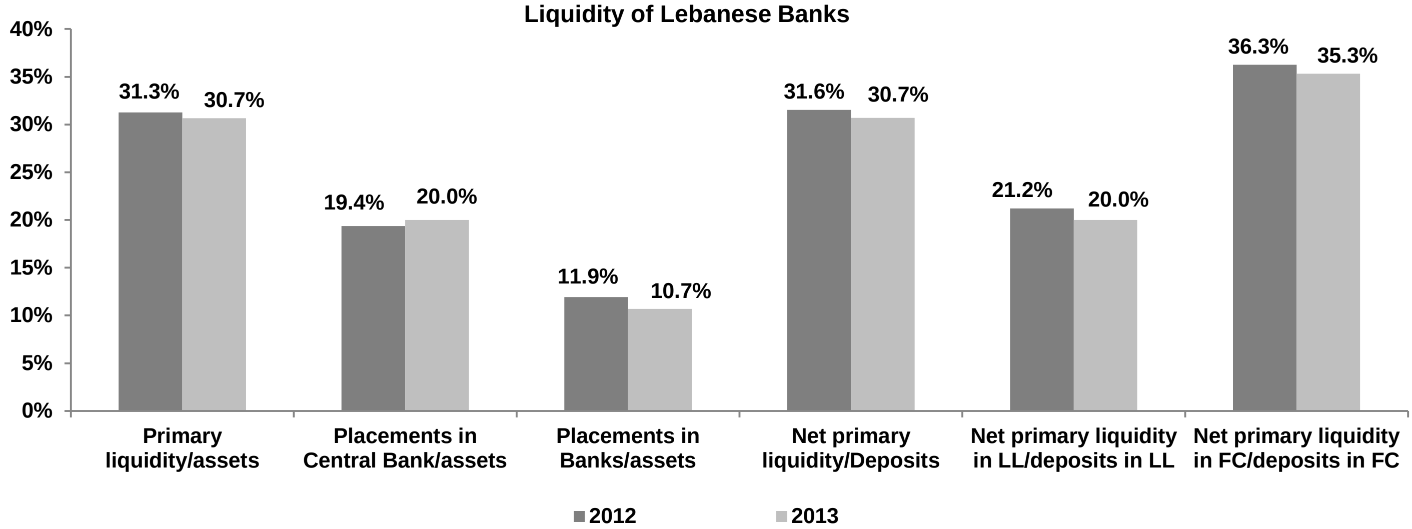
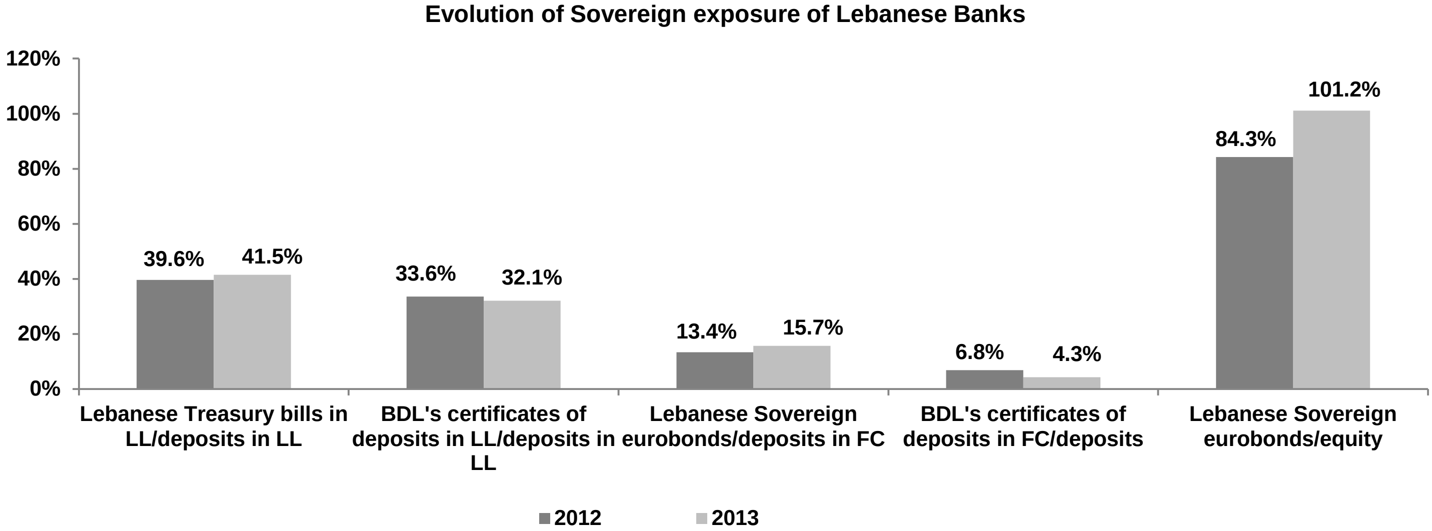
The analysis of sovereign exposure by Lebanese banks' groups in 2013 shows that the Group with the highest exposure in Lebanese Pounds is the Delta Group with a ratio of Lebanese Treasury bills in LL to deposits in LL of 88.7%, followed by the Gamma Group with 57.6%, the Beta Group with 57.3% and the Alpha Group with 39.3%. In parallel, the Group with the highest exposure in foreign currency in 2013 is the Gamma Group with a ratio of Lebanese sovereign Eurobonds to deposits in foreign currency of 39.1%, followed by the Delta Group with 34.6%, the Alpha Group with 15.3% and the Beta Group with 14.9%.

Liquidity of Lebanese Banks' Groups (Year 2013)

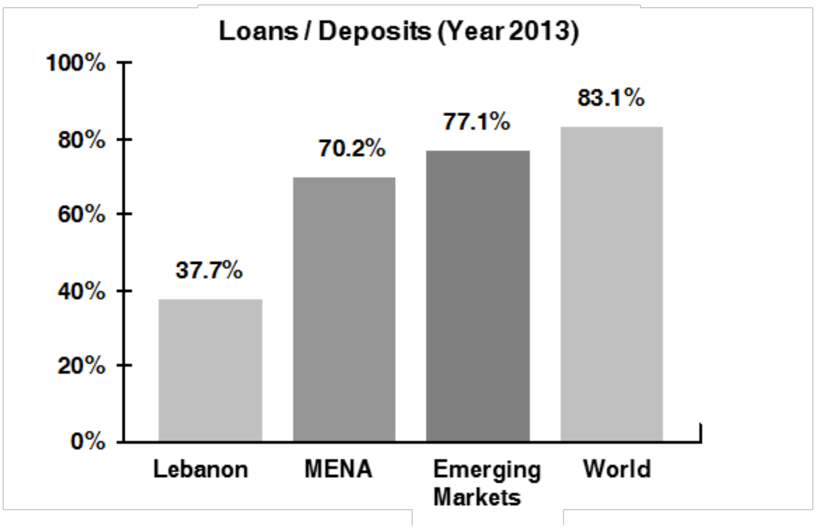
	Alpha	Beta	Gamma	Delta
Primary liquidity/assets	**31.0%**	**25.0%**	**41.4%**	**36.6%**
o.w. Central Bank/assets	20.5%	15.7%	20.9%	16.9%
o.w. Banks/assets	10.5%	9.3%	20.5%	19.7%
Net primary liquidity/Deposits	**31.4%**	**24.5%**	**32.8%**	**7.5%**
o.w. net primary liquidity in LL/deposits in LL	21.1%	8.3%	38.8%	3.7%
o.w. net primary liquidity in FC/deposits in FC	35.9%	32.2%	30.1%	8.9%



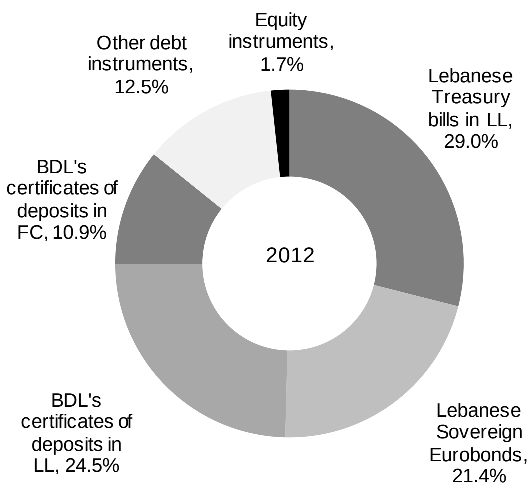


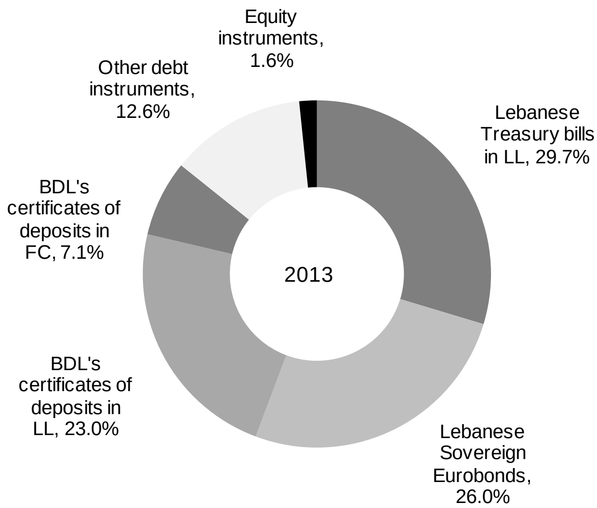
Sovereign exposure of Lebanese Banks' Groups (Year 2013)

	Alpha	Beta	Gamma	Delta
Lebanese Treasury bills in LL/deposits in LL	39.3%	57.3%	57.6%	88.7%
BDL's certificates of deposits in LL/deposits in LL	33.8%	18.2%	27.6%	4.6%
Lebanese Sovereign eurobonds/deposits in FC	15.3%	14.9%	39.1%	34.6%
BDL's certificates of deposits in FC/deposits in FC	4.3%	3.9%	1.9%	3.7%
Lebanese Sovereign eurobonds/equity	103.3%	105.9%	121.0%	32.1%



Portfolio securities breakdown





Lending Quality and Provisioning

The past year saw an active lending activity on behalf of Lebanese banks, partly supported by significant stimulus packages from the Central Bank of Lebanon. The loan portfolio reported last year its most significant rise among the three years of regional turmoil that started at the beginning of 2011. Net loans grew by 15.2% to reach a total of US$ 62.0 billion at end-2013. The analysis by currency suggests that local currency loans and foreign currency loans grew similarly, with the former registering a growth of 15.8% and the latter reporting a growth of 15.1%, which lead to a stability in loan dollarization at 81.9%. The breakdown of the sector's loan portfolio to the private sector by various types of loans shows that loans to SMEs reported the most significant growth of 26.4%, followed by loans secured by commercial real estate with 19.8%, housing loans with 17.7%, corporate loans with 11.4% and retail loans with 8.6%. Corporate loans continue to represent the bulk of the loan portfolio, with 40.6% of total loans in 2013, against 42.0% in 2012.

Despite adverse economic conditions domestically and in the main regional markets of presence, asset quality reported a slight improvement over the past year. This performance stems from active remedial management and steady moves to improve risk management. The ratio of doubtful loans to gross loans dropped from 7.1% in 2012 to a record low over the past decade of 6.8% in 2013, which is higher than the regional average of 4.6% but in line with emerging markets and global benchmarks of 6.7% and 6.6% respectively. This comes within the context of a slower annual growth in doubtful loans (10.7%) relative to total gross loans (14.9%). As a percentage of shareholders equity, net doubtful loans slightly rises to 5.7% in 2013. When adding substandard loans, the total ratio of doubtful and substandard loans to gross loans stabilizes at 7.8%. Notwithstanding a good provisioning level of 77.7% in 2013, though lower than the 79.6% reported in 2012.

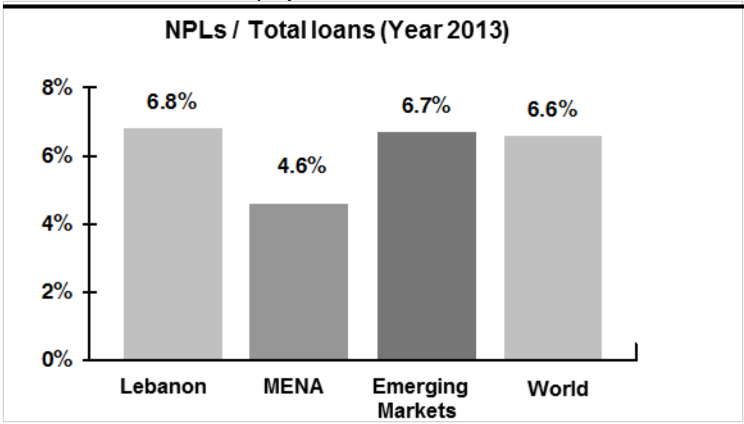
The analysis of lending quality by group of banks shows that lending quality is almost tied to the size of banks, suggesting that larger banks have better asset quality. This is noticed as banks of the Alpha Group reported the lowest doubtful loans to gross loans ratio of 5.9%, followed by the Beta Group with 8.4%, the Delta Group with 23.9% and the Gamma Group with 30.5%. When adding substandard loans, the ratio of doubtful and substandard loans to gross loans reported a low of 6.8% for the Alpha Group, 10.4% for the Beta Group, 25.8% for the Delta Group and 32.8% for the Gamma Group. On the other hand, middle sized banks are the best provisioned. The ratio of loan loss reserves on doubtful loans as a percentage of doubtful loans reported considerably high ratios of 90.5% and 81.7% for the Gamma and Beta Groups, while the Alpha Group registered a ratio of 76.8% and the Delta Group recorded a ratio of 67.7%.

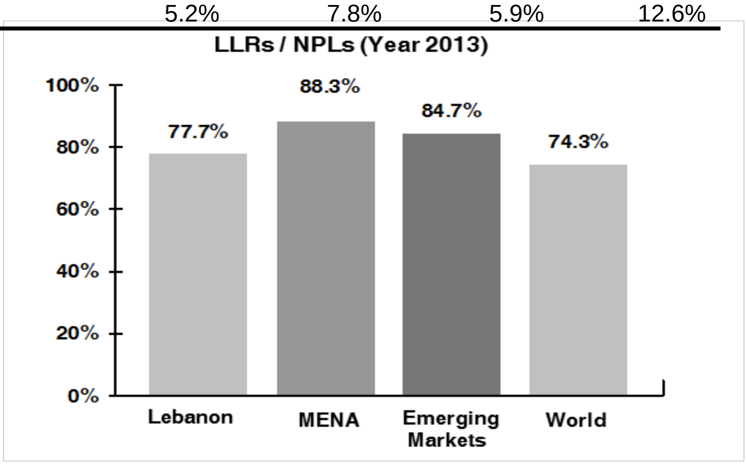
Asset Quality of Lebanese Banks

	2008	2009	2010	2011	2012	2013	Var 13/12
Doubtful loans/Gross loans	10.7%	9.5%	7.3%	6.9%	7.1%	6.8%	-0.3%
Substandard loans + doubtful loans/Gross loans	12.0%	10.4%	8.2%	7.7%	7.8%	7.8%	0.0%
Net doubtful loans/Gross loans	1.3%	1.1%	1.2%	1.2%	1.4%	1.5%	0.1%
Loan loss reserves on doubtful /Doubtful loans	87.7%	88.8%	83.2%	81.8%	79.6%	77.7%	-1.9%
Net doubtful loans/Equity	4.4%	3.2%	4.0%	4.6%	5.1%	5.7%	0.6%

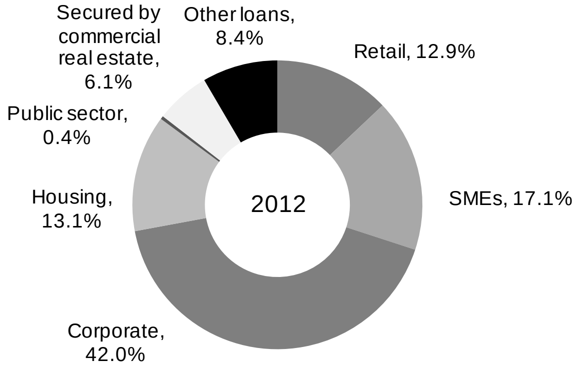
Asset Quality of Lebanese Banks' Groups (Year 2013)

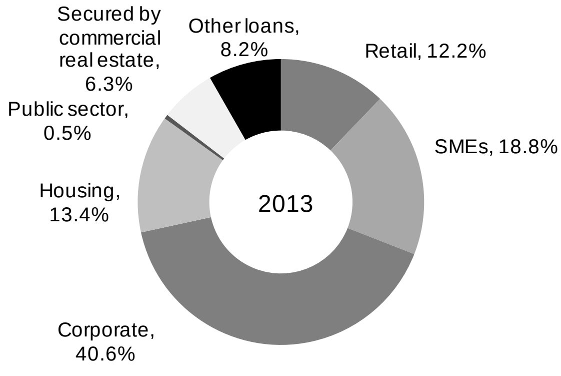
	Alpha	Beta	Gamma	Delta
Doubtful Loans/Gross loans	5.9%	8.4%	30.5%	23.9%
Substandard Loans + Doubtful Loans/Gross loans	6.8%	10.4%	32.8%	25.8%
Net Doutful Loans/Gross loans	1.4%	1.5%	2.9%	7.7%
Loan Loss Reserves on Doubtful Loans/Doubtful Loans	76.8%	81.7%	90.5%	67.7%
Net Doubtful Loans/Equity	5.2%	7.8%	5.9%	12.6%





Loans and advances breakdown





Capital Adequacy and Solvency

The Lebanese banking system reported a further reinforcement in its capitalization status in 2013. Shareholders equity rose by 8.6% in 2013, though lower than the 13.4% rise reported in 2012. The rise in equity, close to the increase in the activity base of banks, maintained the equity to assets ratio at a sound 8.9% in 2013. At the mirror image of Lebanon’s banking sector capitalization is the leverage ratio of average assets to average equity, which slightly declined from 11.3 in 2012 to 11.1 in 2013. Comparative analysis suggests that Lebanese banks have still somehow acceptable leverage relative to international benchmarks. As for the ratio of shareholders’ equity to net loans, it reported a high of 28.7%, against a regional average of 24.1%, an emerging markets average of 15.0% and a global average of 14.8%.

Lebanon is in the process of implementing Basle III capital requirements, with minimum common equity Tier 1, Tier 1 and total capital ratios of 8%, 10% and 12% respectively, which are set to be phased in by the end of 2015. Lebanese banks are well prepared to meet these more stringent capital requirements, with reportedly high Basle II Tier 1 and capital adequacy ratios, while banks’ capital is largely composed of common equity.

As a matter of fact, as per Basle II, the total capital ratio of the Lebanese banking system rose to 14.31% in 2013, against 13.86% in 2012. The total capital ratio in 2013 is the result of a total capital of US$ 15.9 billion in 2013, against total risk weighted assets of US$ 111.0 billion that represent in turn 55.8% of total assets (56.5% in 2012). It is worth mentioning that the total capital ratio is broken down over a Tier 1 ratio of 13.11% and a Tier 2 ratio of 1.21%. In turn, the Tier 1 ratio consists of a 10.00% common Tier 1 ratio and a 3.11% additional Tier 1 ratio.

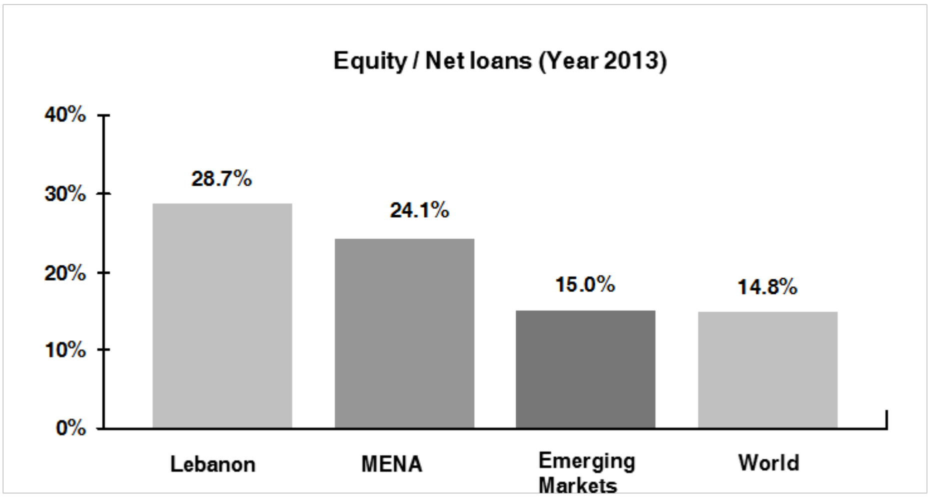
The analysis of capital adequacy by Group of banks suggests that the smaller banks are the most highly capitalized. Capital adequacy (as per Basle II requirements) reported a high of 42.4% for the Delta Group, followed by a ratio of 20.1% for the Gamma Group, 13.9% for the Alpha Group and 13.1% for the Beta Group in 2013. Likewise, the equity to assets ratio is the highest for the Delta Group with 27.6%, followed by the Gamma Group with 13.6%, the Alpha Group with 8.7% and the Beta Group with 8.1% in 2013.

Capitalization of Lebanese Banks

	2008	2009	2010	2011	2012	2013	Var 13/12
Capital adequacy (as per Basel II requirements)	12.0%	12.8%	13.1%	11.7%	13.9%	14.3%	0.4%
Equity to assets	8.6%	8.8%	9.1%	8.5%	9.0%	8.9%	-0.1%
Leverage	11.7	11.5	11.1	11.4	11.3	11.1	-0.2

Capitalization of Lebanese Banks' Groups (Year 2013)

	Alpha	Beta	Gamma	Delta
Capital Adequacy (as per Basel II requirements)	13.9%	13.1%	20.1%	42.4%
Equity Assets	8.7%	8.1%	13.6%	27.6%
Leverage	11.5	12.4	7.6	3.6



Profitability and efficiency

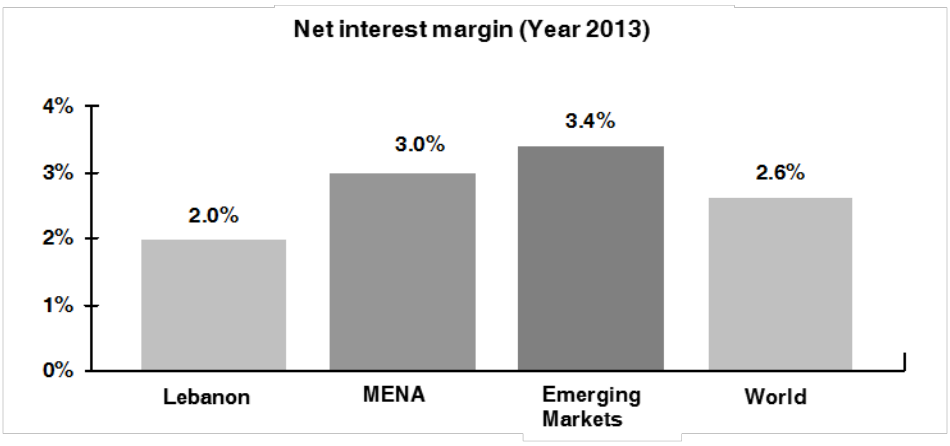
The Lebanese banking sector profitability reported a relative standstill in 2013 in an overall tough operating environment characterized by sluggish domestic economic conditions and ensuing pressures on fee income generation and a low interest rate context pressurizing interest margins and spreads. Net profits registered US$ 1,894 million, rising by a mild 0.5% relative to 2012.

Such profit stagnation comes within the context of a 5.3% growth in net interest income and a 4.2% increase in net fee and commission income leading to a 3.9% growth in total operating income, yet offset by an 8.4% rise in operating expenses, ultimately leading to stagnation in bottom lines. It is worth mentioning that the ratio of non-interest income to total income has slightly regressed in 2013 relative to 2012, from 35.5% to 34.6% respectively. The breakdown of non-interest income in 2013 shows that net fee and commission income hold the lion's share with 47.4% of non-interest income, followed by net gain on financial assets and/or investments with 31.5%, net profits on foreign exchange with 11.4% and other income with 9.6% of the total.

The various components of return ratios show that pressures on interest margins and spreads continued during 2013, and overall asset utilization and net operating margins have been on the decline, driving an overall contraction in return ratios. In details, Lebanese banks net interest margin reached 1.98% in December 2013, contracting by 8 basis points over the year (contractions of 12 basis points in LL and 6 basis points in FC). The spread contraction actually drove down asset utilization from 3.04% in 2012 to 2.90% in 2013. This was compounded with a decline in net operating margin from 35.07% to 34.36% between the two years. Despite the improvement in credit cost from 7.84% to 6.56%, the shrinkage in the operating margin was mainly driven by the increase in the cost to income ratio from 49.65% to 51.82% respectively. As a result, Lebanese banks return on average assets shrank from 1.07% to 1.00%, while their return on average equity contracted from 12.08% to 11.09% (from 13.21% to 12.13% for the return on average common equity).

The comparative global analysis shows that return on average assets and return on average equity are underperforming relative to global benchmarks. Lebanese banks' return on average assets reported 1.0% in 2013, against an average of 1.6% for the MENA region, an average of 1.8% for emerging markets and an average of 1.4% globally. In parallel, Lebanese banks' return on average equity reported 11.1% in 2013, against an average of 11.7% for the MENA region, an average of 13.4% for emerging markets and an average of 12.5% globally. As for cost to income, it reported 51.8% in Lebanon, versus 40.8% in the MENA region, 46.9% in emerging markets and 53.7% in the world at large.

The analysis by group of banks suggests that while Beta banks have reported a rise of 11.8% in their bottom line in 2013, Alpha banks reported a mild rise of 0.1%, and Delta and Gamma banks reported net contractions of 4.2% and 10.1% respectively. But return ratios seem to be directly proportional to the size of banks, with the return on average equity registering the highest ratio of 11.7% for Alpha banks, followed by Beta banks with 9.0%, Gamma banks with 6.5% and Delta banks with 4.5%. Subsequently, the larger banks displayed the highest efficiency, with a cost to income ratio of 50.0% for Alpha banks, followed by Beta banks with 63.3%, Delta banks with 66.8% and Gamma banks with 68.1%. Similarly, the cost to average assets is inversely proportional to the size of banks, with the Alpha Group reporting the lowest ratio of 1.44%, followed by the Beta Group with 1.72%, the Gamma Group with 2.07% and the Delta Group with 3.58%.

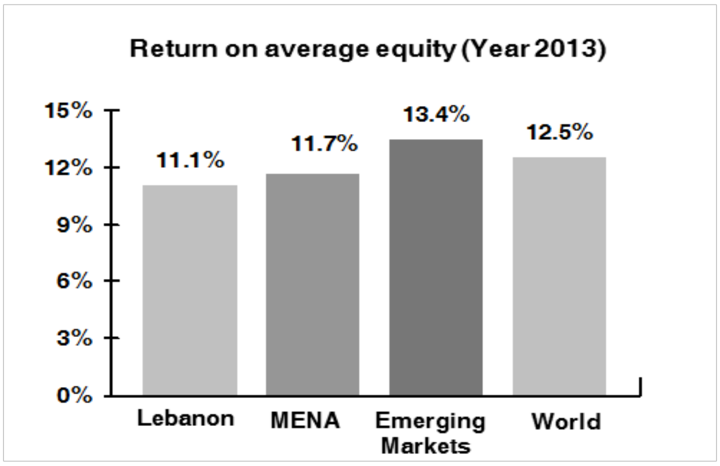


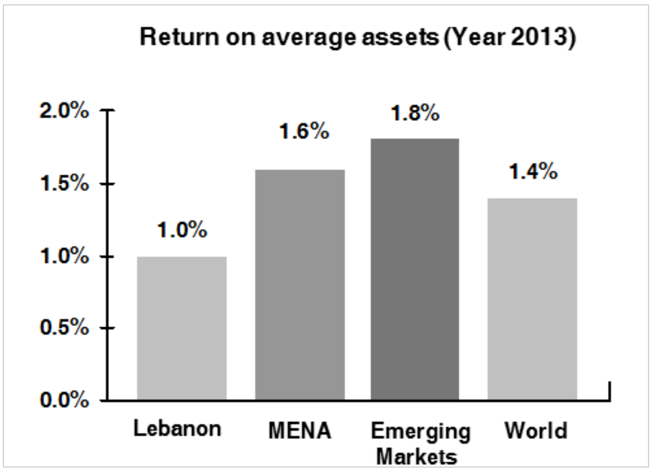
Return Ratios of Lebanese Banks

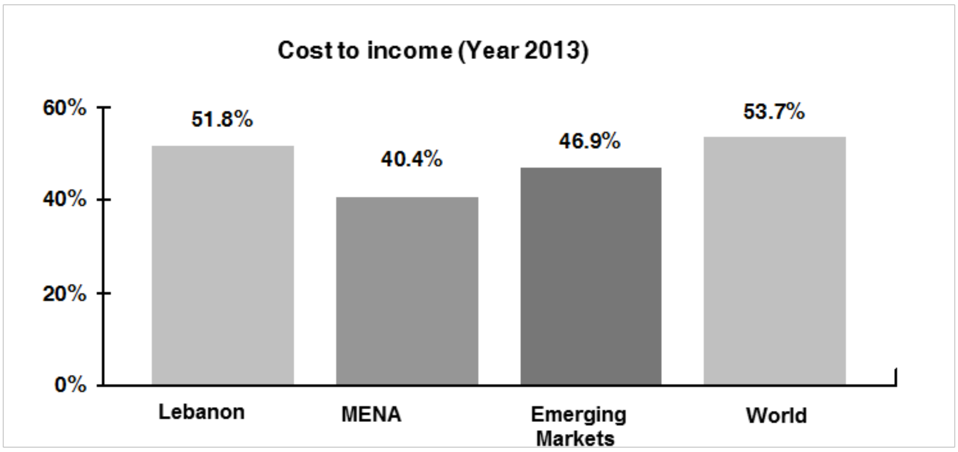
	2012	2013	Var 13/12
Yield on earning assets	5.54%	5.48%	-0.06%
o.w. in LL	*7.18%*	*6.95%*	*-0.23%*
o.w. in FX	*4.78%*	*4.80%*	*0.02%*
- Cost of earning assets	3.48%	3.50%	0.02%
o.w. in LL	*4.88%*	*4.77%*	*-0.11%*
o.w. in FX	*2.83%*	*2.92%*	*0.08%*
= Interest margin	2.06%	1.98%	-0.08%
o.w. in LL	*2.30%*	*2.18%*	*-0.12%*
o.w. in FX	*1.94%*	*1.88%*	*-0.06%*
x Average interest earnings/Average assets	95.57%	95.90%	0.33%
o.w. in LL	*95.71%*	*95.68%*	*-0.02%*
o.w. in FX	*95.50%*	*96.00%*	*0.50%*
= Spread	1.96%	1.90%	-0.07%
o.w. in LL	*2.20%*	*2.08%*	*-0.11%*
o.w. in FX	*1.86%*	*1.81%*	*-0.05%*
+ Non-interest income/Average assets	1.08%	1.00%	-0.08%
= Asset utilization	3.04%	2.90%	-0.15%
x Net operating margin	35.07%	34.36%	-0.71%
o.w. cost to income	*49.65%*	*51.82%*	*2.16%*
o.w. credit cost	*7.84%*	*6.56%*	*-1.28%*
o.w. other provisions	*-0.18%*	*-0.01%*	*0.17%*
o.w. tax cost	*7.62%*	*7.28%*	*-0.34%*
= ROAA	**1.07%**	**1.00%**	**-0.07%**
x Leverage	11.32	11.14	-0.18
= ROAE	**12.08%**	**11.09%**	**-0.99%**

Profitability of Lebanese Banks' Groups (Year 2013)

	Alpha	Beta	Gamma	Delta
Spread	1.87%	1.95%	2.28%	3.12%
Interest margin	1.94%	2.05%	2.37%	3.37%
Non-interest income/total income	35.2%	28.1%	25.1%	41.8%
ROAA	1.02%	0.73%	0.85%	1.24%
ROAE	11.7%	9.0%	6.5%	4.5%







Management efficiency of Lebanese Banks

	2008	2009	2010	2011	2012	2013	Var 13/12
Cost per average branch (US$ million)	1.65	1.73	1.87	1.88	2.01	2.11	4.8%
Staff expenses per average staff (US$ 000s)	40.5	40.5	42.2	43.0	45.8	47.8	4.3%
Staff expenses / general operating expenses (%)	53.9%	53.6%	54.0%	55.6%	54.6%	54.6%	0.0%
Cost to income (%)	52.9%	51.9%	48.2%	49.8%	49.7%	51.8%	2.1%
Cost to average assets (%)	1.64%	1.54%	1.52%	1.47%	1.51%	1.50%	-0.01%

Management efficiency of Lebanese Banks' Groups (Year 2013)

	Alpha	Beta	Gamma	Delta
Cost per average branch (US$ million)	2.19	1.54	2.05	2.68
Staff expenses per average staff (US$ 000s)	49.1	40.5	52.4	49.1
Staff expenses to general operating expenses (%)	54.8%	51.4%	60.7%	55.2%
Cost to income (%)	50.0%	63.3%	68.1%	66.8%
Cost to average assets (%)	1.44%	1.72%	2.07%	3.58%

Investment Considerations

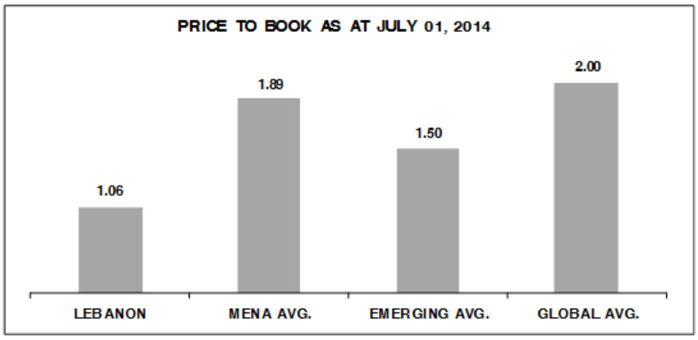
With Lebanese banks posting a tiny increase in their bottom lines while continuing to add new shares to their outstanding stock in order to further strengthen their capital base, their consolidated common earnings per share declined by 5.3% on a yearly basis to LL 642.71. This moderate decrease is also due to an increase in the common dividends distributed by Lebanese banks and which are deducted from the net earnings base when calculating the common earnings per share figures. As a matter of fact, dividends paid by banks on common shares rose by 11.9% year-on-year as banks were likely seeking to compensate shareholders for the sluggishness of domestic equity market performances. The Beirut Stock Exchange actually registered a 3.1% contraction in prices last year, and the share turnover ratio reached a very low level of 3.4% during full-year 2013, reflecting the cautious investor mood amid the prevailing politico-security climate and ensuing lackluster appetite for domestic shares.

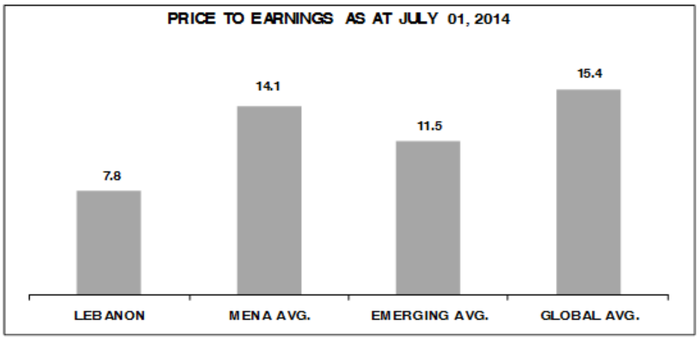
The growth in the dividends paid outpaced that of outstanding common shares pushing the common dividends per share higher by a yearly 6.2% to LL 218.25 in 2013. With the dividend base posting a healthy growth and banks' net profits almost stagnating during 2013, the common payout ratio increased from 29.24% in 2012 to 32.79% last year.

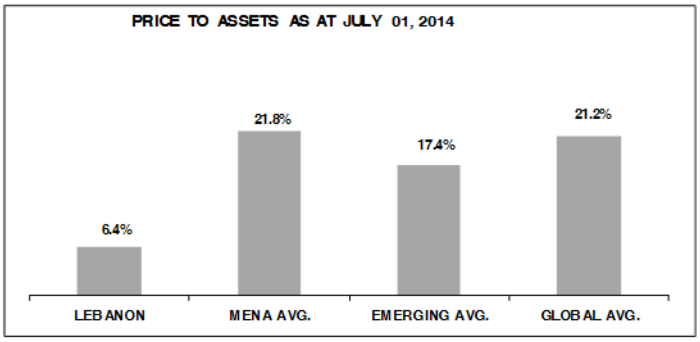
Similarly, the total payout ratio, including preferred shares which benefited from higher yearly dividends as well, inched up from 36.91% in 2012 to 40.53% one year later. It is worth noting that banks' higher capital, reserves and retained earnings fostered a slight 1.2% increase in the common book per share of the sector to LL 5,256.30 last year.

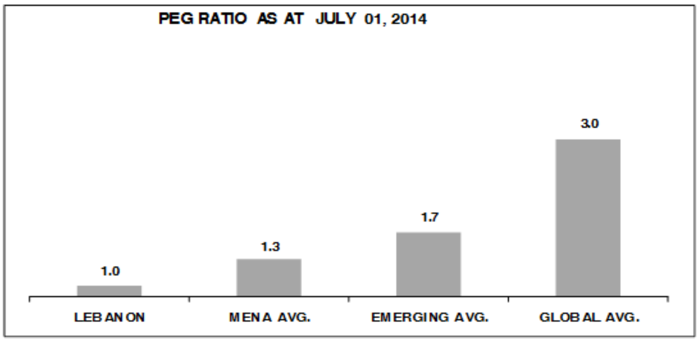
Amidst the lackluster mood on the Beirut Stock Exchange which suffers from a lack of efficiency and liquidity, Lebanese banks continue to boast relatively high dividend yields. Indeed, the average dividend yield on banking stocks for large listed Lebanese banking institutions (common and preferred altogether) attained 5.6% last year, much higher than the banking sector average for emerging markets (3.3%) and more than twice higher than the global banking sector average (2.7%).

Bearing in mind the sector's sound fundamentals on the overall and the low turnover on the Beirut bourse, Lebanese banks are still trading at a significant discount relative to regional and international peers. For instance, the large listed Lebanese banks' average P/E ratio stood at 7.8x at the closing of July 01, 2014, much lower than the regional and international averages which stand at 14.1x for MENA banks, 11.5x for emerging countries and 15.4x for the world. Also, they trade at an average P/BV of 1.06x, against much higher regional and international benchmarks in the 1.50x-2.00x range, and at a price to assets ratio of merely 6.4%, against similar averages in the 17%-22% range. The average PEG ratio, measuring current P/Es over the average EPS per annum growth of the past five years, similarly shows that Lebanese banks are trading at considerable discounts on a comparative basis. The Lebanese banks' PEG ratio stands at 0.95x on average, trading at a 27% discount to MENA banks, at a 44% discount relative to emerging markets and at a circa 68% discount to global market stocks. As such, Lebanese banks, enjoying good liquidity, healthy capitalization, adequate asset quality and satisfactory profitability on the overall, offer relative value in the global banking universe.









Sources: Bloomberg, Zawya Investor, Citigroup, IMF, Beirut Stock Exchange, Bank Audi's Group Research Department

Conclusion

Within an environment of atypical operating conditions, the Lebanese banking system has demonstrated a significant deal of resilience, bearing witness to a sound activity growth while keeping a strong financial standing. The analysis of activity performance indicators and comparative risk metrics throughout this study suggests that Lebanese banks have been faring well with the challenging operating environment, ensuring a sound coverage of all types of exposures on the back of a rigorous risk profile and a conservative financial management at large. Besides a couple of small M&A transactions, no significant consolidation operation took place during the past year. Also, Lebanese banks didn't undergo significant cross border expansions, in view of risks surrounding a number of regional markets on one hand and considerable barriers to entry in other markets on the other hand. Lebanese banks focused on consolidating their positioning in their domestic market and ensuring an adequate risk coverage in their regional markets of presence.

The main challenge of the past year remains that tied to profitability, with bottom lines stagnating throughout 2013 and with return ratios reporting a net reduction relative to the previous year. This profit standstill comes within the context of a persistently low interest rate environment putting pressure on spreads and interest margins, a sluggish domestic economic context confining the growth in non-interest income, in addition to considerable provisioning requirements mainly tied to regional markets of presence in the aftermath of the turmoil of the past few years.

Having said that, Lebanese banks are well positioned today to take advantage of any trend reversal in their domestic market or in regional markets of presence. Their strong financial fundamentals, their well diversified activity profile, their innovative management philosophies, their pioneering services and product mix, all put them in an adequate position to reap the benefits of a pent-up demand for financial services in a number of underbanked markets that have significant growth prospects in the middle to long run. Notwithstanding the potential for new expansions to captive markets in the region and outside it, where they can export their universal banking profiles to lucrative markets that are looking for further financial sector development.