Banking industry 2018: an analysis of activity performance, risk profile and return indicators

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Lebanese banks are considerably open to foreign markets and therefore impacted by global considerations and regional conditions which demand an analysis of the global and regional environment before analyzing domestic market considerations in the year 2018.

The global and regional economy in 2018

During 2018, the global economy saw a continuation of the steady expansion it went through in the past couple of years. Growth across several of the world's largest economies was more or less maintained amid declining unemployment rates which are in some countries below pre-global financial crisis levels, yet proved less balanced. As a matter of fact, global industrial production and trade volumes are decelerating after having witnessed rapid growth in the previous year, adversely affecting investor sentiment and equity prices. Concerns about rising trade protectionism have been weighing on the global investment climate as it would disrupt global value chains. The ongoing trade tensions have resulted in a more uncertain global trade environment weighing to a certain extent on activity momentum and likely leading to reduced appetite for capital spending amid relatively less rosy global conditions. Within this context, the IMF estimated global growth in 2018 to have reached 3.6%, practically the same as the previous year's figure.

Having said that, core inflation, an indicator closely watched by Central Banks across the world, remains contained even if on the rise in some countries, and close to monetary authorities' targets. As such, global financial conditions remain generally accommodative and supportive of growth, even if they mildly tightened throughout the year 2018. Central Banks across the world's largest economies proceeded during 2018 with interest rate increases or the scaling back of asset purchases as global economic conditions have been favorable. In particular, the US Federal Reserve raised its key interest rate by a cumulative one percentage point in 2018 through four rate hikes. This came amid an accelerating domestic economic activity on the back of fiscal stimulus measures and steady gains in the labor market, though current interest rate levels remain low by historical standards and well below previous recoveries while the Fed recently cut its rate for the first time in a decade.

World economic indicators

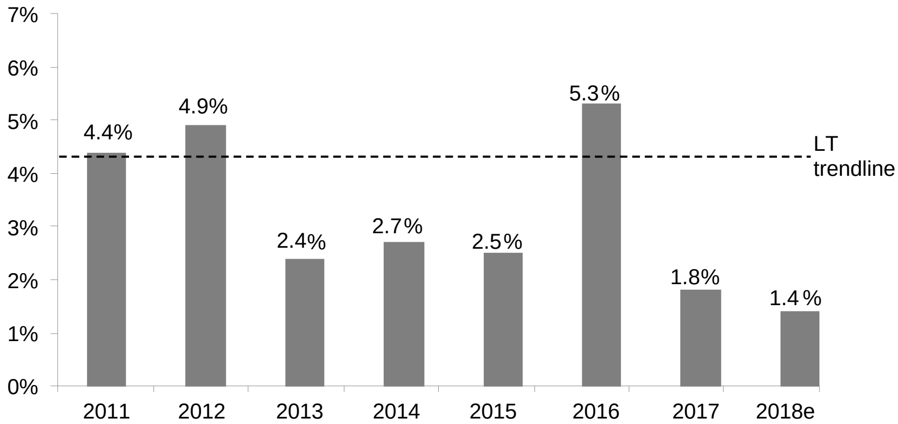
	2013	2014	2015	2016	2017	2018e
Real GDP growth	3.5%	3.6%	3.4%	3.4%	3.8%	3.6%
Average inflation	3.7%	3.2%	2.8%	2.8%	3.2%	3.6%
Current account balance / GDP	0.5%	0.5%	0.3%	0.3%	0.5%	0.4%
Fiscal balance / GDP	-2.8%	-2.8%	-3.2%	-3.4%	-3.1%	-3.0%
Government debt / GDP	78.5%	78.8%	79.9%	83.0%	81.8%	82.2%

Sources: IMF, Bank Audi's Group Research Department

In the MENA region, growth among oil-importing countries has continued at a modest pace in 2018 and is set to strengthen slightly over the medium term. Growth in the region is projected to reach 3.8% in 2018, up from 3.5% in 2017. However, growth is uneven and likely to remain low relative to previous trends, while unemployment remains elevated. Furthermore, higher oil prices are weighing on already weak external and fiscal balances. The outlook is increasingly clouded by tightening global financial conditions, bouts of financial market volatility, and mounting global trade tensions.

The MENA banking sectors remained at the image of macroeconomic developments at large. Measured by the consolidated assets of MENA banks, banking activity reported an annual growth of 4.9% in December 2018 relative to the same month of the previous year. Likewise, deposits registered a growth of 3.9% and loans reported a growth of 3.0% over the same period. Not less importantly, MENA banks' net profitability remained under pressure within the context of relatively low activity growth and tough operating conditions in their respective economies.

MENA Real GDP Growth



Sources: IMF, Bank Audi's Group Research Department

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Banking sectors' assets in the Arab MENA region

in US$ billion	**Dec-16**	**Dec-17**	**Dec-18**	**Var 18**	**Var 17**
Algeria	118.1	122.7	*130.6*	7.9	4.6
Bahrain	82.8	83.3	86.4	3.1	0.5
Egypt	218.7	271.0	303.2	32.1	52.3
Iraq	184.9	94.5	103.1	8.6	-90.4
Jordan	68.2	69.3	71.8	2.5	1.0
Kuwait	197.8	210.3	219.3	9.0	12.5
Lebanon	241.3	257.8	285.2	27.4	16.5
Libya	72.0	85.8	83.8	-2.1	13.8
Morocco	128.6	147.0	151.8	4.8	18.4
Oman	70.3	72.5	77.9	5.4	2.2
Qatar	346.9	374.6	389.5	14.9	27.7
Saudi Arabia	601.7	614.9	630.2	15.4	13.2
Sudan	20.1	30.1	9.4	-20.7	10.0
Tunisia	42.7	44.8	40.2	-4.6	2.1
United Arab Emirates	711.7	733.5	781.1	47.6	21.8
Arab MENA	**3,105.8**	**3,212.0**	**3,363.5**	**151.5**	**106.2**

Sources: Central Banks, Bloomberg. Figures in italic are the latest available.

Banking sectors' deposits in the Arab MENA region

in US$ billion	**Dec-16**	**Dec-17**	**Dec-18**	**Var 18**	**Var 17**
Algeria	85.9	89.2	*94.9*	5.6	3.4
Bahrain	43.9	45.0	47.4	2.3	1.1
Egypt	152.4	187.5	213.1	25.6	35.1
Iraq	52.2	56.9	64.5	7.5	4.8
Jordan	46.4	46.8	47.7	0.9	0.4
Kuwait	133.0	139.6	143.3	3.7	6.6
Lebanon	193.3	199.6	203.7	4.1	6.3
Libya	58.0	70.7	67.0	-3.7	12.7
Morocco	100.9	114.3	115.6	1.3	13.4
Oman	47.4	48.3	51.9	3.6	0.9
Qatar	199.7	226.1	222.6	-3.5	26.4
Saudi Arabia	431.2	431.7	443.0	11.2	0.5
Sudan	12.1	20.0	6.4	-13.5	7.8
Tunisia	21.7	22.2	19.2	-3.0	0.4
United Arab Emirates	425.6	443.1	478.0	34.9	17.5
Arab MENA	**2,003.8**	**2,141.1**	**2,218.3**	**77.2**	**137.3**

Sources: Central Banks, Bloomberg. Figures in italic are the latest available.

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Banking sectors' loans in the Arab MENA region

in US$ billion	**Dec-16**	**Dec-17**	**Dec-18**	**Var 18**	**Var 17**
Algeria	36.4	39.7	*41.3*	1.6	3.3
Bahrain	23.2	23.8	26.2	2.4	0.6
Egypt	71.8	82.4	101.3	18.9	10.6
Iraq	26.0	25.1	24.5	-0.6	-0.9
Jordan	32.3	34.9	36.8	1.9	2.6
Kuwait	118.5	123.3	127.4	4.1	4.9
Lebanon	74.1	75.8	73.0	-2.9	1.7
Libya	13.1	12.9	11.8	-1.1	-0.2
Morocco	84.9	96.8	97.2	0.4	11.9
Oman	45.6	47.3	48.6	1.3	1.7
Qatar	230.6	250.3	258.4	8.1	19.7
Saudi Arabia	360.4	357.3	367.7	10.4	-3.1
Sudan	10.3	14.7	3.5	-11.1	4.4
Tunisia	28.3	29.6	26.3	-3.2	1.3
United Arab Emirates	292.9	295.8	307.7	11.9	2.9
Arab MENA	**1,448.2**	**1,509.6**	**1,551.7**	**42.1**	**61.4**

Sources: Central Banks, Bloomberg. Figures in italic are the latest available.

In Lebanon, the real sector of the Lebanese economy has witnessed relatively tough conditions in 2018 but the financial sector continues to grow moderately. The IMF has revised down its 2018 real growth for Lebanon to 0.3% from a previous forecast of 1.0%. While 2018 has seemingly reported a further slowdown in growth, it is still non-recessionary in the technical definition of recession, i.e. negative growth or net contraction in Lebanon's real economy.

The further growth slowdown in 2018 is related to the overall wait and see attitude characterizing private sector investors refraining from investing in Lebanon's various economic sectors within the context of politico-economic uncertainties. Private consumption managed to continue growing moderately (especially benefitting last year from the public sector wage scale) and rising government spending provided a tiny support to growth.

Lebanon's major economic indicators

US$ million	**2017**	**2018**	**Var 18/17**
Macroeconomy			
GDP	53,394	56,409	5.6%
Real GDP growth (%)	0.6%	0.3%	-0.3%
GDP per capita (US$)	8,778	9,257	5.5%
Monetary sector			
Var M3	5,586	2,672	-52.2%
Velocity	0.41	0.39	-5.8%
Average CPI inflation (%)	4.5%	6.1%	1.6%
Public sector			
Gross domestic debt	49,139	51,643	5.1%
Foreign debt	30,381	33,490	10.2%
Total gross debt	79,520	85,133	7.1%
Gross debt/GDP (%)	149%	151%	2.0%
Fiscal deficit	3,756	6,246	66.3%
Fiscal deficit/GDP (%)	7.0%	11.1%	4.0%
External sector			
Imports	19,582	19,980	2.0%
Exports	2,844	2,952	3.8%
Trade deficit	16,738	17,028	1.7%
Current account deficit	13,709	15,238	11.2%
Current account deficit/GDP	25.7%	27.0%	1.3%
Gross financial inflows	16,582	12,223	-26.3%
Balance of payments	-156	-4,805	-

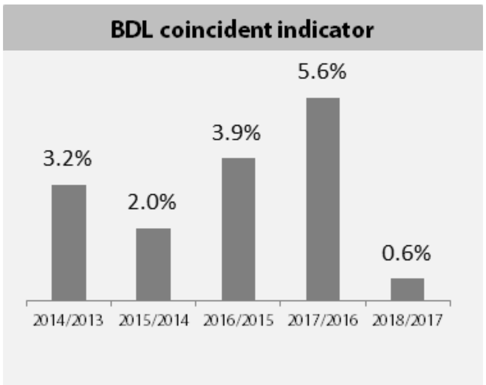
Sources: Lebanon Ministry of Finance, BDL & concerned public & private entities.

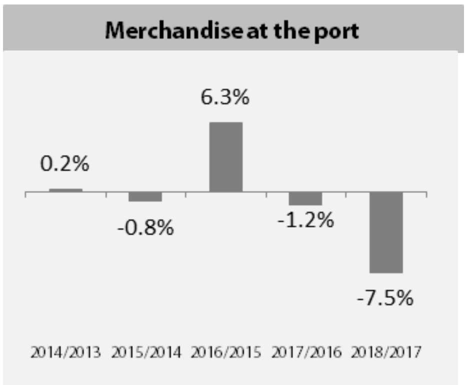
Out of 11 real sector indicators, 5 are up and 6 are down in 2018. Among indicators with positive growth, we mention the number of passengers at the Airport with an expansion of 7.4%, the number of tourists with a rise of 5.8%, total exports with a growth of 3.8%, total imports with an increase of 2.0% and electricity production with a growth of 1.4%. Among indicators with negative growth, we mention construction permits with a fall of 23.1%, value of property sales with a contraction of 18.3%, new car sales with a decline of 11.3%, cement deliveries with a decrease of 8.7%, merchandise at the Port with a fall of 7.5% and cleared checks with a decline of 2.5% year-on-year.

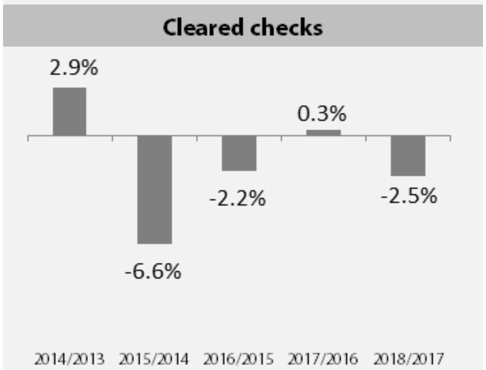
At the external level, the considerable improvement in non-resident deposit growth partially explains the widening balance of payments deficits between the past two years. The balance of payments recorded a deficit of US$ 4.8 billion in 2018, compared to a small deficit of US$ 156 million in 2017, amid contracting inflows and widening trade deficit.

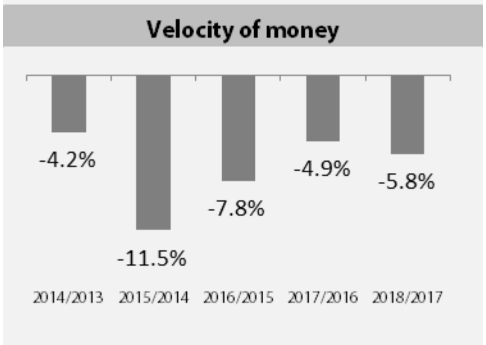
At the fiscal level, a net deterioration was reported in public finance conditions, following the relative improvement of the previous year. Lebanon's public finance deficit actually rose from US$ 3.8 billion in 2017 to US$ 6.2 billion in 2018, within the context of a 15.7% growth in public expenditures and a 0.7% decline in public revenues. In parallel, Public debt reached US$ 85 billion, the equivalent of 151% of GDP.

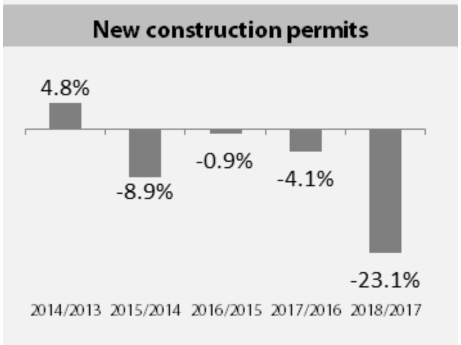
At the capital markets level, equity and bond markets came under pressure in 2018. Domestic political uncertainties along with emerging market weakness took their heavy toll on the Lebanese Eurobond market. The weighted average yield rose by 341 bps in 2018 to reach 9.95%, falling from a peak level of 11.23% mid-September 2018. Lebanon's five-year CDS spreads closed the year at 750 bps, up by 229 bps, after crossing the 800 bps threshold several times during the second half of the year. On the equity market, the BSE saw a 15% drop in prices in 2018 amid increased price volatility, while the total turnover contracted by circa 38% year-on-year.











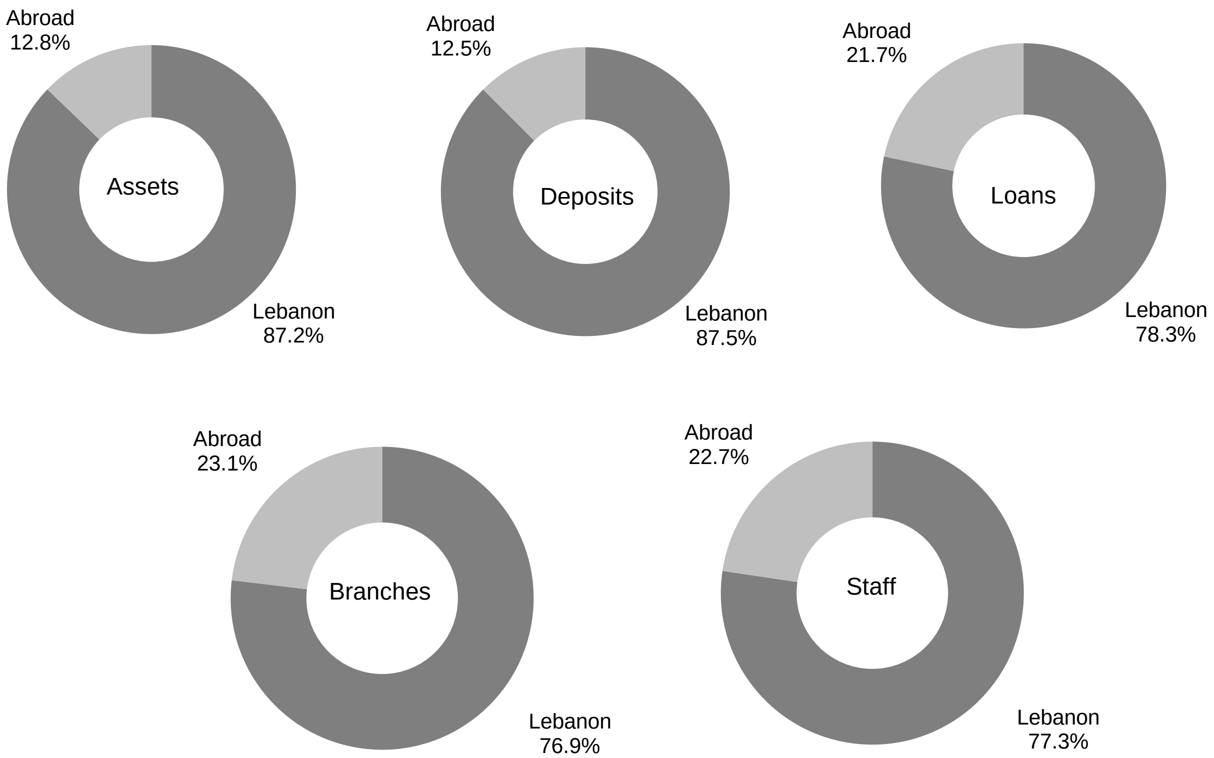
Sources: BDL & concerned public & private entities.

Consolidated activity growth

The year 2018 was a somewhat satisfactory year for Lebanese banks. It saw a 10.6% growth in their consolidated activity, compared with a 6.8% growth in 2017, with their total assets reaching US$ 285.2 billion at end-December 2018 (US$ 248.6 billion for domestic assets). The branch network increased by 10 branches to reach 1,424 branches at end-2018, along with a contraction in their staff count by 178 employees, translating noticeable efficiency measures introduced.

Lebanese banks mostly fund their balance sheet growth through a large and resilient customer deposit base amounting to US$ US$ 203.7 billion, accounting for 71.4% of total assets, of which US$ 178.2 billion of domestic deposits, the equivalent of 316% of Lebanon's GDP. Comparatively, deposits to GDP stand at 82% in MENA, 40% in emerging markets and 52% at the global level. The large bank dimension relative to the size of the domestic economy translates into noticeable bank loans to GDP ratio although at a less accentuated pace amid the newly implemented consolidation strategies at Lebanese banks. Domestic Loans to GDP amount to 101.2% in Lebanon today, against 58% for the regional average, 31% for the emerging markets average and 44% for the global average.

Geographic Concentration (Year 2018)



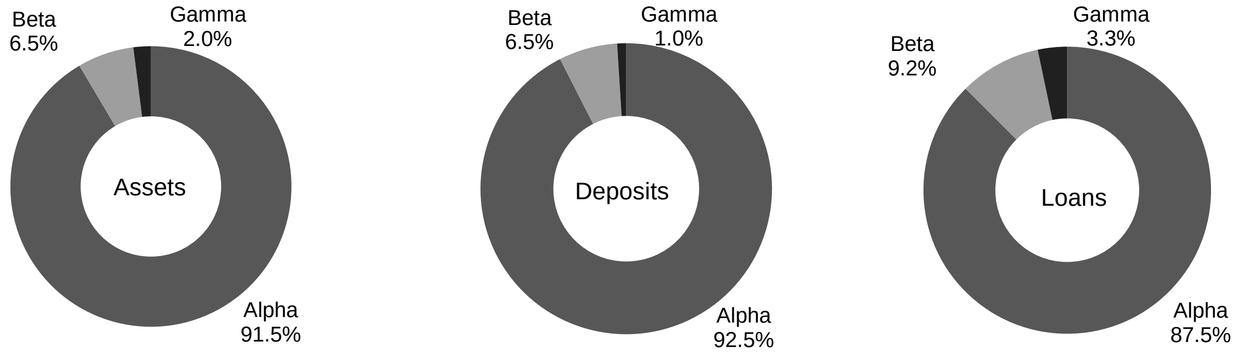
Deposits from customers managed to report a positive growth of 2.0% over the year 2018, with domestic deposits rising by 2.6% while deposits of foreign entities contracted by 1.6% mainly due to FX translation impact in foreign markets that witnessed exchange rate depreciation relative to the US dollar. The breakdown of domestic deposits by currency suggests that there were net conversions from LL deposits to FX deposits, raising deposit dollarization to a 10-year high at 73.0%. For domestic deposits, dollarization reported 69.1% for domestic deposits at end-2018 against 67.2% at end-2017. As a matter of fact, LL deposits contracted by 3.5% in 2018, while domestic FX deposits rose by 5.6% over the year.

Amid a persistently challenging environment in Lebanon and foreign markets of presence, Lebanese banks adopted a policy focusing on improving efficiency and de-risking, resulting mainly in net loan settlements and a reduction of loan exposures. As such, loans to customers contracted by 3.8% in 2018, with a 2.3% reduction in domestic loans and an 8.7% decrease in loans in foreign entities that were also affected by some FX translation impact. The reduction in domestic loans to the private sector was especially due to a contraction in the LP loan portfolio of 5.7%, noting that the BDL requested banks during 2018 to reduce the LP loans to LP deposits ratio to a maximum of 25% by end-2019. Subsequently, the dollarization of domestic loans rose from 68.1% at end-2017 to 69.2% at end-2018.

The analysis by group of banks according to their size shows that activity growth was realized at different paces by the different bank groups. Bilanbanques divides the banking sector into three groups by size, the first being the Alpha Group (Group of large banks), then the Beta Group (Group of middle size banks), then the Gamma Group (Group of small banks). The fastest activity growth in 2018 was realized by the Alpha group displaying a growth rate of 11.0%, followed by the Beta Group with 9.0% while the Gamma Group reported a contraction of 0.2% over the year.

But banking activity continues to be significantly concentrated. The Alpha Group's share remains highly dominant at 91.5% of the sector's consolidated assets (91.2% in 2017), followed by the Beta Group with 6.5% (6.6% in 2017), and the Gamma Group with 2.0% (2.2% in 2017).

Domestic Market share (Year 2018)



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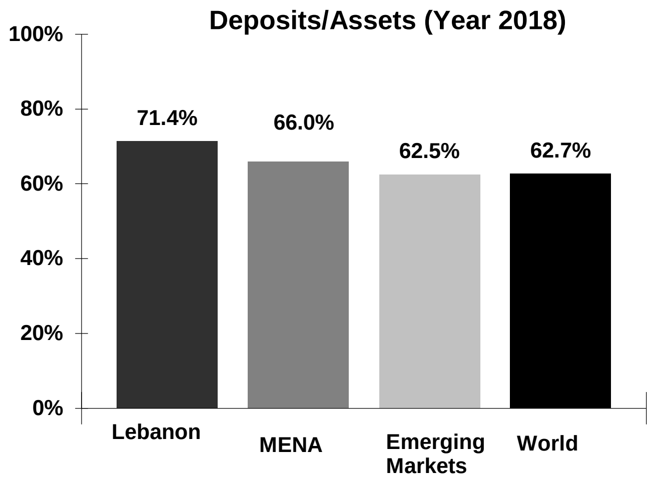
The analysis of Lebanese banks groups by dollarization ratios suggests that the group of large banks is the most dollarized in terms of deposits and loans. Deposit dollarization stands at 73.3% for the Alpha Group, followed by 69.7% for the Beta Group and 65.7% for the Gamma Group. On the other hand, loan dollarization is the largest for the Alpha Group with 78.1%, followed by 72.2% for the Beta Group and 27.9% for the Gamma Group.

Growth rates of banking aggregates

	2012	2013	2014	2015	2016	2017	2018	Var 18/17
Assets	8.4%	9.6%	9.3%	4.8%	5.9%	6.8%	10.6%	3.8%
Loans to customers	11.4%	15.1%	11.0%	5.6%	2.0%	2.3%	-3.8%	-6.1%
Customer deposits	8.8%	9.6%	8.5%	4.5%	3.6%	3.3%	2.0%	-1.3%
Shareholders' equity	13.4%	8.5%	10.8%	6.9%	9.9%	6.6%	0.4%	-6.2%
Annual L/C openings	-5.3%	-5.8%	1.5%	-21.0%	5.8%	16.0%	3.3%	-12.7%
Net profits for the year	7.6%	0.2%	9.1%	6.9%	12.6%	4.3%	-5.0%	-9.3%

Growth Rates of Lebanese Banks' Groups (Year 2018)

	Alpha	Beta	Gamma
Assets	11.0%	9.0%	-0.2%
Loans to customers	-4.7%	5.3%	-2.3%
Customer deposits	2.1%	1.9%	-4.7%
Shareholders' equity	0.2%	2.1%	2.3%
Annual L/C openings	6.3%	-35.6%	21.4%
Net profits for the year	-5.7%	6.5%	-3.9%



Liquidity and sovereign exposure

The year 2018 also portrayed a continuation of the banks' adequate financial standing in terms of liquidity, capital adequacy, financial flexibility and asset quality, suggesting a sound risk coverage in a tough operating environment. With respect to liquidity, net primary liquidity represented 56.5% of customers' deposits at year-end 2018, against 44.9% at end-2017. Comparatively, the average liquidity ratio in MENA banks stands at 36.1%, that in emerging countries reports 18.2%, while the ratio stands at 25.9% at the global level.

The analysis of liquidity by currency in 2018 suggests that liquidity is increasingly sound in both LP and in foreign currencies. Net primary liquidity in FX as a percentage of deposits in FX rose from 39.6% in 2017 to 42.7% in 2018. Net primary liquidity in LP as a percentage of deposits in LP reached a high of 94.0% at end-2018. Those liquidity ratios come on the background of a low transformation ratio of loans to deposits at 35.8% at end-2018 (32.0% in LL and 37.3% in FX).

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Having said that, 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 32.0% in 2017 to 38.7% in 2018, while liquidity in foreign banks declined from 7.3% to 6.5% 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 2018.

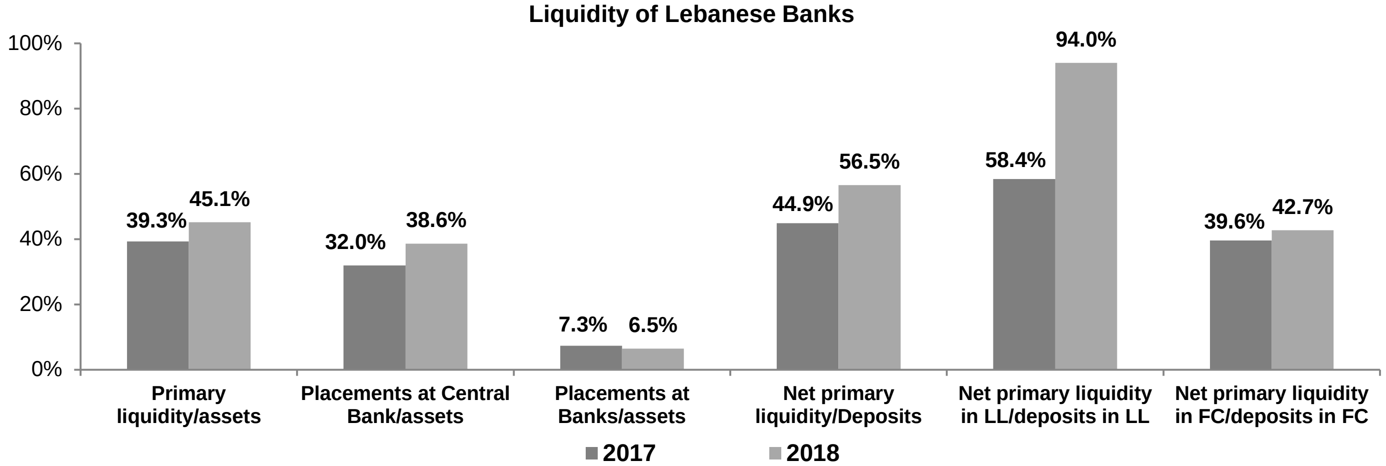
In parallel, as a result of the Lebanese banks' purchases of Lebanese eurobonds from BDL following its debt swap operation with the Ministry of Finance, the Lebanese banks' eurobond portfolio rose from US$ 14.9 billion in December 2017 (10.4% of FX deposits) to US$ 16.8 billion (11.3% of FX deposits) in December 2018. Lebanese banks' sovereign eurobond portfolio is yet still way below their consolidated shareholders' equity. The ratio of Lebanese sovereign eurobonds to shareholders equity actually rose from 60.4% at end-2017 to 67.7% at end-2018.

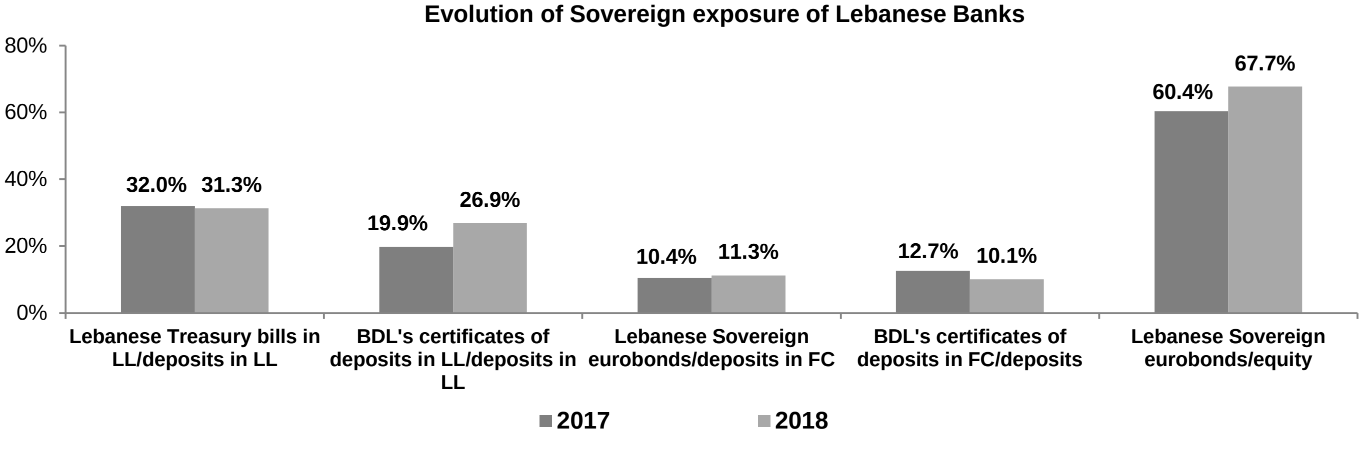
The analysis of liquidity by Lebanese banks' groups in 2018 shows that liquidity is correlated with the size of banks. The most liquid group is the Alpha Group with a ratio of 57.9%,followed by the Beta Group with a net primary liquidity to deposits ratio of 44.2%, while the Gamma Group stands with a negative ratio of -8.3% as it holds a significantly large amount of government paper among its asset base.

The analysis of sovereign exposure by Lebanese banks' groups in 2018 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 Beta Group with a ratio of Lebanese Treasury bills in LL to deposits in LL of 42.1%, followed by the Gamma Group with 40.3%, and the Alpha Group with 30.4%. In parallel, the group with the highest exposure in foreign currency in 2018 is the Gamma Group with a ratio of Lebanese sovereign eurobonds to deposits in foreign currency of 23.3%, followed by the Beta Group with 12.3% and the Alpha Group with 11.1%. 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 39.7% for the Alpha Group, followed by Beta Group with 29.8% and the Gamma Group with 18.3% at end-2018.

Liquidity of Lebanese Banks' Groups (Year 2018)

	Alpha	Beta	Gamma
Primary liquidity/assets	**46.0%**	**35.2%**	**35.6%**
o.w. Central Bank/assets	39.7%	29.8%	18.3%
o.w. Banks/assets	6.3%	5.4%	17.3%
Net primary liquidity/Deposits	**57.9%**	**44.2%**	**-8.3%**
o.w. net primary liquidity in LL/deposits in LL	97.9%	62.8%	-71.6%
o.w. net primary liquidity in FC/deposits in FC	43.3%	36.2%	24.8%

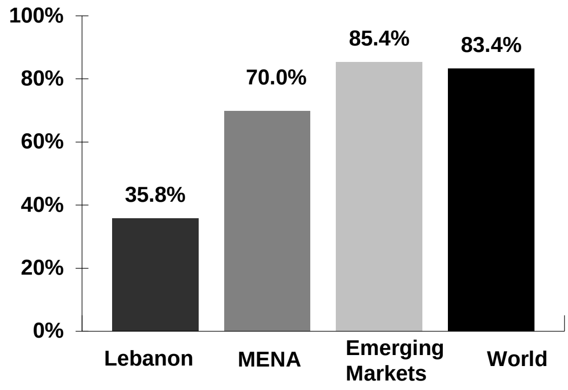




Sovereign exposure of Lebanese Banks' Groups (Year 2018)

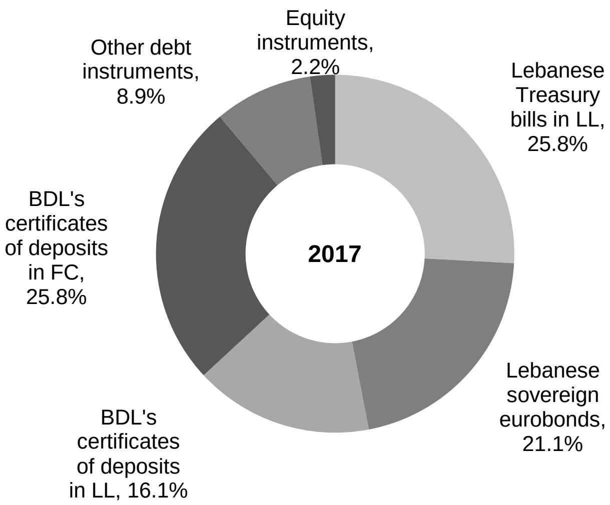
	Alpha	Beta	Gamma
Lebanese Treasury bills in LL/deposits in LL	30.4%	42.1%	40.3%
BDL's certificates of deposits in LL/deposits in LL	27.5%	22.1%	10.8%
Lebanese Sovereign eurobonds/deposits in FC	11.1%	12.3%	23.3%
BDL's certificates of deposits in FC/deposits in FC	10.4%	6.7%	6.6%
Lebanese Sovereign eurobonds/equity	69.7%	66.2%	28.4%

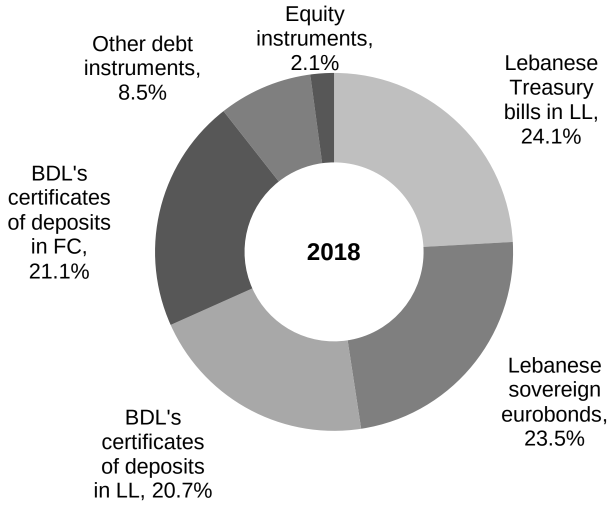
Loans/Deposits (Year 2018)



Sources: Bankdata Financial Services, IMF, Bank Focus, Fitch, MENA central banks

Portfolio securities breakdown





Lending Quality and Provisioning

In 2018, Lebanese banks were generally shying away from extending new waves of loans to customers and corporates in the currently prevailing weak overall economic conditions and looming uncertainties. In fact, banks' loan portfolio to the private sector contracted by 3.8% over the year 2018 when compared to the previous year. As such, total loans reached US$ 73.0 billion at end-December 2018, with a US$ 2.9 billion decline in lending volumes during 2018 compared to a US$ 1.7 billion increase during 2017. However, with the loan-to-deposit ratio at a low 35.8% at end-December 2018, banks benefit from sufficient firepower to extend new waves of loans to the economy once conditions improve tangibly and sustainably.

Breakdown of loans and advances to customers (as a % of total loans) in 2018

	All Banks	Alpha	Beta	Gamma
Corporate	39%	38%	47%	42%
Housing	17%	17%	11%	42%
SMEs	16%	15%	24%	4%
Retail	11%	11%	7%	2%
Secured by commercial real estate	9%	9%	10%	0%
Other loans	9%	9%	2%	10%
Public sector	1%	1%	0%	0%

On another hand, the conservative practices with extensive risk management and scrutinized credit analysis are some of the factors that have helped Lebanese banks to avoid a broad deterioration in their asset quality. Still, the consolidated gross credit-impaired loans represented 10.4% of gross loans at end-December 2018, from 8.6% at end-December 2017. It is important to mention that the ratio of net credit-impaired loans to gross loans stood at 4.0%, which still compares favorably to international benchmarks. In parallel, the coverage ratio of credit-impaired loans by provisions reported 61.7% last year, slightly lower than its end-December 2017 level of 62.3%, leading to a coverage of the total loan portfolio by loan loss reserves of 7.9%, up from 6.8% a year ago.

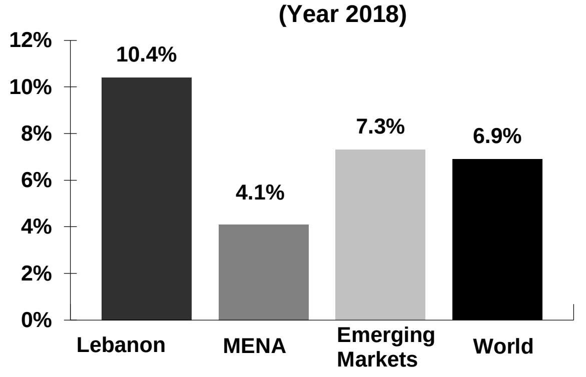
The analysis by group of banks suggests the Alpha Group reported the lowest gross credit-impaired loans to gross loans ratio of 9.0%, followed by the Beta Group with 14.9% and the Gamma Group with 30.6%. In parallel, the ratio of net credit-impaired loans to gross loans reported a low of 3.5% for the Alpha Group, 6.8% for the Beta Group and 9.2% for the Gamma Group. On the other hand, small sized banks were the best provisioned, the ratio of loan loss reserves on credit-impaired loans as a percentage of credit-impaired loans reported high ratios of 70.0% for the Gamma Group, while the Alpha Group registered a ratio of 61.7% and the Beta Group recorded a ratio of 54.7% in 2018.

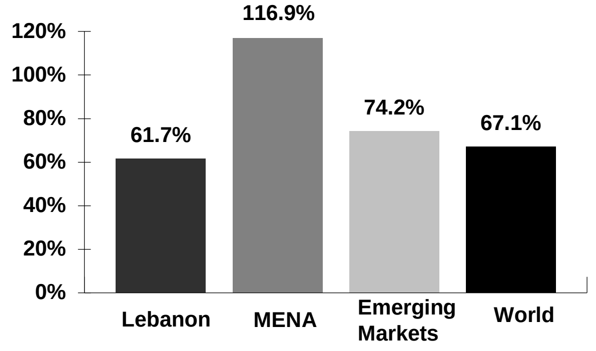
Asset Quality of Lebanese Banks

	2017	2018	Var 18/17
Gross credit-impaired loans/Gross loans	8.6%	10.4%	1.8%
Net credit-impaired loans/Gross loans	3.3%	4.0%	0.7%
Loan loss reserves on credit-impaired loans/CILs	62.3%	61.7%	-0.6%
Allowances for ECL on Stages 1&2/Net loans	1.5%	1.6%	0.1%
Net credit-impaired loans/Equity	10.7%	12.7%	2.0%

Asset Quality of Lebanese Banks' Groups (Year 2018)

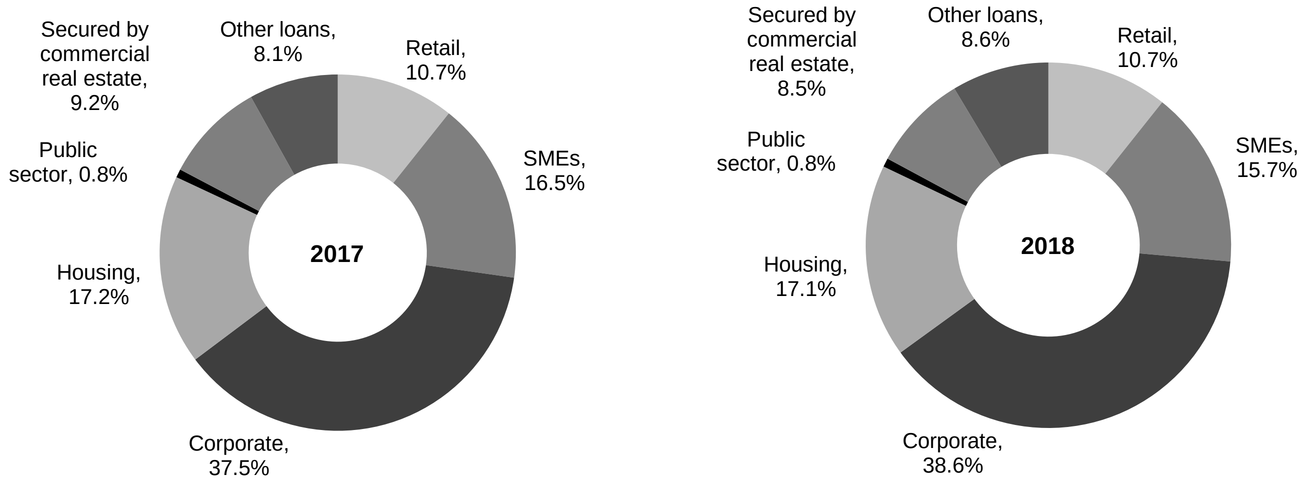
	Alpha	Beta	Gamma
Gross credit-impaired loans/Gross loans	9.0%	14.9%	30.6%
Net credit-impaired loans/Gross loans	3.5%	6.8%	9.2%
Loan loss reserves on credit-impaired loans/CILs	61.7%	54.7%	70.0%
Allowances for ECL on Stages 1&2/Net loans	1.7%	0.8%	0.8%
Net credit-impaired loans/Equity	10.8%	28.8%	27.3%





Sources: Bankdata Financial Services, IMF, Bank Focus, Fitch, MENA central banks

Loans and advances breakdown



Capital Adequacy and Solvency

Lebanon's banking sector remained well capitalized on the overall in 2018, with persistently sound capital buffers covering the various types of risk involved. The total capital reported a healthy growth of 5.3%. As a matter of fact, the growth in Tier 2 capital was the most vigorous at 32.3% at end-December 2018 amid a challenging operating environment.

With the growth in shareholders' equity lagging behind asset growth, the equity-to-asset ratio dropped from 9.6% in 2017 to 8.7% in 2018. A related measure is the ratio of shareholders' equity to net loans which reached 33.9% for Lebanon's banking sector at end-2018, against a regional average of 23.7% and an average of 15.2% in emerging markets and 14.2% 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 up from 10.5 times in 2017 to 11.0 times in 2018, indicating a higher financial leverage.

In parallel, the total capital adequacy ratio as per Basle framework reported 17.8% at end-December 2018 as compared to 16.9% at end-December 2017, well exceeding requirements and reflecting an adequate coverage of the aggregation of credit, market and operational risks. The sound capital adequacy ratio in 2018 comes within the context of a total capital of US$ 24.4 billion in 2018 against a total risk-weighted assets of US$ 137.4 billion amid a declining share of risk-weighted assets in total assets from 53.3% in 2017 to 48.2% in 2018. It is worth mentioning that the total capital ratio is broken down over a Tier 1 ratio of 15.5% and a Tier 2 ratio of 2.3%. In turn, the Tier 1 ratio consists of a 12.7% common Tier 1 ratio and a 2.8% additional Tier 1 ratio.

The analysis of capital adequacy by Group of banks shows that the capital adequacy (as per Basle framework) reported a high of 24.2% for the Gamma Group, followed by 17.7% for the Alpha Group and 16.3% for the Beta Group in 2018. When compared to the previous year, the Alpha Group reported the highest growth in capital adequacy in 2018 of 0.93%. This is explained by a 5.5% rise in total capital (the equivalent of US$ 1.15 billion) within the context of a challenging operating environment. On the other hand, the equity to assets ratio is the highest for the Gamma Group with 18.6%, followed by the Beta Group with 9.2% and the Alpha Group with 8.4% in 2018.

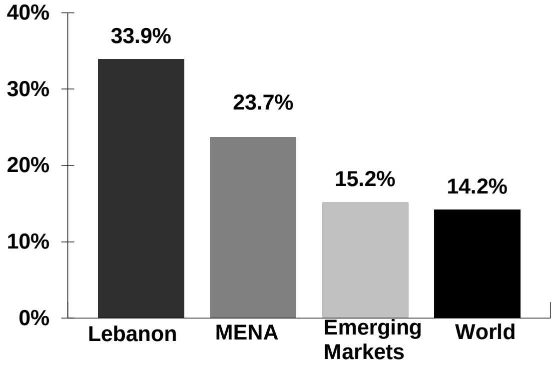
Capitalization of Lebanese Banks

	2012	2013	2014	2015	2016	2017	2018	Var 18/17
Capital adequacy (as per Basel II requirements)	13.8%	14.2%	14.6%	15.1%	16.5%	16.9%	17.8%	0.9%
Equity to assets	9.0%	8.9%	9.1%	9.2%	9.6%	9.6%	8.7%	-0.9%
Leverage (times)	11.3	11.1	11.1	10.9	10.6	10.5	11.0	0.5

Capitalization of Lebanese Banks' Groups (Year 2018)

	Alpha	Beta	Gamma
Capital Adequacy (as per Basel II requirements)	17.7%	16.3%	24.2%
Equity Assets	8.4%	9.2%	18.6%
Leverage (times)	11.3	10.5	5.5

Equity/Net Loans (Year 2017)



Sources: Bankdata Financial Services, IMF, Bank Focus, Fitch, MENA central banks

Profitability

Moving on to profitability, a slight decline was witnessed in the Lebanese banking sector's consolidated net profits to reach US$ 2.46 billion in 2018, contracting by 5.0% from the previous year. At the level of return ratios, results remained similar with the return on average assets dropping to 0.90% in 2018 (1.04% in 2017), while the return on average common equity dropped from 11.83% to 10.68%.

The components of Lebanon's return ratios suggest that the LL spread rose by 24 bps moving from 2.17% to 2.41%, the FC spread declined by 24 bps moving from 1.81% to 1.57%, coupled with a decline in the ratio of non-interest income to average assets from 0.96% to 0.60%, generating a retreat in asset utilization from 2.90% to 2.47%. This was yet offset by a noticeable rise in the net operating margin from 35.78% to 36.61%, mainly tied to the drop in credit cost from 6.38% to 4.95%, while cost to income rose from 48.30% to 50.38% over the same period.

Moving on to a comparative global analysis, Lebanon's return on average assets and return on average equity ratios came short of global

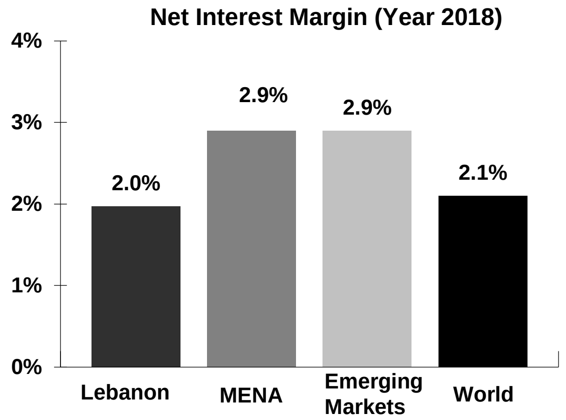
benchmarks. The local banking sector's return on average assets attained 0.90% in 2018, below an average of 1.6% for the MENA region, an average of 2.0% for emerging markets and an average of 1.7% globally.

At the same time, Lebanese banks' return on average equity reported 9.95% in 2018, compared to an average of 11.6% for the MENA region, an average of 15.3% for emerging markets and an average of 13.7% for the global benchmark.

Regarding the profitability of banks by group, Alpha and Gamma banks reported profit contractions of 5.7% and 3.9% respectively, while Beta banks witnessed an expansion of 6.5% in their bottom line in 2018. 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 10.30% for Alpha banks in 2018, 8.37% for Beta banks, and Gamma banks with 5.02%.

In parallel, interest margin reported a low of 1.94% for Alpha banks, followed by 2.02% for Beta banks, and 2.85% for Gamma banks. The share of non-interest income to total income reported 23.79% for Alpha banks, 27.05% for Gamma banks, and 27.54% 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 49.20%, while Beta banks reported 63.35% and Gamma banks 55.29%. Parallel to the cost-to-average assets falls as the size of banks increases. Banks in the Alpha group posted the lowest ratio of 1.20%, followed by the Beta Group with 1.68%, and the Gamma Group with 1.99%.



Sources: Bankdata Financial Services, IMF, Bank Focus, Fitch, MENA central banks

Return Ratios of Lebanese Banks

	2017	2018	Var 18/17
Yield on earning assets	6.1%	6.4%	0.4%
o.w. in LL	*6.7%*	*7.4%*	*0.7%*
o.w. in FX	*5.7%*	*5.9%*	*0.2%*
- Cost of earning assets	4.0%	4.4%	0.4%
o.w. in LL	*4.5%*	*4.9%*	*0.4%*
o.w. in FX	*3.8%*	*4.2%*	*0.4%*
= Interest margin	2.0%	2.0%	-0.1%
o.w. in LL	*2.3%*	*2.5%*	*0.2%*
o.w. in FX	*1.9%*	*1.7%*	*-0.2%*
x Average interest earnings/Average assets	95.7%	95.3%	-0.4%
o.w. in LL	*95.6%*	*96.0%*	*0.5%*
o.w. in FX	*95.8%*	*94.9%*	*-0.9%*
= Spread	1.9%	1.9%	-0.1%
o.w. in LL	*2.2%*	*2.4%*	*0.2%*
o.w. in FX	*1.8%*	*1.6%*	*-0.2%*
+ Non interest income/Average assets	1.0%	0.6%	-0.4%
= Asset utilization	2.9%	2.5%	-0.4%
x Net operating margin	35.8%	36.6%	0.8%
o.w. cost to income	*48.3%*	*50.4%*	*2.1%*
o.w. credit cost	*6.4%*	*5.0%*	*-1.4%*
o.w. other provisions	*1.8%*	*0.5%*	*-1.3%*
o.w. tax cost	*7.8%*	*7.5%*	*-0.2%*
= ROAA	**1.0%**	**0.9%**	**-0.1%**
x Leverage	10.5	11.0	0.5
= ROAE	**10.8%**	**10.0%**	**-0.9%**

Return Ratios of Lebanese Banks

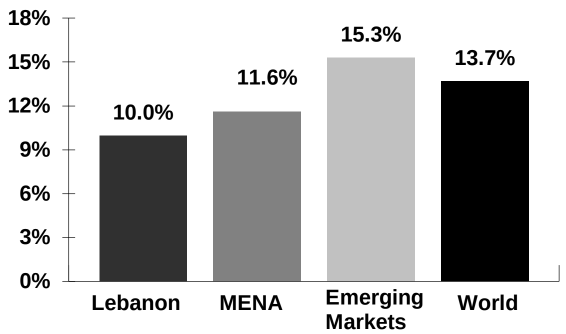
	Alpha	Beta	Gamma
Yield on earning assets	6.4%	6.4%	4.9%

o.w. in LL	*7.5%*	*7.2%*	*4.7%*
o.w. in FX	*5.9%*	*5.9%*	*5.3%*
- Cost of earning assets	4.5%	4.4%	2.1%
o.w. in LL	*4.9%*	*5.2%*	*1.9%*
o.w. in FX	*4.3%*	*3.9%*	*2.4%*
= Interest margin	1.9%	2.0%	2.9%
o.w. in LL	*2.5%*	*2.0%*	*2.8%*
o.w. in FX	*1.6%*	*2.1%*	*2.9%*
x Average interest earnings/Average assets	95.4%	95.0%	92.2%
o.w. in LL	*96.3%*	*93.5%*	*92.9%*
o.w. in FX	*94.9%*	*95.9%*	*91.3%*
= Spread	1.9%	1.9%	2.6%
o.w. in LL	*2.5%*	*1.8%*	*2.6%*
o.w. in FX	*1.5%*	*2.0%*	*2.7%*
+ Non interest income/Average assets	0.6%	0.7%	1.0%
= Asset utilization	2.4%	2.6%	3.6%
x Net operating margin	37.5%	30.1%	25.5%
o.w. cost to income	*49.2%*	*63.3%*	*55.3%*
o.w. credit cost	*5.1%*	*0.4%*	*11.5%*
o.w. other provisions	*0.6%*	-	*0.7%*
o.w. tax cost	*7.7%*	*6.1%*	*7.0%*
= ROAA	**0.9%**	**0.8%**	**0.9%**
x Leverage	11.3	10.5	5.5
= ROAE	**10.3%**	**8.4%**	**5.0%**

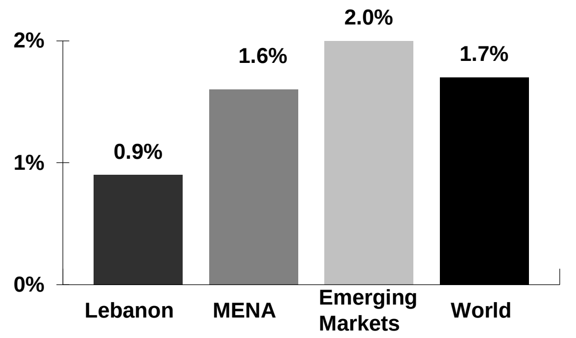
Non interest income of Lebanese Banks

	2013	2014	2015	2016	2017	2018	Var 18/17
Non interest income / total income	33.9%	33.6%	33.0%	46.2%	33.2%	24.2%	-9.1%
Net fees and commissions / average assets	0.5%	0.5%	0.5%	0.7%	0.4%	0.4%	0.0%
Operating expenses / average assets	1.5%	1.5%	1.4%	1.6%	1.4%	1.2%	-0.2%
Credit cost / pre-provision, pre-tax profit	13.9%	13.5%	15.2%	25.5%	12.7%	10.0%	-2.7%
Income tax / profit before tax	17.5%	18.3%	18.4%	23.4%	18.4%	17.1%	-1.3%

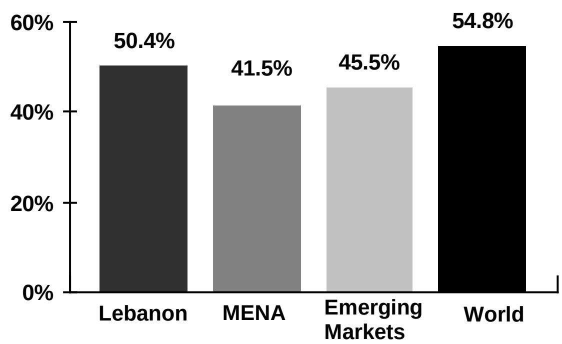
Return on Average Equity (Year 2018)



Return on Average Assets (Year 2018)



Cost to income (Year 2018)



Sources: Bankdata Financial Services, IMF, Bank Focus, Fitch, MENA central banks

Management efficiency of Lebanese Banks

	2012	2013	2014	2015	2016	2017	2018	Var 18/17
Cost per average branch (US$ million)	2.01	2.10	2.18	2.19	2.56	2.46	2.38	-3.1%

Staff expenses per average staff (US$ 000s)	45.8	48.4	51.3	50.7	54.0	53.3	53.7	0.8%
Staff expenses to general operating expenses (%)	54.6%	55.6%	56.4%	55.8%	52.1%	54.5%	56.5%	2.0%
Cost to income (%)	49.7%	51.8%	51.5%	50.3%	44.3%	48.3%	50.4%	2.1%
Cost to average assets (%)	1.51%	1.50%	1.48%	1.44%	1.59%	1.40%	1.25%	-0.2%

Management efficiency of Lebanese Banks' Groups (Year 2018)

	Alpha	Beta	Gamma
Cost per average branch (US$ million)	2.43	1.85	3.09
Staff expenses per average staff (US$ 000s)	54.0	49.5	55.7
Staff expenses to general operating expenses (%)	56.6%	53.0%	61.8%
Cost to income (%)	49.2%	63.3%	55.3%
Cost to average assets (%)	1.20%	1.68%	1.99%

Investment Considerations

Lebanese banks' adequate financial standing, conservative practices and full compliance with international standards allowed them to demonstrate resilience in the recent past and remain on investors' radar screens, the latter having noticed that they fare well in quite atypical conditions. It is true that those atypical conditions are the main reason why share price declined in the recent past and the share turnover of Lebanese stocks at large trended lower and now stands at a weak single-digit ratio, given the lack of appetite for domestic banking stocks in the currently prevailing conditions. But lower price levels are also part of what makes banking stocks look appealing given their tested resilience.

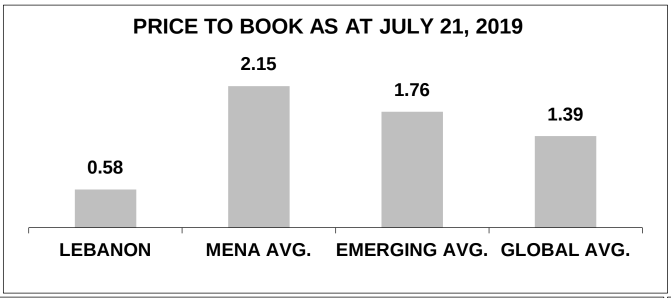
Such an appeal can be seen through three noticeable stock market metrics, namely valuation ratios, dividend yield and dividend payout. Their valuation ratios are practically at all-time lows given compressed share prices and lack of momentum, and continuously rising balance sheet and income statement metrics, despite a slight retreat from highs attained in recent times. For instance, Lebanese banks' price to earnings ratio stood at 6.1x by the closing of the report, against a MENA average of 13.8x, an emerging markets average of 12.4x and a global average of 11.1x for banking stocks. Similarly, Lebanese banks trade below their book value, given that their price to book value ratio reached 0.58x, against a much higher regional average of 2.15x, and emerging markets and international benchmarks in the 1.4x-1.8x range at the same date.

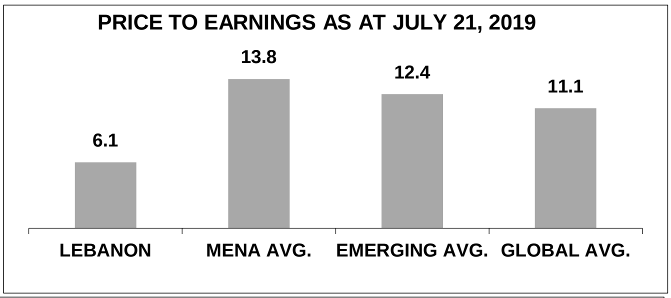
Along the same lines, Lebanese banks' price to assets ratio currently stands at a low 4.1%, against noticeable regional and emerging markets averages in the range of 20%-28% and a global benchmark of 15.0%. The PEG ratio, measured by dividing the P/E ratio by the earnings per common share growth over the past few years, is at 0.51, while international benchmarks are in the 1.5-2.1 range for banking stocks, which implies a 66%-76% discount relative to those averages.

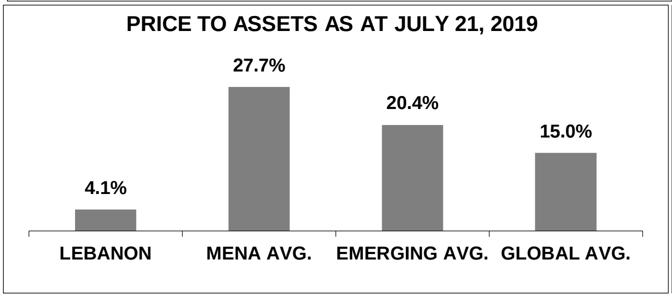
This means that banking stocks in Lebanon are generally undervalued given their established resilience and adequate financial standing ratios. Banks also reward shareholders better than peers in the region and across the world, on average, by paying them more dividends relative to their share prices (measured by the dividend yield ratio for listed banks) and even relative to the income they generate (measured by the dividend payout ratio).

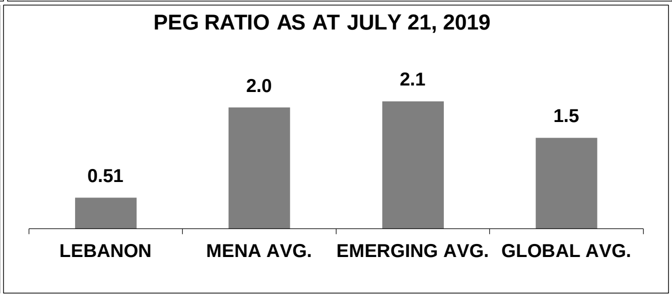
On the one hand, the dividend yield of listed banks, measured by dividing the 2018 common dividends per share by the last available share price, stood at 12.8%, against 3.3% for MENA banks, 2.0% for emerging markets and 3.5% for global banks. On the other hand, the common dividend payout ratio of the entire banking sector, measured by dividing the 2018 common dividends per share by the 2018 common earnings per share, reached 36.2% (noting that the total payout ratio including preferred shares stood at 42.6%). This compares to a payout ratio of 36.8% for MENA banks, 27.3% for emerging markets peers and 28.8% globally.

All in all, Lebanese banks might be an atypical case for stock market investors, but they have succeeded throughout the recent past in sustaining their growth story while rewarding shareholders with above-peer dividend metrics and enticing potential shareholders with comparatively favorable valuation ratios. Banks stand ready to benefit from a gradual amelioration in overall operating conditions especially should long-awaited economic and fiscal reforms be properly enacted and sustained in the near future.









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

Conclusion

While it is true that Lebanese banks are facing persistently tough operating conditions characterized by local political bickering and regional geopolitical tensions weighing on domestic economic activity and their income generation capacity on top of new taxes affecting their bottom lines, they remain well placed to navigate through difficulties without much trouble. This is mainly owed to their stable and large deposit base, comfortable financial standing, widely acknowledged conservative practices and globally praised compliance with international standards.

While lending to the private sector has contracted over the past year, banks can adequately reinforce their financial intermediation role once conditions improve and support the private sector economy without pressure on their balance sheet books. This also comes along a high primary liquidity ratio, covering more than half their deposit base. Moreover, Lebanese banks maintain solid capitalization levels should pressures arise, boasting a Basle III capital adequacy ratio of 17.8%, the bulk of which consists of Tier 1 capital.

Having said that, as banks ratings remain constrained by the sovereign ceilings, they have been subjected to downgrades and changes in outlook in tandem with the rating actions on Lebanon's sovereign ratings. The impact of such actions on the depositors community remained however immaterial, given the maintained confidence in Lebanese banks that enjoy sound financial standing amid a tough operating environment and a weak public sector on the overall constraining the sovereign ratings that are capping bank ratings.

In parallel, Lebanese banks are very keen on fully complying with all international regulatory standards and are quite active in fighting against money laundering and terrorism financing. They have adequate policies and procedures as well as due diligence rules on clients to promote ethical and professional standards in the banking sector and to prevent any bank from being used in any illegal activity. Banks maintain solid relationships with global banking authorities and hold periodic meetings with the latter to keep them abreast of the latest measures adopted in this regard.

Finally, Lebanon's banking sector remains a major pillar of the Lebanese economy, proving resilient in difficult times, maintaining noticeable financial soundness and its ability to fund the private and public sectors of the real economy. Notwithstanding its financial intermediation role in foreign economies and banking systems, whereby they adequately exported their domestic expertise at the service of a number of cross border markets of presence. Shall Lebanon or foreign economies of presence witness trend reversals in their operating conditions, Lebanese banks would be the first to benefit given their latent growth opportunities and wide expansion capacities in markets that are in big needs for developed banking products and services at large.