LEBANON BANKING SECTOR REPORT

ADEQUATE RISK METRICS IN AN INCREASINGLY CHALLENGING OPERATING ENVIRONMENT

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- **Resilient banking activity despite growth slowdown**
  Within an atypical environment domestically and in foreign markets of presence, the Lebanese banking sector continued to be relatively resilient to tough operating conditions in 2017, displaying acceptable profit metrics and a persistently consistent risk profile, while its growth performance has been less pronounced than in previous years. All in all, the banking sector activity grew by 6.9% in 2017 (8.1% domestically and 0.2% abroad), to reach an asset base of US$ 258 billion. The main activity driver, customer deposits, grew by US$ 6.4 billion in 2017, rising by 3.3% on an annual basis, lower than previous years' growth (average previous 5-year growth of 7%), noting that the 2017 full year growth was impacted by the relative November outflows driven by the resignation crisis before its settlement by year-end and that renewed with positive deposit growth.

- **Persistently good financial standing amid sound risk metrics**
  The banks' slowing down growth performance in 2017 was yet coupled with good financial standing which continued to bear witness to a strong liquidity, good asset quality, adequate capitalization and satisfactory profitability. Regarding liquidity, net primary liquidity placed with central banks and foreign banks represented 39.8% of customer deposits as at end-December 2017, up from 35.2% at end-December 2016, a high level when compared to regional and global averages.

- **Relative stability in asset quality despite delicate operating conditions**
  Despite the delicate operating conditions across a number of countries of presence, lending quality reported a relative stability over the past year, as the consolidated gross doubtful loans continued to represent 6.7% of gross loans at end-December 2017, somewhat similar to the end-2016 level. When accounting for loan loss provisions, the ratio of net doubtful loans to gross loans stood at 1.6%, reaching 3.2% upon including substandard loans, which still compares favorably to international benchmarks. As to collective provisioning, the ratio of collective provisions to net loans maintained its sound 1.6% by end-2017.

- **Further reinforcement in capital adequacy**
  Concerning capitalization, the Lebanese banking system reported a further reinforcement in its capitalization status in 2017. Lebanese banks' shareholders' equity grew by 6.6% over the past year, to reach US$ 24.7 billion at end-December. The total Basel II capital adequacy ratio reported 16.82% at end-December 2017 as compared to 16.49% at end-December 2016, well exceeding requirements and reflecting an adequate coverage of the aggregation of credit, market and operational risks. .

- **Return ratios short of global benchmarks despite profit growth**
  Moving on to profitability, a slight rise was witnessed in the Lebanese banking sector's consolidated net profits to reach US$ 2.6 billion in 2017, growing by 4.4% from the previous year. Subsequently, the return on average assets stabilized at 1.04% in 2017, while the return on average common equity dropped from 12.18% to 11.76%. Lebanon's return ratios yet came short of global benchmarks, especially as the return on equity continues to lag behind the overall cost of equity for the sector.

- **Attractive valuation ratios in a weakly traded equity market**
  As to investment considerations, even though Lebanese banks' shares continue to be impacted by the very little liquidity and turnover in the equity market affecting their multiples, they still arouse investors' attention mainly with respect to their long-established resilience to tough operating conditions, sustainably healthy fundamentals, enticing dividend returns and attractive market pricing ratios.

The following banking sector research is based on "consolidated" Lebanese banking figures as at end-2017 as provided by Bankdata Financial Services. It aims at an in-depth analysis of Lebanon's banking industry, with a thorough investigation of banks' performance drivers, their current financial standing and their overall risk profile.

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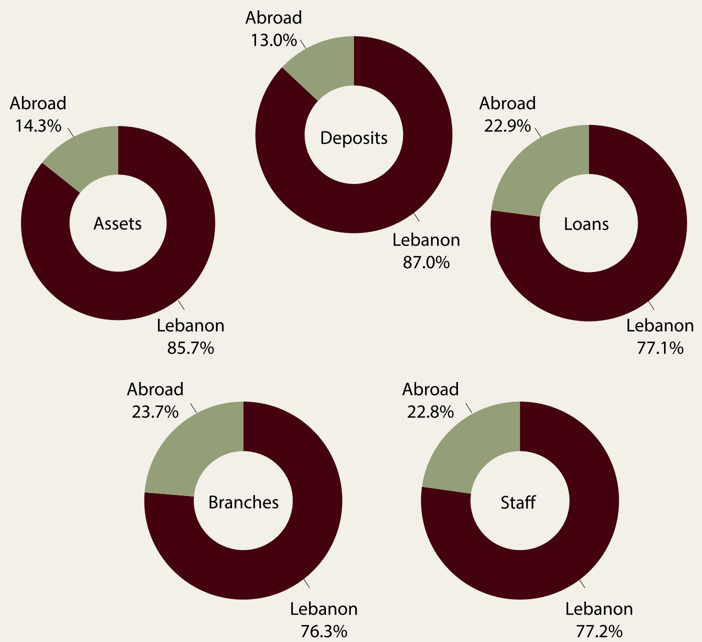
Within an atypical overall environment, the consolidated activity of Lebanese banks continued to grow at satisfactory growth rates over the past year. Domestically, Lebanon's banking sector had to face the repercussions of the short-lived political crisis in November, which had yielded some deposit outflows. The return to stability in December helped improve operating conditions and saw money flows flocking back to the country also partly due to some year-end window-dressing operations. Externally, the tough operating conditions coupled with exchange rate depreciation in some markets of presence limited the growth potential.

All in all, the banking sector activity grew by 6.9% in 2017 (8.1% domestically and 0.2% abroad), with asset growth reporting US$ 16.5 billion to reach US$ 257.8 billion at year-end. Out of consolidated figures, the share of foreign entities represent 14.3% for assets, 13.0% for deposits, 22.9% for loans, 23.7% for branches and 22.8% for staff as at end-2017.

Having said that, the main activity growth driver, i.e. customer deposits, slowed down in 2017. They grew by US$ 6.4 billion in full year 2017, rising by 3.3% on an annual basis, lower than previous years' growth (average previous 5-year growth of 7%), noting that the 2017 full year growth was impacted by the temporary November outflows. While it is true that the 2017 deposit growth lagged behind, this is partly due to the November outflows and the one-off deposit inflows to the domestic banking sector in light of the BDL financial engineering operations that took place in 2016.

A look at banking deposits by currency shows that LL deposits contracted by the equivalent of US$ 2.2 billion, while those in foreign currencies surged by US$ 8.6 billion. Apart from the wave of currency conversions seen in the first five months of the year (prior to the renewal of the BDL Governor term), the month of November 2017 was largely responsible for the decline in LL deposits in full year 2017. In fact, LL deposits dropped significantly in November, before recouping some of the losses in December amid higher interest rates granted on LL accounts. Given the conversions into foreign currencies in November and the earlier part of 2017, foreign currency deposits were the sole driver of total deposit growth in 2017. As such, the deposit dollarization ratio rose to 71.5% at end-December 2017 (67.2% for domestic deposit dollarization), against 69.4% at end-2016 (64.4% for domestic deposit dollarization), noting that this is its highest level in a decade.

GEOGRAPHIC CONCENTRATION (YEAR 2017)



Source: Bankdata Financial Services wll

At the level of lending activity, loans saw a US$ 1.7 billion increase in full year 2017, or 2.3%, marking a slightly higher volume growth relative to the year 2016 but remaining slow on the overall. This slight rise comes within the context of a tiny amelioration in economic activity following the Presidential elections and cabinet formation at the end of 2016, along with BDL support through subsidized lending programs. In this respect, consolidated figures show a US$ 2.7 billion increase in LL loans along with a US$ 975 million contraction in foreign currency loans. In other terms, BDL measures aimed at fostering local currency loans drove LL loans to keep total lending activity growth in positive territory in 2017.

This lead the loan dollarization ratio to continue on its declining trend and close the year at a record low of 75.3% (68.0% for domestic loan dollarization). Domestically, the spread between loan dollarization and deposit dollarization shrank to a new low of 0.8% at end-2017, suggesting that the Lebanese Pound is increasingly regaining its role as a standard of deferred payment while slightly losing part of its role as a store of value.

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 2017 was realized by the Delta and Beta groups displaying a growth rate of 31.4 and 12.2% respectively, while the Gamma Group reported a growth of 9.5%, and the Alpha Group's assets rose by 6.1%.

But banking activity continues to be significantly concentrated, with no significant changes in the shares of the different bank groups. The Alpha Group's share remains highly dominant at 90.3% of the sector's consolidated assets (90.9% in 2016), followed by the Beta Group with 7.5% (7.1% in 2016), the Delta Group with 1.2% (1.0% in 2016) and the Gamma Group with 1.0% (0.9% in 2016).

The analysis of Lebanese banks groups by dollarization ratios suggests that the group of large banks is the most dollarized in terms of deposits and loans. Deposit dollarization stands at 72.1% for the Alpha Group followed by 65.4% for the Beta Group, 63.6% for the Gamma Group and 63.4% for the Delta Group. On the other hand, loan dollarization is the largest for the Alpha Group with 77.9%, followed by 66.3% for the Beta Group, 63.2% for the Gamma Group, and 21.8% for the Delta Group.

GROWTH RATES OF BANKING AGGREGATES

	2011	2012	2013	2014	2015	2016	2017	Var 17/16
Assets	7.9%	8.4%	9.6%	9.3%	4.8%	5.9%	6.9%	1.0%
Loans to customers	13.6%	11.4%	15.1%	11.0%	5.6%	2.0%	2.3%	0.3%
Customer deposits	7.4%	8.8%	9.6%	8.5%	4.5%	3.6%	3.3%	-0.3%
Shareholders' equity	1.9%	13.4%	8.5%	10.8%	6.9%	9.9%	6.6%	-3.3%
Annual L/C openings	-8.4%	-5.3%	-5.8%	1.5%	-21.0%	5.8%	14.5%	8.7%
Net profits for the year	-4.7%	7.6%	0.2%	9.1%	6.9%	12.6%	4.4%	-8.2%

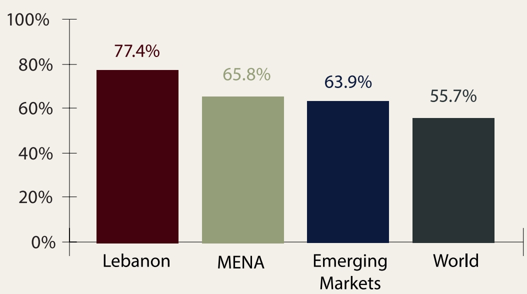
Source: Bankdata Financial Services wll

GROWTH RATES OF LEBANESE BANKS' GROUPS (YEAR 2017)

	Alpha	Beta	Gamma	Delta
Assets	6.1%	12.2%	9.5%	31.4%
Loans to customers	0.8%	8.1%	-4.0%	56.9%
Deposits from customers	3.0%	5.9%	5.3%	9.5%
Shareholders' equity	5.9%	16.0%	5.5%	7.8%
Total L/C openings of the year	13.7%	40.5%	-30.8%	-56.7%
Net profits for the year	4.8%	-9.0%	133.1%	17.7%

Source: Bankdata Financial Services wll

DEPOSITS/ASSETS RATIOS (YEAR 2017)



Sources: Bankdata Financial Services, IMF, Orbis Bank Focus, Fitch, MENA Central Banks

LIQUIDITY AND SOVEREIGN EXPOSURE

The banks' growth performance was coupled with good financial standing which continued to bear witness to a strong liquidity. Net primary liquidity placed with central banks and foreign banks represented 39.75% of their customer deposits as at end-December 2017, up from 35.15% at end-December 2016, a high level when compared to regional and global averages. Liquidity remains increasingly placed at the Central Bank which in turn has prime liquid assets abroad. The ratio of liquidity at the Central Bank as a percentage of assets rose from 26.49% in 2016 to 31.93% in 2017, while liquidity in foreign banks was stable at around 8% of total assets over the past two years.

The rise in the banks placements at the Central Bank follow attractive financial engineering operations undertaken in 2017. In June, commercial banks were allowed to place their local currency liquidity with the BDL at rates that were 1% above the yield curve, on condition that the banks also deposit with BDL equivalent amounts in US dollars. The US dollar deposits received yields that were 0.5% above market rates. The September operations allowed banks to benefit from LL facilities at 2% against placing long-term foreign currency term deposits at BDL for a minimum of five years, provided that the LL proceeds are used to purchase LL Treasury securities from the primary or secondary market.

The analysis of liquidity by currency in 2017 suggests that liquidity is increasingly sound in both LL and in foreign currencies. Net primary liquidity in LL as a percentage of deposits in LL rose from 37.55% in 2016 to 38.79% in 2017. Net primary liquidity in FX as a percentage of deposits in FX rose from 34.09% in 2016 to 40.13% in 2017. Those liquidity ratios come on the back of a low transformation ratio of loans to deposits at 38.00% (32.87% in LL and 40.05% in FX).

In parallel, as a result of the Lebanese banks' net sales of Lebanese Eurobonds to foreigners in 2017 to replenish their foreign currency prime liquidity, the Lebanese banks' Eurobond portfolio fell from US$ 16.2 billion in December 2016 (12.06% of FX deposits) to US$ 14.9 billion (10.44% of FX deposits) in December 2017. Lebanese banks indeed enhanced their sales efforts with foreign investors holding Lebanese Eurobonds and that are mainly underweight relative to the bond indices. As such, the Lebanese banks' sovereign Eurobond portfolio is now increasingly below their consolidated shareholders' equity, which sheds light on the improving sovereign exposure profile. The ratio of Lebanese sovereign Eurobonds to shareholders equity fell from 69.95% at end-2016 to 60.42% at end-2017.

The analysis of liquidity by Lebanese banks' groups in 2017 shows that liquidity is correlated with the size of banks. The most liquid group is the Alpha Group with a ratio of 41.46%, followed by the Gamma Group with a ratio of 35.77%, the Beta Group with a net primary liquidity to deposits ratio of 27.80%, and the Delta Group with a negative ratio as it holds a significantly large amount of government paper among its asset base.

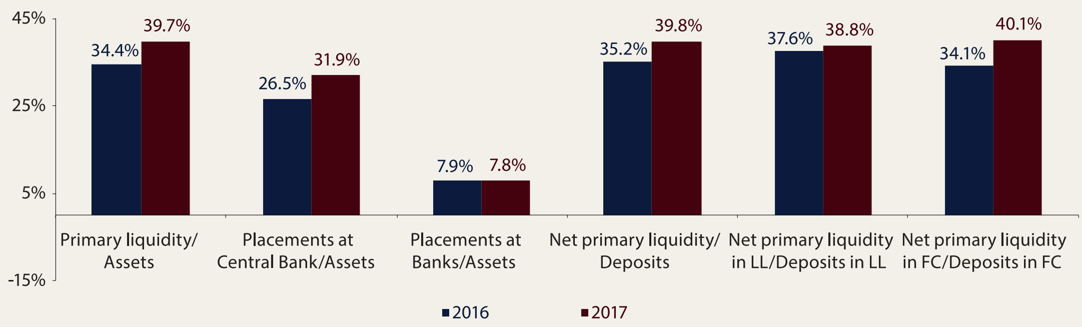
The analysis of sovereign exposure by Lebanese banks' groups in 2017 suggests that sovereign exposure seems to be almost inversely related to the size of banks. The group with the highest exposure in Lebanese Pounds is the Delta Group with a ratio of Lebanese Treasury bills in LL to deposits in LL of 58.82%, followed by the Beta Group with 43.21%, the Alpha Group with 30.12%, and the Gamma Group with 26.57%. In parallel, the group with the highest exposure in foreign currency in 2017 is the Gamma Group with a ratio of Lebanese sovereign Eurobonds to deposits in foreign currency of 32.16%, followed by the Delta Group at 22.37%, the Beta Group with 13.67% and the Alpha Group with 10.02%. Nonetheless, the large banks tend to have the largest Central Bank exposure in relative terms. As a percentage of their asset base, placements at the Central Bank represent 32.83% for the Alpha Group, followed by the Gamma Group with 26.44%, the Beta Group with 24.98% and the Delta Group with 11.89% at end-2017.

LIQUIDITY OF LEBANESE BANKS' GROUPS (YEAR 2017)

	Alpha	Beta	Gamma	Delta
Primary liquidity/Assets	**40.6%**	**31.5%**	**48.8%**	**20.6%**
o.w. Central Bank/Assets	32.8%	25.0%	26.4%	11.9%
o.w. Banks/Assets	7.8%	6.5%	22.4%	8.7%
Net primary liquidity/Deposits	**41.5%**	**27.8%**	**35.8%**	**-138.1%**
o.w. Net primary liquidity in LL/Deposits in LL	43.4%	12.4%	62.6%	-365.5%
o.w. Net primary liquidity in FC/Deposits in FC	40.7%	35.9%	20.4%	-6.6%

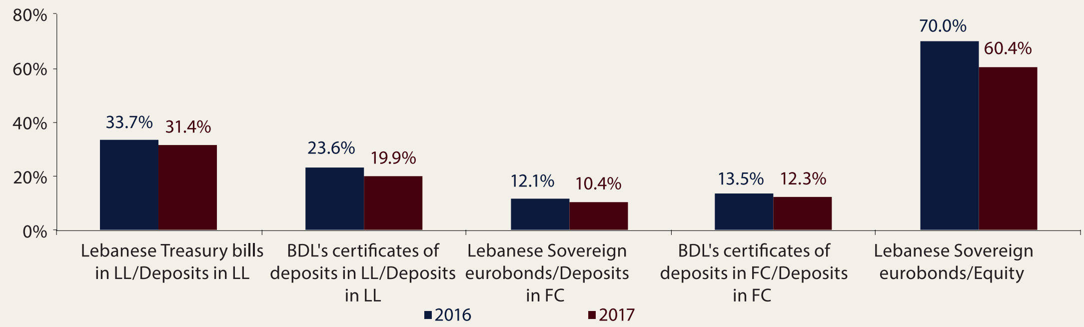
Source: Bankdata Financial Services wll

LIQUIDITY OF LEBANESE BANKS



Source: Bankdata Financial Services wll

SOVEREIGN EXPOSURE OF LEBANESE BANKS



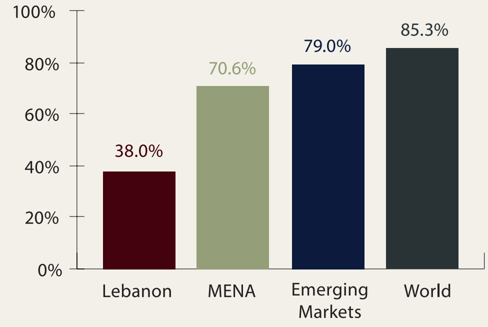
Source: Bankdata Financial Services wll

SOVEREIGN EXPOSURE OF LEBANESE BANKS' GROUPS (YEAR 2017)

	Alpha	Beta	Gamma	Delta
Lebanese Treasury bills in LL/Deposits in LL	30.1%	43.2%	26.6%	58.8%
BDL's certificates of deposits in LL/Deposits in LL	20.6%	14.9%	14.9%	0.9%
Lebanese Sovereign eurobonds/Deposits in FC	10.0%	13.7%	32.2%	22.4%
BDL's certificates of deposits in FC/Deposits in FC	12.5%	9.6%	6.3%	13.7%
Lebanese Sovereign eurobonds/Equity	60.6%	71.3%	73.9%	15.6%

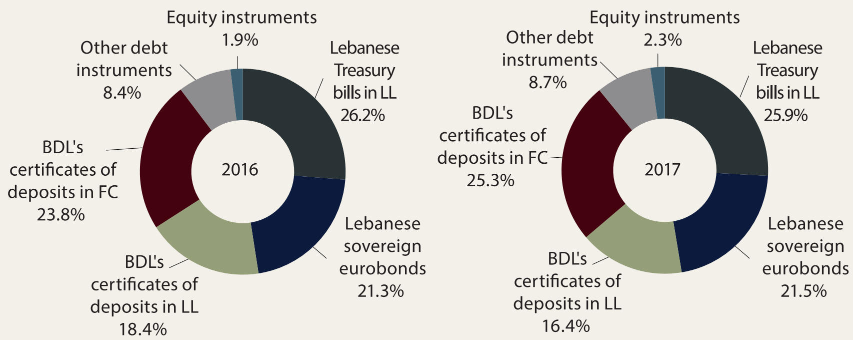
Source: Bankdata Financial Services wll

LOANS/DEPOSITS (YEAR 2017)



Sources: Bankdata Financial Services, IMF, Orbis Bank Focus, Fitch, MENA Central Banks

PORTFOLIO SECURITIES BREAKDOWN



Source: Bankdata Financial Services wll

LENDING QUALITY AND PROVISIONING

Bank lending activity continued its slow pace in 2017, amidst a scarcity in lending opportunities in a mild economic growth environment locally and tough operating conditions in foreign markets of presence. As a matter of fact, Lebanese banks reported last year a shy increase in lending activity of 2.3%, with consolidated net loans reaching US$ 75.8 billion at end-December 2017. The growth in total loans was attributed mainly to local currency loans amid contracting foreign currency loans. This falls in line with the trend observed over the previous few years when Lebanese banks, encouraged by the Central Bank's measures aimed at fostering local currency lending, increased their share of LL loans in the total, and thus reflecting the return of the Lira as a standard of deferred payment. As a result, the loan dollarization ratio extended its decline, reaching 75.3% at end-December 2017, against 78.4% at end-December 2016. It is worth mentioning that the breakdown of bank loans by type of borrower reveals that corporates accounted for 38% of loans extended in 2017, followed by housing loans and SMEs loans with 17% each.

BREAKDOWN OF LOANS AND ADVANCES TO CUSTOMERS (% OF TOTAL LOANS) IN 2017

	All Banks	Alpha Group	Beta Group	Gamma Group	Delta Group
Corporate	38%	37%	42%	46%	42%
SMEs	17%	16%	24%	31%	1%
Housing	17%	17%	11%	5%	48%
Retail	11%	11%	6%	9%	1%
Secured by commercial real estate	9%	9%	14%	4%	0%
Other loans	8%	9%	2%	5%	7%
Public sector	1%	1%	0%	-	-

Source: Bankdata Financial Services wll

In parallel, despite the delicate operating conditions across a number of countries of presence, asset quality reported a relative stability over the past year, as the consolidated gross doubtful loans continued to represent 6.68% only of gross loans at end-December 2017, somewhat similar to the end-2016 level of 6.54%, while reaching 8.61% when including substandard loans (slightly up from 8.00% at end-December 2016). It is important to mention that the ratio of net doubtful loans to gross loans stood at 1.63%, reaching 3.24% when including substandard loans, which still compares favorably to international benchmarks. In parallel, the coverage ratio of doubtful loans by specific provisions reported 75.65% last year, from 75.83% at end-December 2016, leading to a coverage of the total loan portfolio by loan loss provisions to 6.83%, up from 6.63%. As to collective provisioning, the ratio of collective provisions to net loans maintained its sound 1.57% by end-2017.

The analysis by group of banks suggests the Alpha Group reported the lowest doubtful loans to gross loans ratio of 5.88%, followed by the Beta Group with 8.24%, the Delta Group with 10.77% and the Gamma Group with 45.32%. But when adding substandard loans, the ratio of doubtful and substandard loans to gross loans reported a low of 7.53% for the Alpha Group, 12.51% for the Delta Group, 12.84% for the Beta Group and 46.47% for the Gamma Group. On the other hand, smaller sized banks were the best provisioned, the ratio of loan loss reserves on doubtful loans as a percentage of doubtful loans reporting high ratios of 97.09% for the Gamma Group, while the Beta and Alpha Group registered ratios of 76.46% and 74.01% respectively while the Delta group recorded a ratio of 63.89%.

ASSET QUALITY OF LEBANESE BANKS

	2011	2012	2013	2014	2015	2016	2017	Var 17/16
Doubtful loans/Gross loans	6.9%	7.1%	6.8%	6.6%	6.4%	6.5%	6.7%	0.1%
Substandard loans + Doubtful loans/Gross loans	7.7%	7.8%	7.8%	7.4%	7.3%	8.0%	8.6%	0.6%
Net doubtful loans/ Gross loans	1.3%	1.4%	1.5%	1.5%	1.6%	1.6%	1.6%	0.0%
Loan loss reserves on doubtful loans/Doubtful loans	81.8%	79.6%	78.3%	77.3%	75.4%	75.8%	75.7%	-0.2%
Net doubtful loans/Equity	4.6%	5.1%	5.5%	5.5%	5.8%	5.4%	5.4%	-0.1%

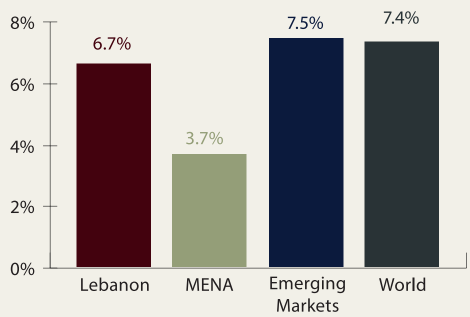
Source: Bankdata Financial Services wll

ASSET QUALITY OF LEBANESE BANKS' GROUPS (YEAR 2017)

	Alpha	Beta	Gamma	Delta
Doubtful loans/Gross loans	5.9%	8.2%	45.3%	10.8%
Substandard loans + Doubtful loans/Gross loans	7.5%	12.8%	46.5%	12.5%
Net doubtful loans/Gross loans	1.5%	1.9%	1.3%	3.9%
Loan loss reserves on doubtful loans/Doubtful loans	74.0%	76.5%	97.1%	63.9%
Net doubtful loans/Equity	5.0%	7.9%	3.4%	12.7%

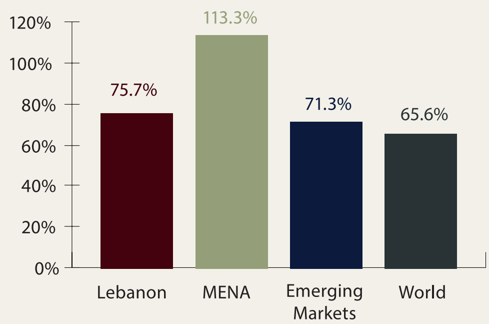
Source: Bankdata Financial Services wll

NPLs/TOTAL LOANS (YEAR 2017)



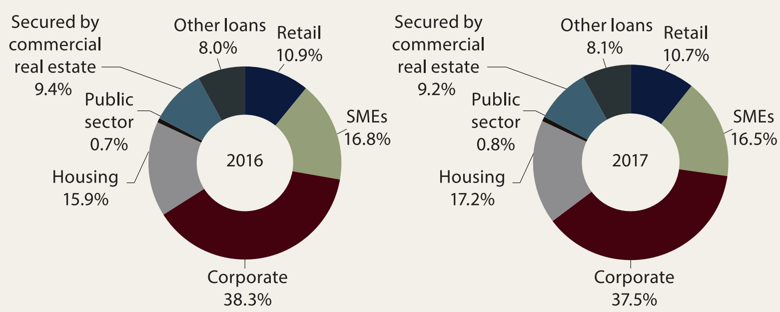
Sources: Bankdata Financial Services, IMF, Orbis Bank Focus, Fitch, MENA Central Banks

LLRs/NPLs (YEAR 2017)



Sources: Bankdata Financial Services, IMF, Orbis Bank Focus, Fitch, MENA Central Banks

LOANS AND ADVANCES BREAKDOWN



Source: Bankdata Financial Services wll

CAPITAL ADEQUACY AND SOLVENCY

The Lebanese banking system reported a further reinforcement in its capitalization status in 2017. Lebanese banks' shareholders' equity grew by 6.6% over the past year, moving from US$ 23.1 billion at end-December 2016 to US$ 24.7 billion at end-December 2017, though lower than the 9.9% growth reported in 2016. The equity-to-asset ratio remained quoted at a high level of 9.57% in 2017, with no change relative to the previous year, amid a US$ 16.5 billion growth in total assets and a US$ 1.5 billion rise in total shareholders' equity over the year. A related measure is the ratio of shareholders' equity to net loans which reached 32.5% for Lebanon's banking sector at end-2017, against a regional average of 24.3% and an average of 15.0% in emerging markets and in the world at large. At the mirror image of Lebanon's banking sector capitalization is the leverage ratio of average assets to average equity, which went down from 10.63 in 2016 to 10.45 in 2017.

Indeed, Lebanese banks remained adequately capitalized on the overall. The total Basel II capital adequacy ratio reported 16.82% at end-December 2017 as compared to 16.49% at end-December 2016, well exceeding requirements and reflecting an adequate coverage of the aggregation of credit, market and operational risks. The sound capital adequacy ratio in 2017 comes within the context of a total capital of US$ 23.1 billion in 2017 against a total of risk-weighted assets of US$ 137.3 billion amid a declining share of risk-weighted assets in total assets from 54.1% in 2016 to 53.3% in 2017. It is worth mentioning that the total capital ratio is broken down over a Tier 1 ratio of 15.07% and a Tier 2 ratio of 1.75%. In turn, the Tier 1 ratio consists of a 12.11% common Tier 1 ratio and a 2.96% additional Tier 1 ratio.

The analysis of capital adequacy by Group of banks suggests that the small banks are the most capitalized relative to the size of their activity. Capital adequacy (as per Basle II requirements) reported a high of 28.39% for the Delta Group, followed by a ratio of 17.71% for the Gamma Group, 16.69% for the Alpha Group and 16.15% for the Beta Group in 2017. Likewise, while Alpha and Beta Groups reported equity to asset ratios of 9.34% and 9.72% respectively, the Gamma and Delta Groups reported levels of 14.68% and 20.75% respectively in 2017.

CAPITALIZATION OF LEBANESE BANKS

	2011	2012	2013	2014	2015	2016	2017	Var 17/16
Capital adequacy (as per Basel II requirements)	11.8%	13.8%	14.2%	14.6%	15.1%	16.5%	16.8%	0.3%
Equity to assets	8.5%	9.0%	8.9%	9.1%	9.2%	9.6%	9.6%	0.0%
Leverage (times)	11.4	11.3	11.1	11.1	10.9	10.6	10.5	-0.2

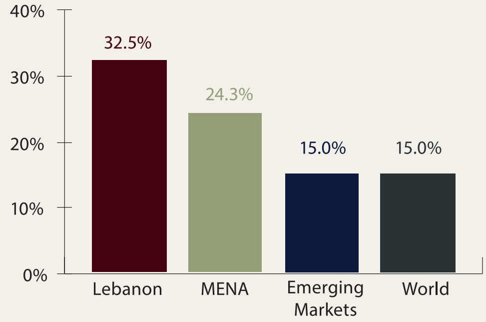
Source: Bankdata Financial Services wll

CAPITALIZATION OF LEBANESE BANKS' GROUPS (YEAR 2017)

	Alpha	Beta	Gamma	Delta
Capital adequacy (as per Basel II requirements)	16.7%	16.2%	17.7%	28.4%
Equity/Assets	9.3%	9.7%	14.7%	20.8%
Leverage (times)	10.7	10.5	6.7	4.4

Source: Bankdata Financial Services wll

EQUITY/NET LOANS (YEAR 2017)



Sources: Bankdata Financial Services, IMF, Orbis Bank Focus, Fitch, MENA Central Banks

PROFITABILITY

Moving on to profitability, a slight rise was witnessed in the Lebanese banking sector's consolidated net profits to reach US$ 2.6 billion in 2017, growing by 4.4% from the previous year. Should we exclude the result of discontinued operations, profits after tax from operating activities would have posted a decrease of 6.0% year-on-year in 2017.

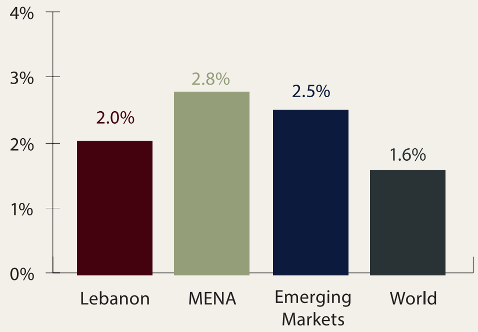
At the level of return ratios, results were mixed with the return on average assets stabilizing at 1.04% in 2017 (1.06% in 2016), while the return on average common equity dropped from 12.18% to 11.76%. The components of Lebanon's return ratios suggest that the LL spread rose by 34 bps moving from 1.87% to 2.21%, the FC spread declined by 14 bps moving from 1.95% to 1.81%, coupled with a decline in the ratio of non-interest income to average assets from 1.66% to 0.93%, generating a retreat in asset utilization from 3.58% to 2.87%. This was yet offset by a noticeable rise in the net operating margin from 29.52% to 36.11%, mainly tied to the drop in credit cost from 14.71% to 6.65%, while cost to income rose from 44.30% to 49.06% over the same period. It is yet worth mentioning that both the asset utilization ratio and the credit cost ratio of 2016 were inflated on the one hand by the non-recurrent revenues and on the other hand by the BDL requirement for banks to use their exceptional revenues in one-time extra provisions.

Moving on to a comparative global analysis, Lebanon's return on average assets and return on average equity ratios came short of global benchmarks. The local banking sector's return on average assets attained 1.04% in 2017, below an average of 1.5% for the MENA region, an average of 2.0% for emerging markets and an average of 1.7% globally. At the same time, Lebanese banks' return on average equity reported 10.84% in 2017, compared to an average of 11.0% for the MENA region, an average of 15.2% for emerging markets and an average of 13.6% for the global benchmark.

Regarding the profitability of banks by group, Alpha, Delta and Gamma banks reported profit expansions of 4.8%, 17.7%, and 133.1% respectively, while Beta banks witnessed a contraction of 9.0% in their bottom line in 2017. With regards to return ratios, they seem to be almost positively correlated with the size of banks, with the return on average equity registering the highest ratio of 11.27% for Alpha banks in 2017, 8.70% for Beta banks, followed by Delta banks with 5.84% and Gamma banks with 4.78%. Interest margin reported a low of 1.87% for Beta banks, followed by 2.02% for Alpha banks, 2.32% for Gamma banks and 3.87% for Delta banks. The share of non-interest income to total income reported 23.36% for Gamma banks, 30.87% for Delta banks, 32.14% for Alpha banks, and 36.58% for Beta banks.

Last but not least, the Alpha banks group proved to be among the most efficient due to the economies of scale and strong organizational structures. One of the lowest cost-to income ratios was reported by Alpha banks at 48.01%. The Delta banks group had a close ratio of 47.81%, while Beta banks reported 60.01%, and Gamma banks 69.08%. Parallel to the cost-to-income ratio, the cost-to-average assets fell as the size of banks increased. Banks in the Alpha group posted the lowest ratio of 1.37%, followed by the Beta Group with 1.69%, the Gamma Group with 1.91% and the Delta Group with 2.48% in 2017.

NET INTEREST MARGIN (YEAR 2017)



Sources: Bankdata Financial Services, IMF, Orbis Bank Focus, Fitch, MENA Central Banks

RETURN RATIOS OF LEBANESE BANKS

	2016	2017	Var 17/16
Yield on earning assets	5.8%	6.1%	0.3%
o.w. in LL	6.6%	6.8%	0.2%
o.w. in FX	5.4%	5.7%	0.3%
- Cost of earning assets	3.8%	4.0%	0.3%
o.w. in LL	4.6%	4.5%	-0.1%
o.w. in FX	3.4%	3.8%	0.4%
= Interest margin	2.0%	2.0%	0.0%
o.w. in LL	2.0%	2.3%	0.4%
o.w. in FX	2.0%	1.9%	-0.1%
x Average interest earning assets/Average assets	96.0%	95.7%	-0.3%
o.w. in LL	95.5%	95.6%	0.2%
o.w. in FX	96.2%	95.7%	-0.5%
= Spread	1.9%	1.9%	0.0%
o.w. in LL	1.9%	2.2%	0.3%
o.w. in FX	2.0%	1.8%	-0.1%
+ Non interest income/Average assets	1.7%	0.9%	-0.7%
= Asset utilization	3.6%	2.9%	-0.7%
x Net operating margin	29.4%	36.1%	6.6%
o.w. cost-to-income	44.3%	49.1%	4.8%
o.w. credit cost	14.7%	6.7%	-8.1%
o.w. other provisions	1.8%	0.1%	-1.6%
o.w. tax cost	9.7%	8.1%	-1.6%
= ROAA	**1.1%**	**1.0%**	**0.0%**
x Leverage	10.6	10.5	-0.2
= ROAE	**11.2%**	**10.8%**	**-0.4%**

Source: Bankdata Financial Services wll

NON INTEREST INCOME OF LEBANESE BANKS

	2012	2013	2014	2015	2016	2017	Var 17/16
Non interest income/Total income	35.5%	33.9%	33.6%	33.0%	46.2%	32.4%	-13.9%
Net fees and commissions/Average assets	0.5%	0.5%	0.5%	0.5%	0.7%	0.4%	-0.3%
Operating expenses/Average assets	1.5%	1.5%	1.5%	1.4%	1.6%	1.4%	-0.2%
Credit cost/Pre-provision, pre-tax profit	15.6%	13.9%	13.5%	15.2%	25.5%	13.4%	-12.1%
Income tax/Profit before tax	17.9%	17.5%	18.3%	18.4%	23.4%	18.8%	-4.6%

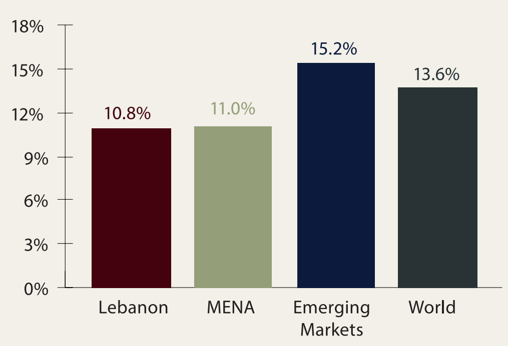
Source: Bankdata Financial Services wll

PROFITABILITY OF LEBANESE BANKS' GROUPS (YEAR 2017)

	Alpha	Beta	Gamma	Delta
Spread	1.93%	1.78%	2.12%	3.59%
Interest margin	2.02%	1.87%	2.32%	3.87%
Non-interest income/total income	32.14%	36.58%	23.36%	30.87%
ROAA	1.05%	0.83%	0.71%	1.33%
ROAE	11.27%	8.70%	4.78%	5.84%

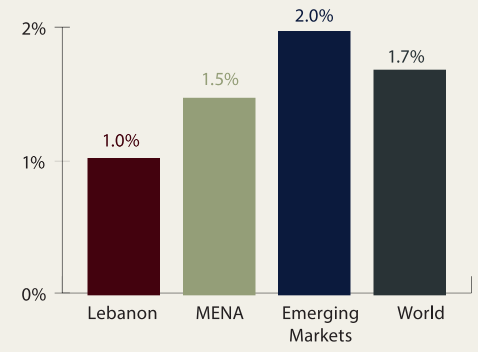
Source: Bankdata Financial Services wll

RETURN ON AVERAGE EQUITY (YEAR 2017)



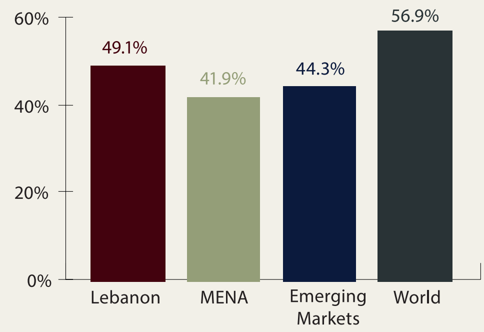
Sources: Bankdata Financial Services, IMF, Orbis Bank Focus, Fitch, MENA Central Banks

RETURN ON AVERAGE ASSETS (YEAR 2017)



Sources: Bankdata Financial Services, IMF, Orbis Bank Focus, Fitch, MENA Central Banks

COST-TO-INCOME (YEAR 2017)



Sources: Bankdata Financial Services, IMF, Orbis Bank Focus, Fitch, MENA Central Banks

MANAGEMENT EFFICIENCY OF LEBANESE BANKS

	2011	2012	2013	2014	2015	2016	2017	Var 17/16
Cost per average branch (US$ million)	1.89	2.01	2.10	2.18	2.19	2.56	2.48	-3.1%
Staff expenses per average staff (US$ 000s)	43.1	45.8	48.4	51.3	50.7	54.0	53.2	-1.5%
Staff expenses to general operating expenses (%)	55.6%	54.6%	55.6%	56.4%	55.8%	52.1%	54.1%	1.9%
Cost-to-income (%)	49.7%	49.7%	51.8%	51.5%	50.3%	44.3%	49.1%	4.8%
Cost-to-average assets (%)	1.46%	1.51%	1.50%	1.48%	1.44%	1.59%	1.41%	-0.2%

Source: Bankdata Financial Services wll

MANAGEMENT EFFICIENCY OF LEBANESE BANKS' GROUPS (YEAR 2017)

	Alpha	Beta	Gamma	Delta
Cost per average branch (US$ million)	2.57	1.73	3.01	3.25
Staff expenses per average staff (US$ 000s)	53.7	45.8	57.0	52.4
Staff expenses to general operating expenses (%)	54.1%	52.0%	58.5%	60.6%
Cost-to-income (%)	48.0%	60.0%	69.1%	47.8%
Cost-to-average assets (%)	1.37%	1.69%	1.91%	2.48%

Source: Bankdata Financial Services wll

INVESTMENT CONSIDERATIONS

Even though Lebanese banks' shares have been impacted by the lack of efficiency and turnover at the Beirut Bourse, they remained on investors' radar screens for their long-established resilience to tough operating conditions, sustainably healthy fundamentals, enticing dividend returns and attractive market pricing ratios for the listed larger institutions.

It is true that the structurally low market turnover ratios at the local stock exchange (6% last year and less than 4% so far in 2018), lagging way behind regional and international averages due to underdeveloped capital markets and relatively low efficiency and visibility coupled with non-negligible elasticity to political sentiment, has weighed on listed banking stocks throughout the year. This has pushed some of the largest banks to list GDRs on foreign exchanges to increase visibility years ago, and favored a relatively generous dividend payout lately to entice shareholders to continue investing in local banking shares, especially that net income generation has proven sufficient and increasing in this respect.

Within this context and given the sound growth in the consolidated banking sector common earnings per share year-on-year in 2017, banks have increased their common dividends distribution last year. Common dividends rose by 12.7% year-on-year in 2017, leading to an almost similar surge in dividends per share to an average of US$ 0.22 amidst a quasi-stagnation in outstanding common shares over the covered year.

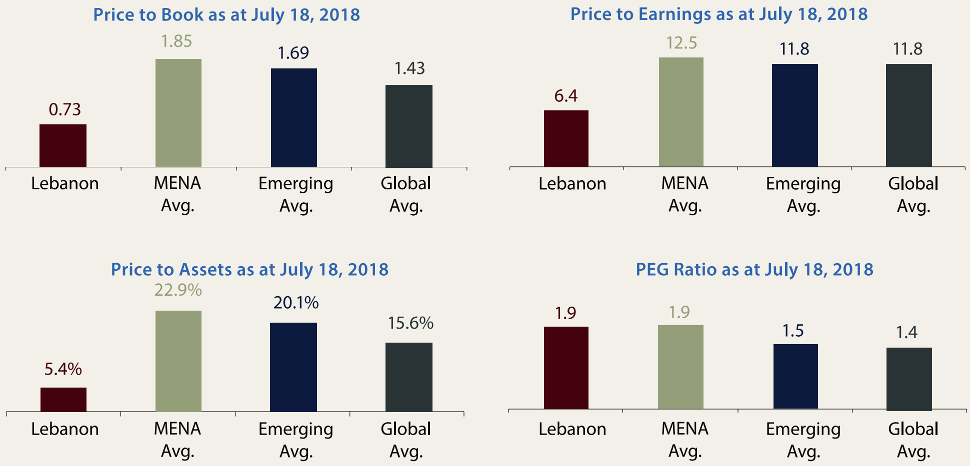
As such, with dividends distributed rising more than banks' bottom lines, the consolidated sector's dividend payout ratio rose anew last year to reach 37.2% for common shares, noting that the total payout ratio (including preferred shares as well) rose to reach 43.3% in 2017. This is considered as quite generous on behalf of Lebanese banks that are sharing the amelioration in earnings generation with their shareholders, noting that peer regional, emerging markets and global averages stand in the 32%-41% range.

Another measure to gauge the interesting reward for shareholders is the dividend yield ratio, which applies to listed stocks (i.e. the largest banks in Lebanon) as it is measured by the ratio of dividends per share to price per share. The average listed banking stocks' dividend yield attained 7.9% in Lebanon last year, rising relative to the previous year's published 6.3% measure as banks distributed more dividends and prices declined in light of political bickering and its repercussions on investor sentiment and stock exchange activity. This measure is noticeably higher than the peer averages for the MENA banking sector, emerging markets banks and the global banking sector that fall in the 2.2%-3.3% range.

A third measure of banking shares attractiveness in absolute and relative terms is the enticing market pricing ratios Lebanese banks boast. Valuation ratios are attractive because banks continue to have healthy fundamentals and because the lack of efficiency and weak turnover on the Beirut Stock Exchange affects price performances. Banks actually trade at a price to earnings ratio (P/E) of 6.4x, representing a discount of 45%-48% relative to regional, emerging markets and global benchmarks. They trade at a price to book ratio below 1x (standing at 0.73x), in other terms a 49%-61% discount relative to the same benchmarks. The price to assets ratio stands at a low level of 5.4%, or a 66%-77% discount relative to benchmarks. Last but not least, when dividing the P/E ratio by the average earnings per share growth of the past four to five years, the PEG ratio thus obtained (excluding outliers) trades at a discount of 47%-61% relative to the averages in the MENA region, emerging markets and the world.

As such, while stock exchange movements have proven correlated with political bickering, a return of political stability in Lebanon followed by the kick starting of long-awaited reforms along with CEDRE funds could favor banks valuations and possibly help unleash the price appreciation potential of banking stocks, in case such developments manage to send the needed signals to capital markets at large.

COMPARATIVE STOCK MARKET PRICING RATIOS



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

CONCLUSION

The Lebanese banking sector has witnessed another good year in 2017, underlined by good activity growth despite the adverse pressures of PM Hariri's resignation crisis in November and a satisfactory profitability. Lebanese banks persistently bear witness to profitable franchises, though their return on equity remain below their cost of equity at large within the context of tough operating conditions in the domestic market or in foreign markets of presence.

At the quantitative level, Lebanese banks have ensured, once again last year, a rigorous risk profile while sustaining their profit metrics. The analysis of their various exposures suggest a large liquidity, adequate capitalization, sustained asset quality and improved management efficiency. At the qualitative level, Lebanese banks continue to assume their fiduciary responsibilities through enjoying adequate corporate governance standards, well developed corporate social responsibility programs and very good transparency and disclosure practices.

The analysis of strengths and weaknesses for the Lebanese banking sector suggests the following: At the level of strengths, we mention the stabilization of operating conditions though remaining challenging, the sound system liquidity mitigating the risk of deposit flight, the acceptable capitalization adequately meeting the higher capital requirements and the rising banks revenues aided by BDL transactions offsetting rising funding costs. At the level of weaknesses, we mention the banks persisting exposure to the sovereign, the subdued domestic credit growth outlook amid scarce lending opportunities and the adverse impact of subdued new business generation and higher taxes on banks profitability outlook.

While the above challenges are real challenges, we believe that opportunities outpace threats at the horizon, driving our overall favorable outlook on the sector. It is within this context that the qualitative strengths of Lebanese banks, added to sound performance metrics and a rigorous risk profile, put Lebanese banks in opportunistic conditions to take advantage of domestic opportunities looking forward or external opportunities in their foreign markets of presence at large.

Domestically, following the launching of the Capital Investment Program and the successful CEDRE conference, the Private Public Partnership, based on sharing expertise and skills, arises as one of the priority options for Lebanese banks, particularly if PPP projects combine economic need and commercial feasibility under the leadership of a hardworking management and within the context of a supportive legal and institutional framework. Once these conditions are met, Lebanese banks would play a crucial role in supporting these partnerships through securing part of the required funds.

Externally, amid continuing tough politico-security conditions the MENAT region is passing through and their adverse repercussions on the operating environment of the countries of presence, banks management are adopting a consolidation mode in their main geographic pillars, while maintaining their networks ready to capture growth opportunities as soon as they arise.

Lastly, Lebanese banks' persistent efforts and forthcoming objectives rest on keeping up with the development dynamics of the continuously changing banking profession and to ensure their constant readiness to meet the needs of their customers who are becoming more demanding and more involved in the world of innovation at large.

DISCLAIMER

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