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19 August 2022

Initiation of Coverage

First Abu Dhabi Bank

A local banking icon

Last Close	19.74
Fair Value	18.40
Stock Rating	EQUAL-WEIGHT

Contents

Investment Case

Initiating with equal-weight and AED 18.40 fair value

First Abu Dhabi Bank is the biggest UAE banking institution and one of the largest in the Middle East. This local and regional champion leads the way in footprint, growth, asset quality, and cost-efficiency. FAB is well positioned to benefit from the current oil bonanza and any recovery in interest rates.

In this note we go over the sector and the company. We value the stock according to three different methodologies and arrive at a fair value of AED 18.40 per share. We initiate our coverage with an Equal-weight recommendation.

Compelling sector dynamics

The Gulf accounted for 1.6% of world banking assets in 2020, while regional banking penetration remains relatively low. This might explain the faster asset growth relative to global banking assets over the past decade.

With the pandemic largely behind us and a benign macro picture, credit growth and banking margins have started their upward journey. This is just the beginning of a virtuous cycle for regional banks in our opinion, as they come out fully restructured, lean and solidly ready to reap the benefits of the next up leg in the oil and interest rate cycle. In this context, FAB appears to be one of the best positioned franchises.

A local champion with regional aspirations

FAB commands roughly one-third of the local banking industry and boasts by far the best and most consistent set of metrics. Its proximity to the Abu Dhabi government makes it a quasi-sovereign institution with presence across the local industrial, commercial, and financial value-chains.

The bank started to grow inorganically and opportunistically with **ITS** landmark BAE acquisition in Egypt, and we believe that this trend should continue as FAB confirms its regional aspirations.

Outside of a macro shock which would derail the oil or interest rate pictures, we believe the path for growth is quite visible and exciting for FAB. Our minor concerns are limited to potential earnings volatility from its global capital markets and local real-estate exposures.

Solid financials all around

With a modest loan-book size relative to its total assets and a loan-to-deposit ratio which trails industry average and comparable lenders, FAB is well positioned to grow its core banking business in the next couple of years. Its lending activity started to recover last year and already boasts double-digit expansion.

As for margins, they seem to have turned the corner in the middle of last year and appear to be on an upward path. Finally, cost-efficiency is one of the best among peers and appears sustainable in the context of the bank's superior asset quality.

If the macro picture remains benign, and absent a sharp reversal in the oil price or in the positive consumer sentiment, FAB will be one of the lenders to own across the next interest-rate cycle. This quality is reflected in the price of the shares, and the current valuation makes the FAB stock more expensive and therefore less appealing relative to other UAE lenders.

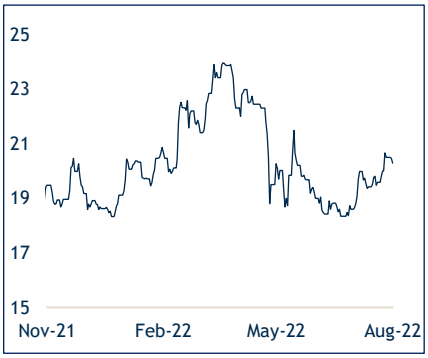
Stock rating

Last Close	19.74
Fair value	18.40
Target downside	-6.8%
Stock Rating	Equal-weight
Abu Dhabi Exchange	FAB
Bloomberg	FAB UH
Reuters	FAB.AD
Sector	Banking

Stock statistics

Market Cap (AED bn)	218.1
Avg Daily Vol (3 Mo)	12,010,582
Shares Outstanding (Mn)	11,041
Free Float	44%
Year-to-date Change (%)	6.0%
52w High Price (AED)	24.1
52w Low Price (AED)	16.4

Stock price



Ratios and margins

	FY22E
P/B	1.9X
P/E	20.2X
D/Y	3.0%
ROE	9.2%
ROA	1.0%

Sources: Al Ramz Investment Research, Refinitiv, Abu Dhabi Securities Exchange

Notes: Market prices at the close of August 17, 2022. ROE and ROA are the normalized net profits as calculated by Al Ramz Investment Research, over average equity, and average assets, respectively.

Compelling sector dynamics

Significant regional growth potential

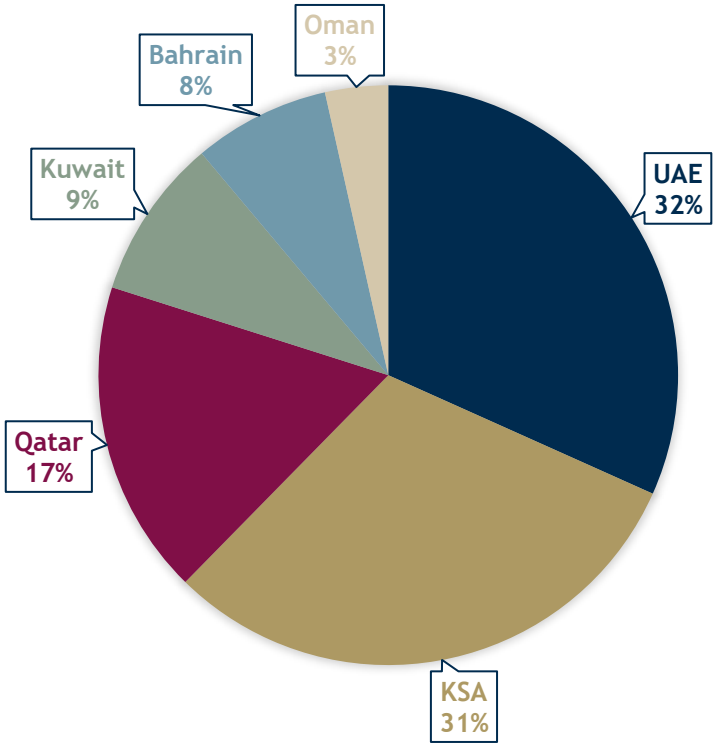
The Gulf Cooperation Council (GCC) comprises six member countries: Bahrain, Kuwait, Oman, Saudi Arabia, Qatar, and the United Arab Emirates (UAE).

According to Statista, the Gulf accounted for 1.6% of total worldwide banking assets in 2020. This looks like a sizable number considering that this region represents only 0.7% of the world population.

The combined size of the GCC banking sector, as measured by total aggregate assets, totaled $2.9tn at the end of 2021. This asset pool is distributed across 235 banking institutions. The UAE currently hosts 22 national and 37 foreign lenders.

There is a significant nine-fold variation in the relative asset size of banking systems in the GCC. Oman stands out as the smallest, while the UAE and Saudi lead the ranking. The latter two account for more than 63% of total assets.

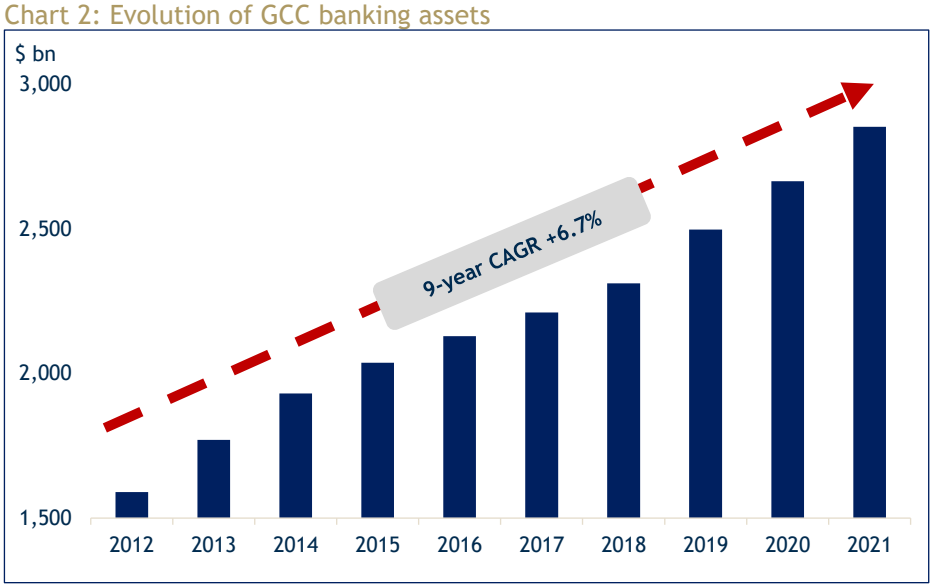
Chart 1: Geographic mix of GCC Banking assets



Source: Al Ramz Investment Research, Central banks of GCC countries

Regional banking assets have clocked a compounded annual growth rate of 6.7% over nine years, nearly doubling from $1.6tn in 2012 to $2.9tn at the end of 2021. This is quite substantial as it significantly exceeds the 3% rate of growth of global banking assets for the equivalent period (source: Statista).

Chart 2: Evolution of GCC banking assets

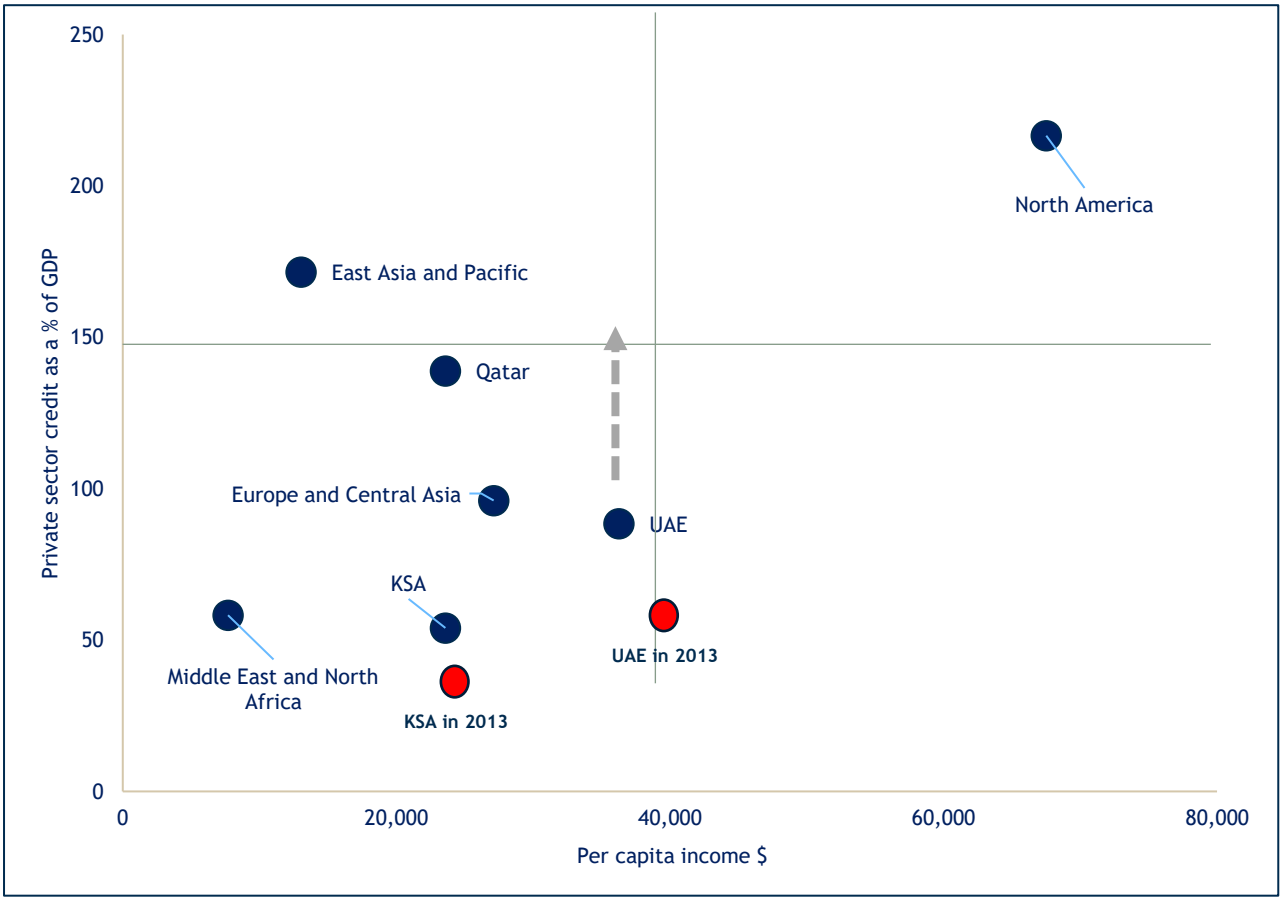


Source: Al Ramz Investment Research, Central banks of GCC countries

High historical asset growth is probably due to the relatively low banking penetration in most GCC countries compared to the global benchmark. We arrive at this conclusion by measuring the private credit penetration as a proportion of GDP – See chart 3 below.

The regional banking sector has been catching up with global peers, as evidenced by its most recent historical growth. We believe this is likely to continue in the foreseeable future, particularly in the case of the UAE.

Chart 3: Private sector credit positioning and expansion in 2020



Source: Al Ramz Investment Research, World Bank

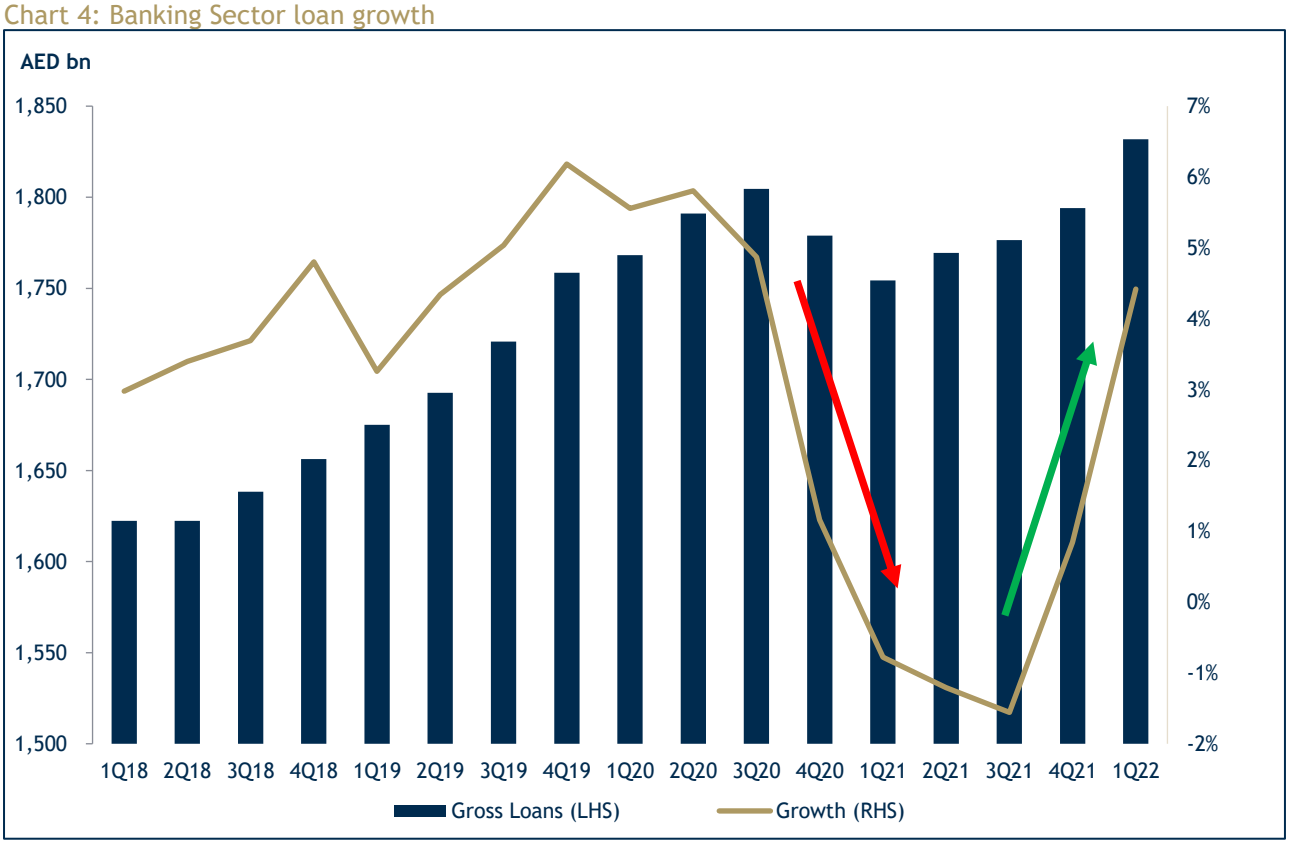
Visible loan growth pickup

The UAE was the seventh largest oil producing country in the world in 2021, as per the U.S. Energy Information Administration. As such, Oil exports contribute significantly to local and regional GDP growth. According to Tellimer Research, oil contribution to UAE GDP with a hypothetical average price of $125 in 2022, could be as high as 70%.

With current, elevated oil prices, economic growth estimates have been revised upwards across the board and across the region. The IMF expects UAE GDP to grow by +4.2% and +3.8% this year and next. Similar estimates from the Central Bank of the UAE are even more optimistic at 5.4% and 4.2%, respectively.

In this context, banking loans which are directly related to consumption and macro-economic growth, are naturally expected to rebound. Loan growth expectedly slowed during the pandemic but has started to pick up in a visible manner and is expected to improve further, well into 2023.

Chart 4: Banking Sector loan growth

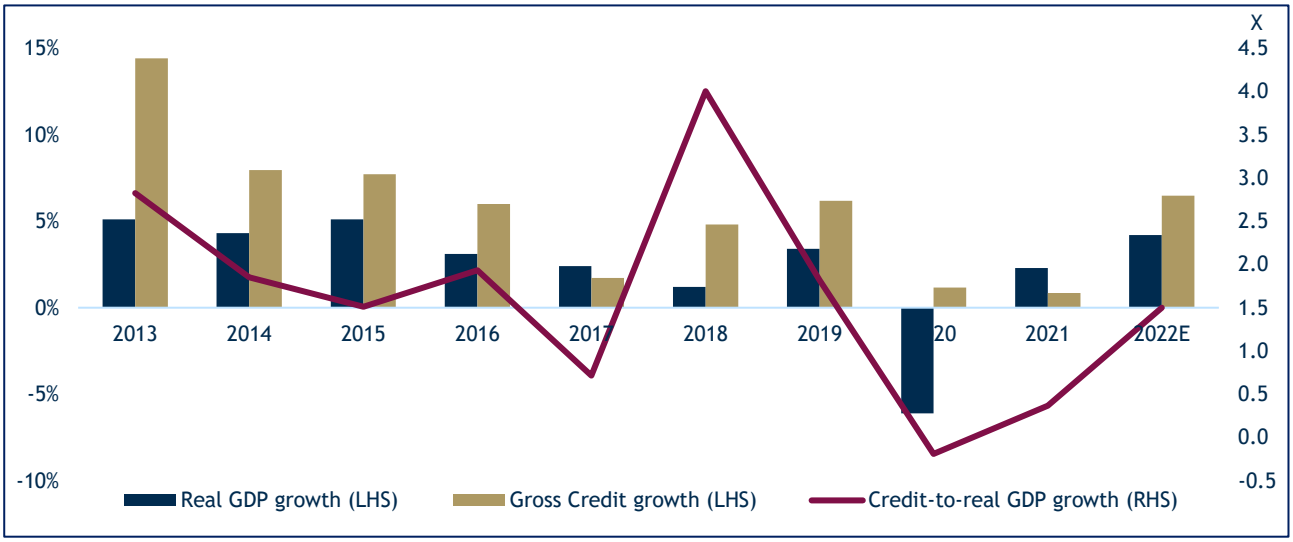


Source: Al Ramz Investment Research, CBUAE

In arriving at a fair expectation for banking loan growth, we looked at its historical evolution against GDP. We find that loans have historically outpaced economic growth in the UAE over the past ten years. We further find that, on average, loans have grown 50% faster than GDP – See next chart.

We conclude that a fair estimate for loan growth in the visible future should be a 1.5X multiple of GDP, or circa 6% based on IMF average economic growth estimates for this year and next. This is also in line with the 2022-23 loan growth guidance we have gathered from UAE listed lenders.

Chart 5: UAE Credit growth compared to economic growth



Source: Al Ramz Investment Research, CBUAE, IMF

Progressive margin expansion

Against earlier expectations by the US Federal Reserve of a "transitory" inflation pickup, the general increase in prices has proven more sticky, more dramatic at a 40-year high, and generally more problematic for central banks to manage than initially anticipated.

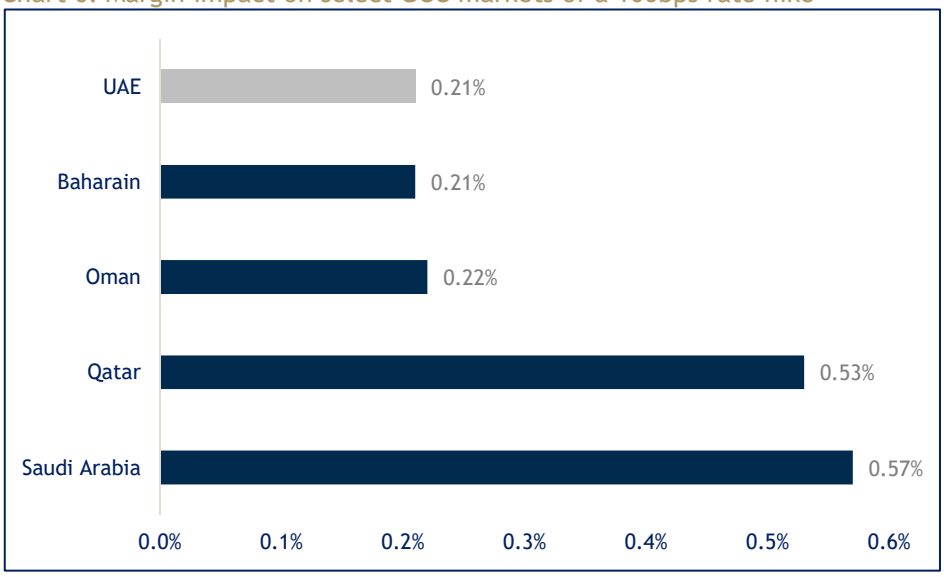
This has resulted in a Fed Fund rate increase of 225bps so far this year. Current expectations are for Fed rates to reach 3.8% by the end 2023, marking the highest level in 15 years. The UAE Dirham is dollar-pegged, and the Central Bank of the UAE should continue to exactly follow the Fed's monetary policy.

The implication for the banking sector in the absence of a recessionary slowdown, is an expected steepening of the yield curve. This should, in turn, translate into higher margins for the local banks including FAB. This impact is expected to materialize progressively in the latter part of 2022.

Research from Tellimer confirms that the impact of rate hikes on GCC banking systems should be margin-positive, with a 100bps rate increase expected to enhance Net Interest Margins by circa 22bps in the UAE and 57bps in KSA.

A recessionary scenario is progressively being priced-in by global markets and would constitute the greatest risk to our benign hypothesis for UAE banks.

Chart 6: Margin impact on select GCC markets of a 100bps rate hike



Source: Al Ramz Investment Research, Tellimer Research

Positive impact will take gradual effect

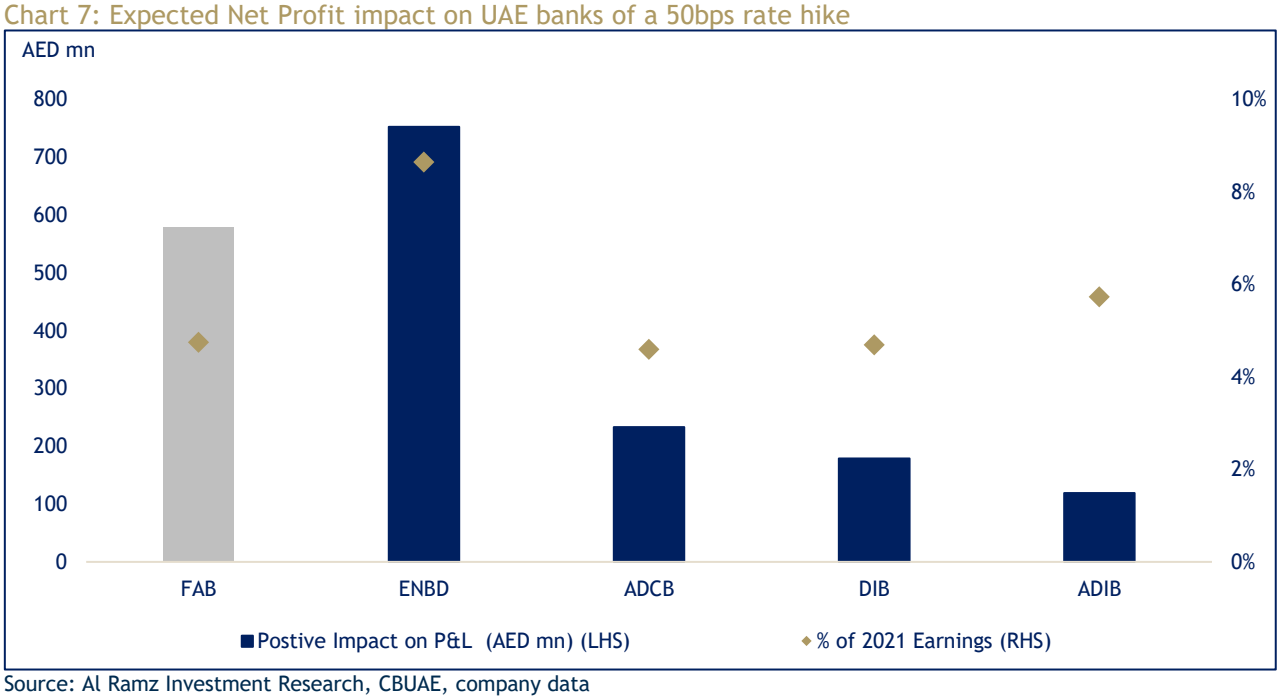
We note that during periods of increasing interest rates, the borrowing rate rises faster than the lending rate because loan books are repriced quarterly while deposits are repriced almost immediately. This could have a negative impact on margins in the short-term. However, margins should begin to expand once loan books have been repriced.

Accordingly, while we see potential marginal pressure in the immediate term, we expect overall progressive improvement into 2023. Management guidance over previous earnings seasons confirm our conviction of a progressive improvement in margins from the steepening yield curve. We illustrate P&L sensitivity of banks to interest rates in the following chart.

On average, we retain an indicative +5.7% positive impact on net profits from every 50bps rate hike for the five largest UAE banks. FAB falls at the median of the group with an estimated impact of +4.7%. This is in the context of sustained economic growth and would change if the increase in rates were to trigger a recessionary environment with potential yield curve flattening or inversion.

Finally, we highlight that the local banks have been on a drive to increase their focus on consumer financing, where pricing is at a premium compared to corporate loans. Large UAE lenders have recently and consequently displayed double-digit growth in consumer loans. This, too, should help expand margins across the sector.

Chart 7: Expected Net Profit impact on UAE banks of a 50bps rate hike



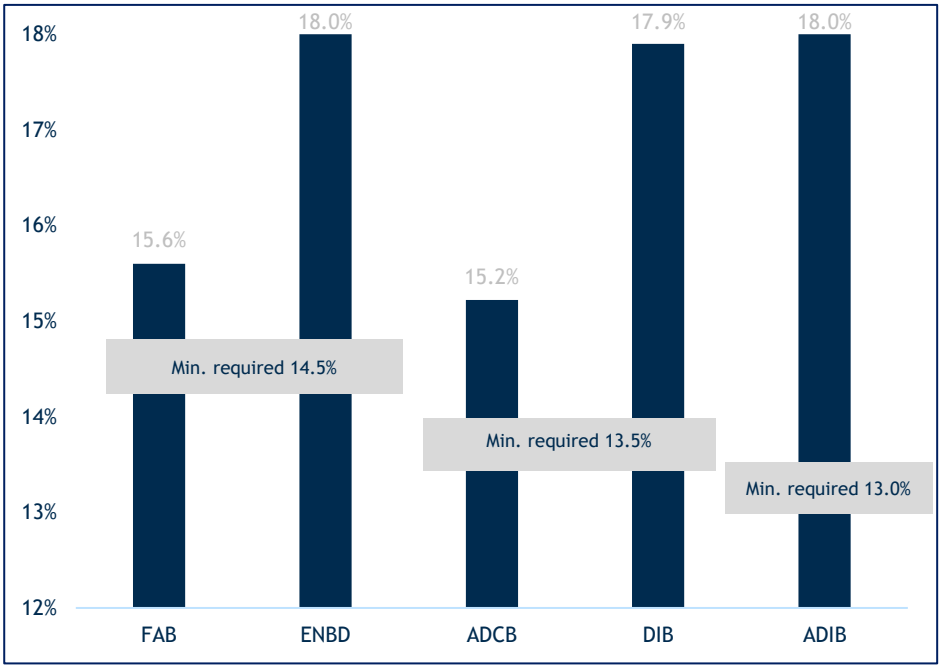
Source: Al Ramz Investment Research, CBUAE, company data

Ample liquidity for credit growth

A rising interest-rate environment, along with strong economic growth leading to a commensurate pickup in private-sector loans, would usually and likely lead to a deterioration in overall asset quality. Credit growth therefore requires sufficient liquidity and capital buffers.

We have repeatedly highlighted the strength of UAE banks in this regard. The pandemic provided an opportunity for local lenders to strengthen their capital ratios and liquidity positions, while maintaining a tight grip on costs. The average Capital Adequacy Ratio (CAR) for the sector currently stands at 17.1%. This is higher than the minimum regulatory requirement of 13.0%.

Chart 8: CAR of top UAE banks

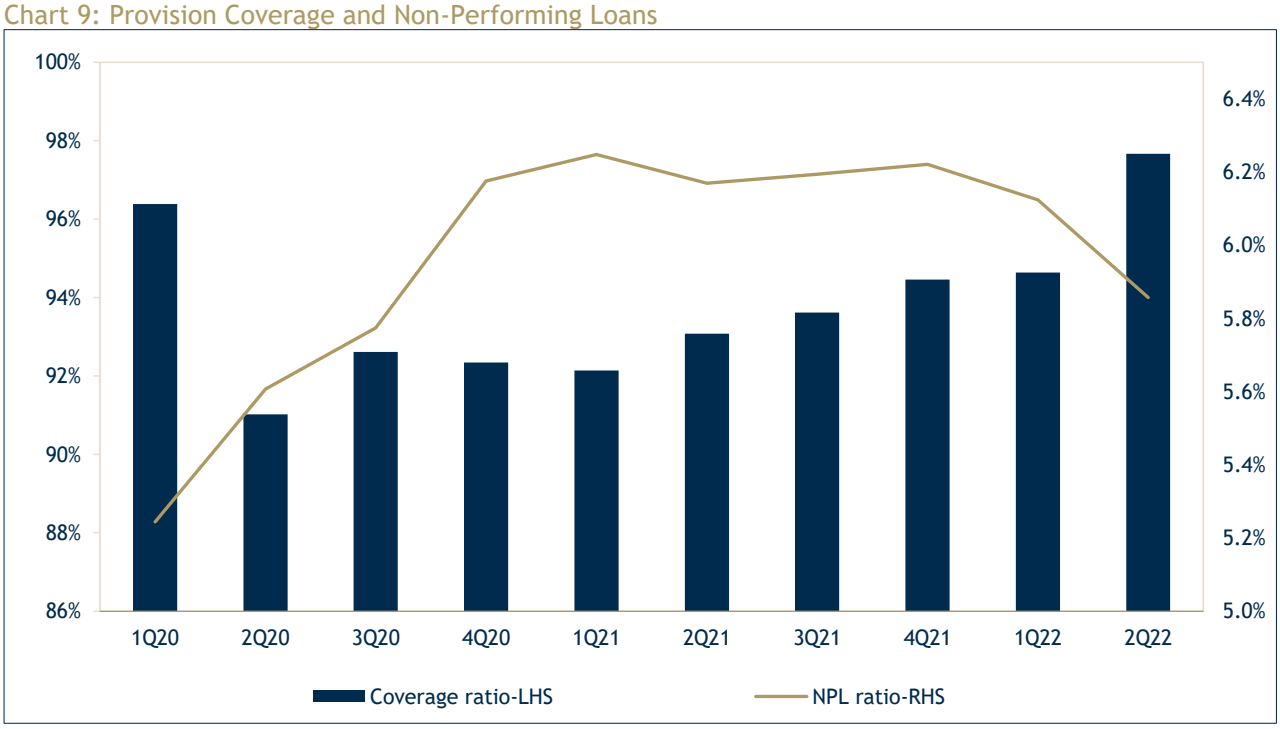


Source: Al Ramz Investment Research, Company data

If we consider the further regulatory tightening post-pandemic, most notably for Domestic Systematic Important Banks (D-SIB), the minimum acceptable CAR would then be closer to 14.5% at the higher end of the spectrum. This remains well below the sector average and allows us to conclude that UAE banks are sufficiently capitalized.

Accordingly, we believe local banks can absorb the expected shock to asset quality without additional capital. Furthermore, we note that aggregate provisioning remains considerably high at circa 98% and has progressively improved from the low levels reached during the pandemic. All-in-all, we believe that the banking sector is well positioned to capture the opportunity of the upcoming lending cycle.

Chart 9: Provision Coverage and Non-Performing Loans



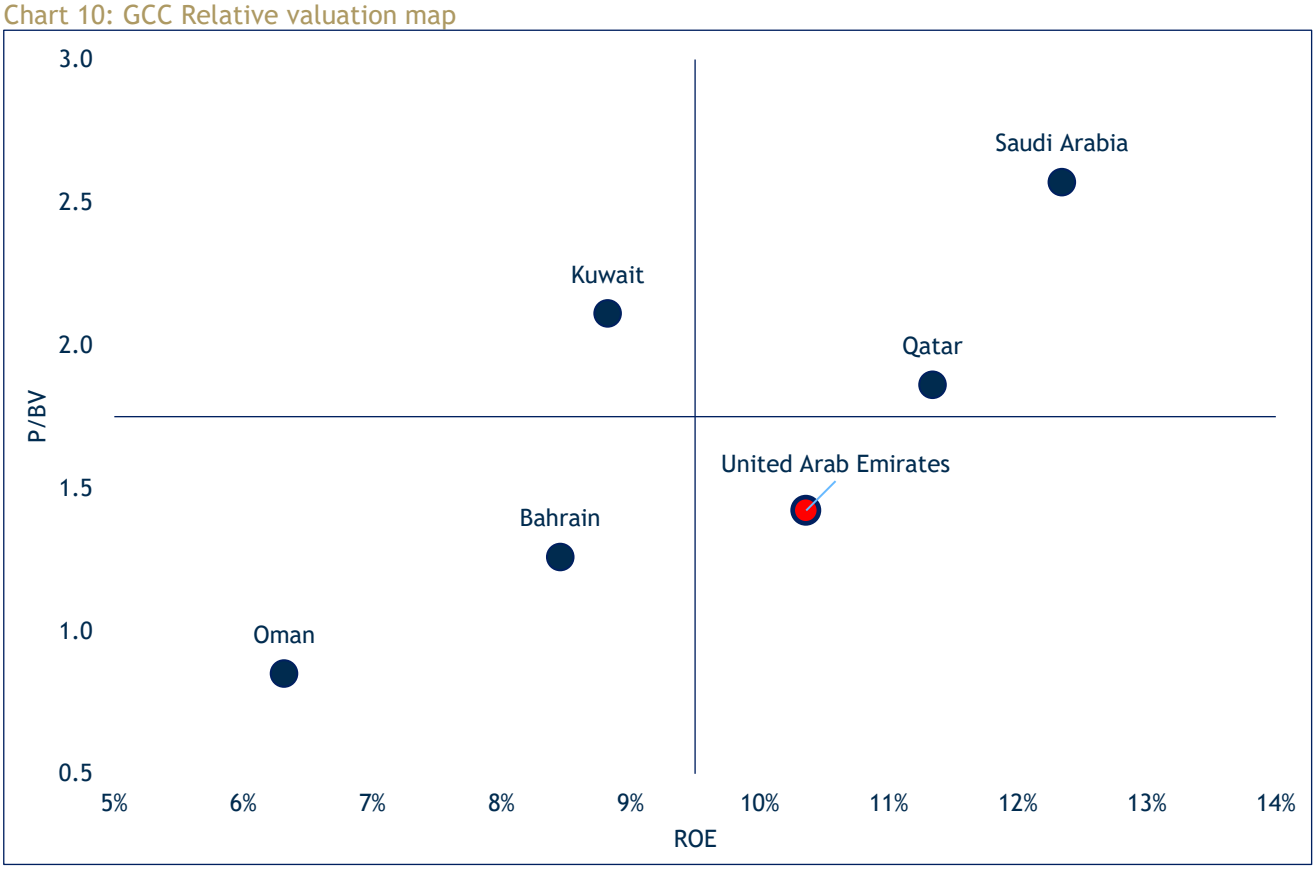
Source: Al Ramz Investment Research, Company data

Compelling UAE sector valuation against regional peers

UAE banks are well positioned to benefit from the current environment of high oil prices, solid economic growth, rising interest rates, and higher consumer spending. They also rank quite high on structural metrics such as profitability or capital adequacy.

When compared to regional peers on valuation metrics, however, the UAE banking sector does not particularly shine. It ranks in the bottom-half of the pack on a price-to-book basis. It trades at a premium to Bahrain and Oman, but lags Saudi, Qatar, and Kuwait, notwithstanding a healthy ROE nearing 10%.

Chart 10: GCC Relative valuation map



Source: Al Ramz Investment Research, Refinitiv

At the current multiple of book value of 1.4x, we find that the UAE trades at a 32% discount to the regional weighted average of 2.1x, and at a significant 45% discount to the peak valuation of the Saudi banking sector.

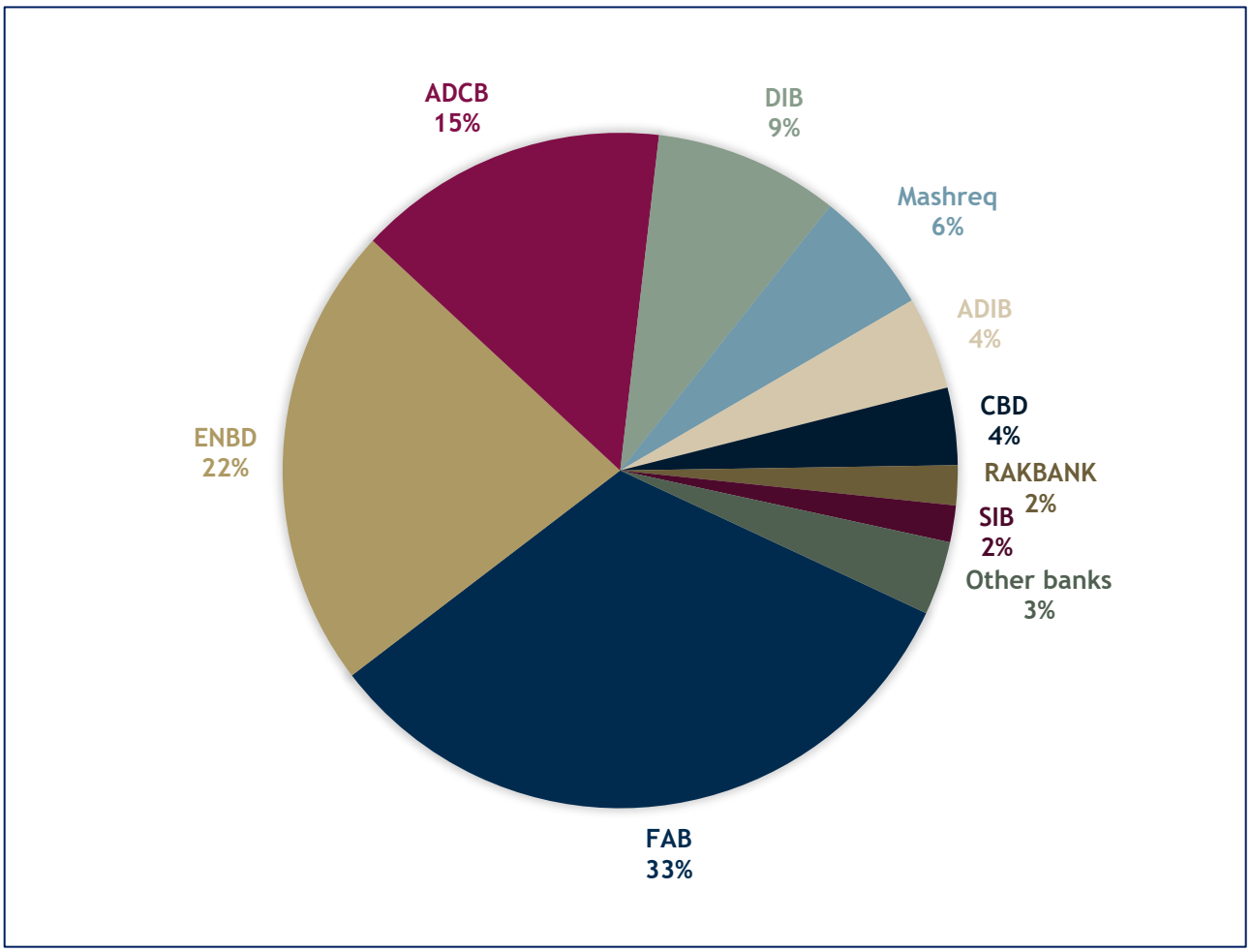
We find that such a discount could partially, but not entirely, be justified by the lesser sensitivity of UAE banking margins to rising interest rates. We also note that the ROE of UAE banks sits close to the top of the sector average.

All-in-all, we conclude that UAE banks should trade more in line with the broader GCC sector. The UAE sector should be up 50% from the current levels to catchup with the GCC average. We believe more conservatively that another 25% valuation expansion from the current levels could be deserved as the margin improvement scenario unfolds.

Local champion, regional aspirations

First Abu Dhabi Bank (FAB) is the largest bank in the United Arab Emirates in addition to being the second largest in the MENA region, with total assets of AED 1,042bn at the end of June 2022.

Chart 11: UAE banks by market share of total system assets



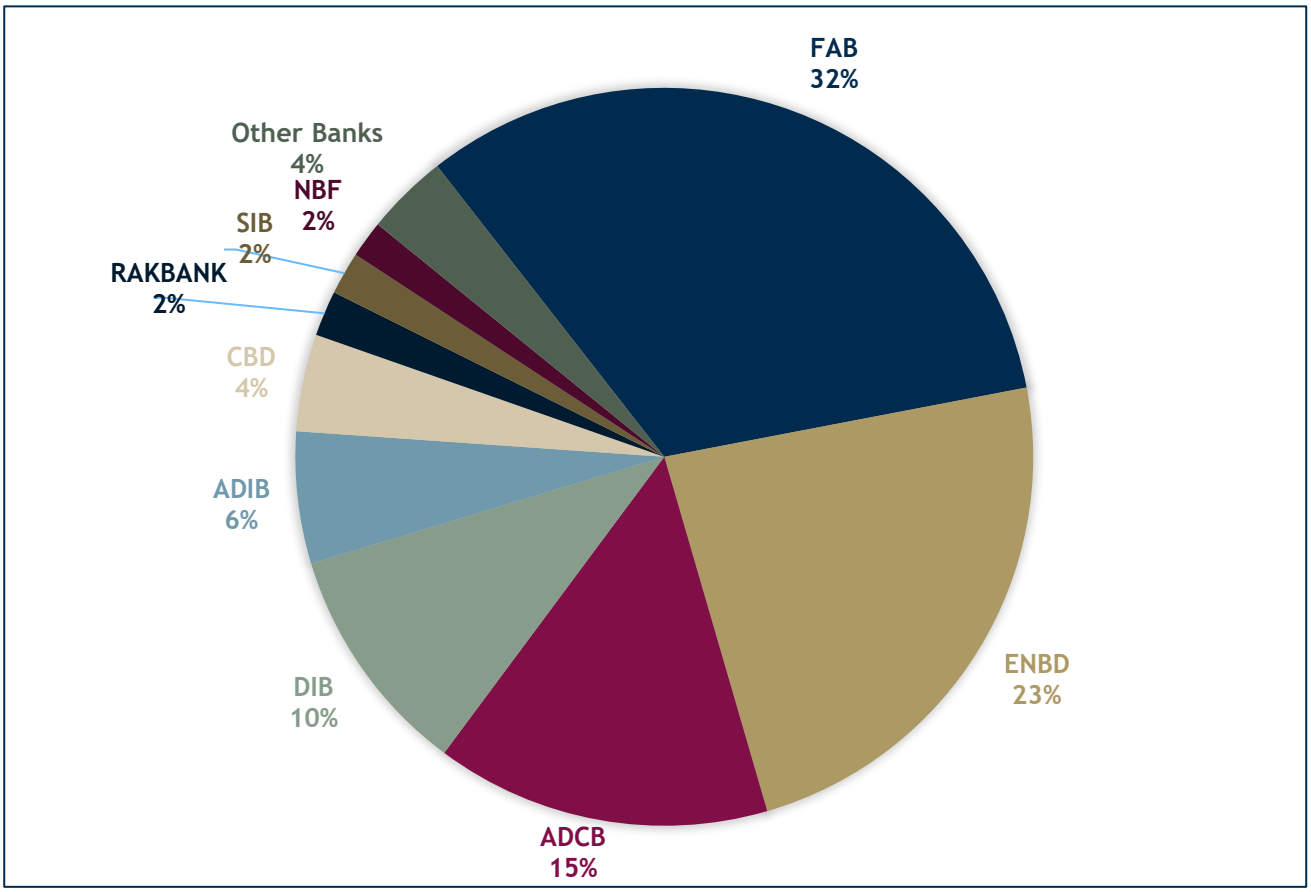
Source: Al Ramz Investment Research, Company data

The bank emanated from the 2017 merger of First Gulf Bank (FGB) and National Bank of Abu Dhabi (NBAD), the two local leaders at the time. The merger was the result of the highly anticipated consolidation of the UAE banking sector.

The market saw several other transactions both locally and regionally, such as the consolidation of UNB into ADCB, the purchase of Denizbank by ENBD, and the most recent acquisition of Bank Audi Egypt by FAB.

Today, First Abu Dhabi is the national leader by assets, loans and by deposits, commanding a near one-third share of the local market with a customer base of more than 3 million accounts and a nationwide distribution network of 66 branches and 406 ATMs/CDMs.

Chart 12: UAE banks by deposits at the end of the second quarter of 2022

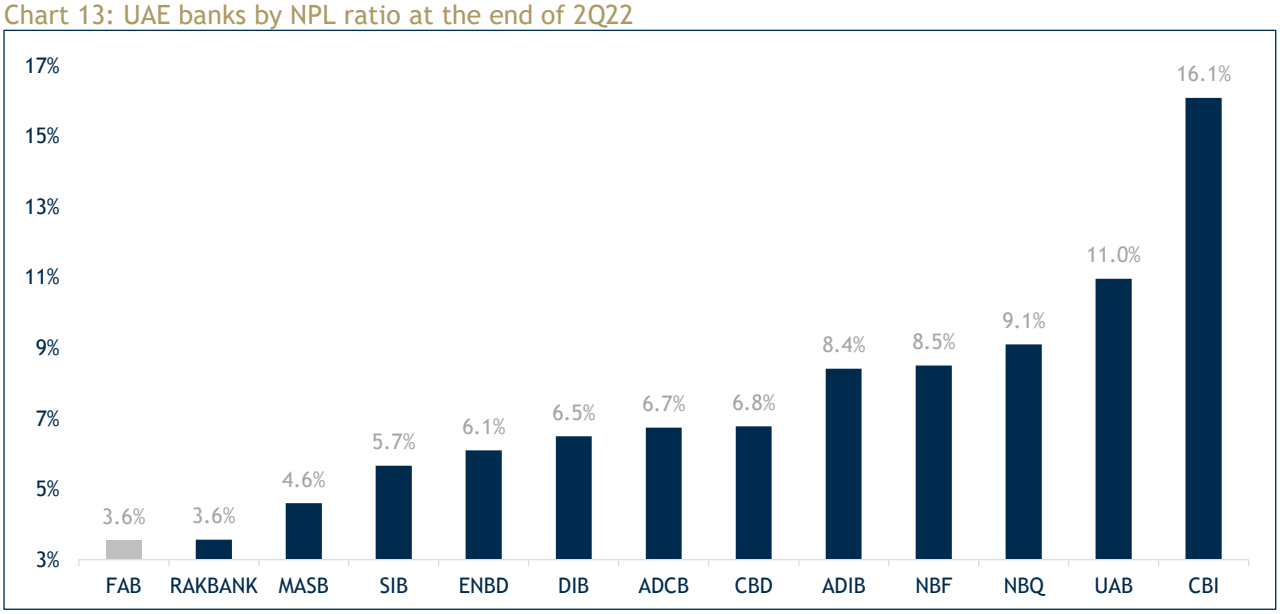


Source: Al Ramz Investment Research, Company data

As further attestation of its local leadership position, FAB also commands the top position nationally when it comes to loan-book quality, with one of the lowest Non-Performing Loan (NPL) ratio of 3.6%.

Admittedly, this is a good ratio by any standard. However, it still lags the metrics of the regional leader Qatar National Bank (QNB) which boasts an impressive NPL ratio of 2.4% along with a coverage ratio of 152%.

Chart 13: UAE banks by NPL ratio at the end of 2Q22



Source: Al Ramz Investment Research, Company data

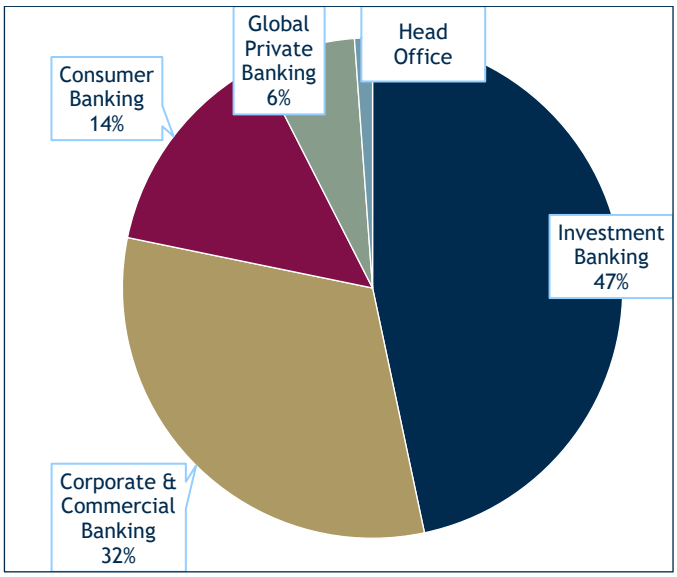
Business mix skewed towards investment banking

The business mix of FAB is in line with the traditional "four-pillar" approach of conventional banks: Retail, Corporate, Private Banking, and Investment Banking.

However, we highlight that the investment banking segment of the national champion is the largest contributor, where we would normally expect the retail or commercial lending businesses to lead.

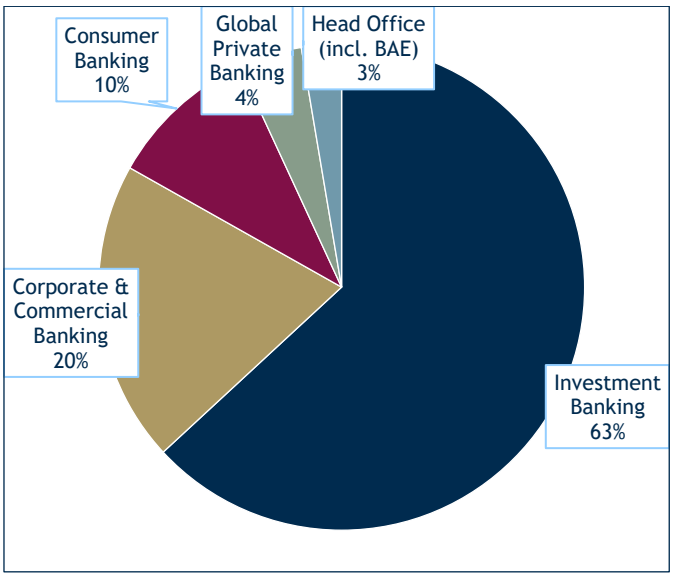
In effect, we note that Investment banking contributes the largest portion of deposits (63%), loans (47%), total income (42%), and net profits (57%).

Chart 14: Loans by segment at end 1H22



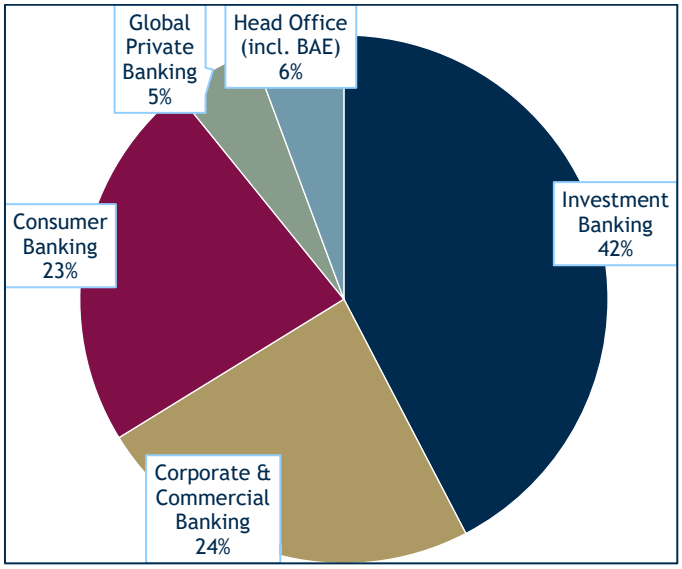
Source: Al Ramz Investment Research, Company data

Chart 15: Deposits by segment at end 1H22



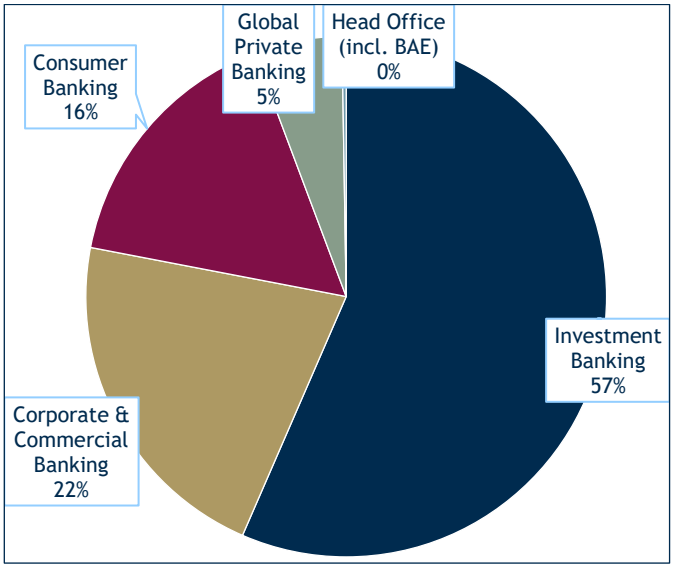
Source: Al Ramz Investment Research, Company data

Chart 16: Total income by segment at end 1H22



Source: Al Ramz Investment Research, Company data

Chart 17: Net Profit by segment at end 1H22



Source: Al Ramz Investment Research, Company data

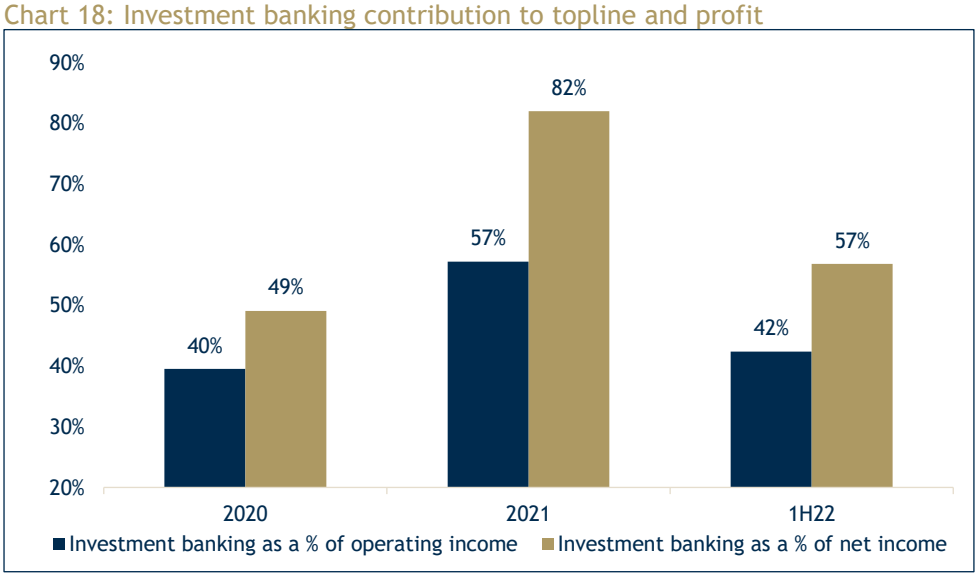
Investment Banking includes lending to Government, Government Related Entities (GREs), Sovereign Wealth Funds (SWFs), and multinational clients. Other investment banking services include managing investment portfolios, Forex trading, Swaps, and intermediation businesses. We highlight that this segment is subject to more interest rate volatility than other business segments.

The investment banking division contributed 57% to total income and 82% to net profits in 2021. This looks like an over-sized representation for this division and may also include some reclassifications from more traditional lending businesses.

Nonetheless, we highlight the volatility in the contribution of investment banking division to the total mix. In the second half of this year, the proportion of total income derived from investment banking declined to 42% from 57% in the full year 2021, while its share in the mix of net profits dropped to 57% from 82%.

As a result, we believe that a large proportion of FAB's income may be exposed to volatility from overall market conditions. For a bank of this size and positioning, we would expect the retail/corporate segment to ideally command a larger, and more stable, share of the business. This is partly mitigated by the over-sized exposure to government-related lending.

Chart 18: Investment banking contribution to topline and profit



Source: Al Ramz Investment Research, Company data

Strong and supportive government ownership

The principal shareholder of FAB is the Government of Abu Dhabi, which indirectly owns 37.9% of outstanding shares through wholly owned Mubadala Investment Company (MIC). The Abu Dhabi ruling family claims another 15.3%. This brings the total government or quasi-government ownership to a substantial 53.2%, as far as we can tell.

This is important for three reasons. Firstly, we assume strategic stability in the shareholding from this large base of government ownership. This is verified historically since these proportions of ownership have been largely stable over time, even if these shareholders are free to dispose of their stakes.

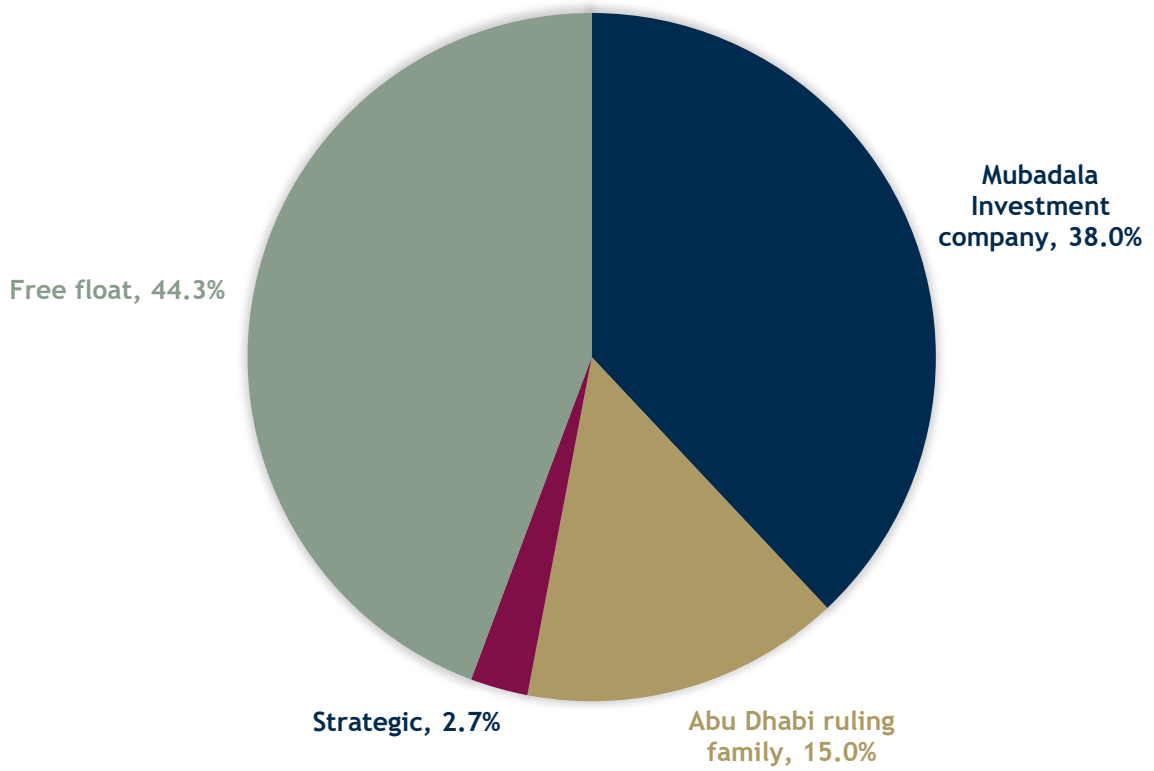
Secondly, we assume that the bank should be positively impacted by the high sovereign credit-rating of Abu Dhabi, as rating agencies might treat FAB as a quasi-sovereign entity with unlikely probability of default.

In this context, we highlight that the government of Abu Dhabi retains a top credit rating of AA with stable outlook as per S&P. This is the highest sovereign rating in the region ahead of Qatar (AA-) or Saudi Arabia (A).

Thirdly, we believe that the distribution policy of the bank might have been impacted, and might continue to be impacted, by the appetite for yield generally expressed by local investing entities such as Mubadala or the ruling families.

The rest of the bank's ownership is made up of another 2.7% attributed to strategic shareholders, as per the definition and understanding of FAB's management. In effect, this brings the strategic ownership of the bank to 55.6% which leaves a smaller effective free float of 44.4%, a slightly tighter definition than might be found with traditional data providers (Reuters, Factset) who estimate the free float closer to two-thirds of the capital.

Chart 19: Shareholding structure as at December 2021

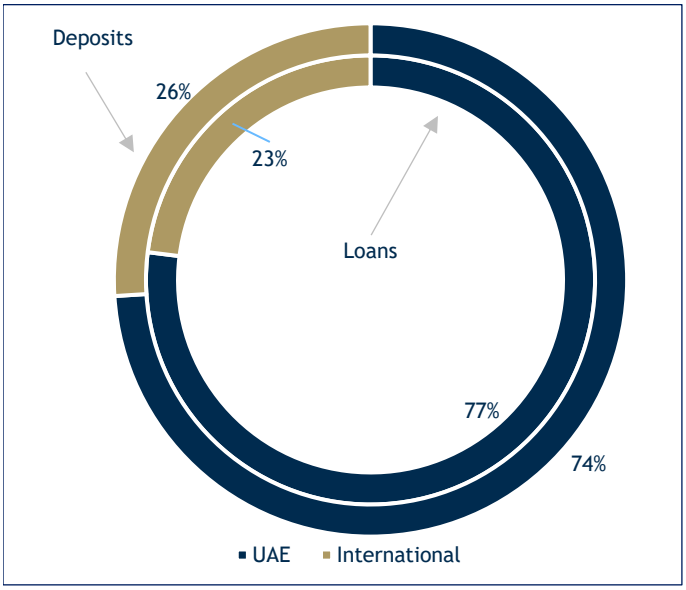


Source: Al Ramz Investment Research, Company data

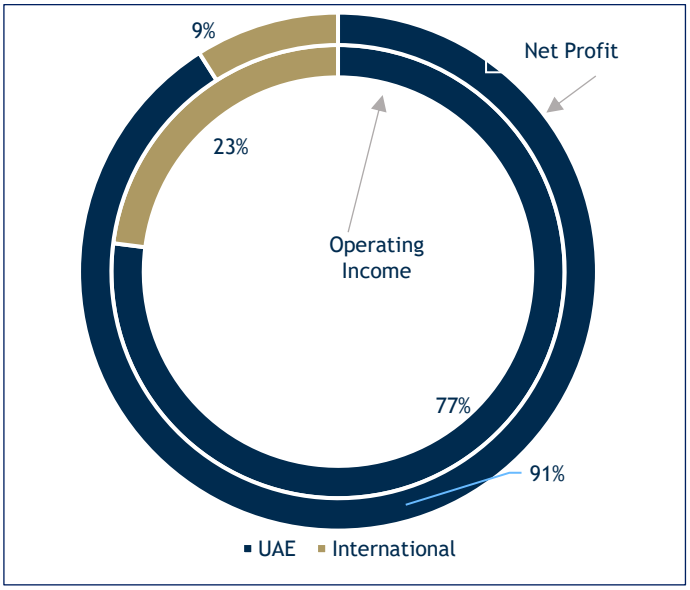
International consolidator

The sheer size of the bank now places it at a crossroad where further growth from its current asset base will probably require aggressive opportunistic expansion, such as the one seen during the acquisition of Bank Audi Egypt (BAE).

Chart 20 - Operating metrics by geography as at 1H22



Source: Al Ramz Investment Research, Company data



Source: Al Ramz Investment Research, Company data

In April 2021, FAB acquired Bank Audi Egypt from Bank Audi, as the latter struggled with its financial woes at home in Lebanon. This was a unique and strategic opportunity for FAB to acquire a presence overnight in the significant Egyptian market. It also confirmed the role of FAB as a regional consolidator.

This is potentially a curse and a blessing. Local growth should no longer suffice, regardless of economic conditions, while international expansion will largely depend on the price tag and the quality of execution. The track record of FAB to date in its international growth efforts has been convincing (e.g., Bank Audi Egypt), but the road might be a winding one.

In February of this year, FAB made a non-binding offer to buy a controlling stake in EFG Hermes, the leading regional investment banking and brokerage franchise, with a further intention to launch a mandatory tender. However, FAB quickly withdrew its offer.

In line with what was briefly documented in the financial press (Bloomberg), we believe that the bid withdrawal by FAB was probably due to potential regulatory pushbacks which were bound to significantly delay the execution of the deal.

In any case, this was a further attestation of the difficulty to meaningfully grow such a large franchise as FAB. While the intent to grow inorganically is convincing as formulated by the bank, execution will be the ultimate key to success.

On the front of organic international growth, the bank recently announced the approval of a trade license from the China Banking and Insurance Regulatory Commission to establish its first mainland branch in Shanghai. The branch started operations in the first quarter of this year.

Figure 1: Geographical presence of FAB

Source: Al Ramz Investment Research, Company data

More strengths than weaknesses or threats

Figure 2: SWOT Analysis of FAB

Strengths	•A strong domestic franchise (#1 in the UAE and #2 in MENA by asset size) •Robust funding and liquidity profile •Historical deposit growth better than the sector •Superior asset quality within large banks •One of the most cost-efficient banks in the UAE •Comfortable cash cushion as a proportion of total assets •Strong shareholding profile with the government as main shareholder
Weaknesses	•Lower NIM due to impact of placing excess liquidity with FED or ECB •Low interest, high-quality lending book (Government and GREs) •High concentration of business in volatile Investment Banking •High concentration of loans in Real Estate
Opportunities	•Lowest LDR in the sector provides scope for further loan growth •Major beneficiary of new government initiatives/projects
Threats	•New NPLs from recovering loan growth and a rise in interest rates •Eventual economic slowdown impacting sector growth •Changes in banking regulation

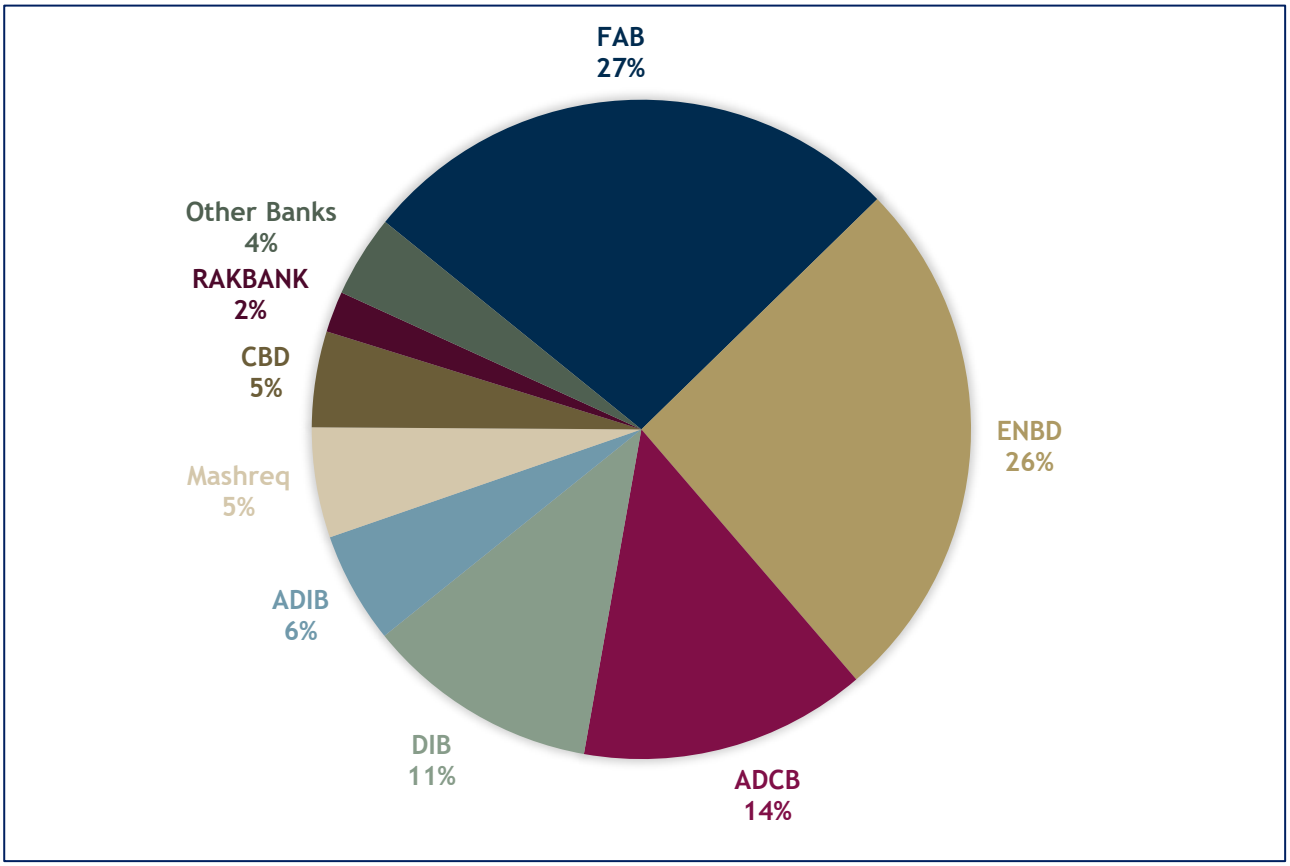
Source: Al Ramz Investment Research, Company data

Strong financials with bright outlook

FAB is the largest lender in the UAE with a total loan-book of AED 478bn at the end of the second quarter. This corresponds to a market share of 25%, compared to its relatively larger 32% share of assets.

The surprisingly smaller scale of the lending portfolio compared to total balance sheet size is due to the bank's over-sized investment portfolio and to a strong cash buffer. This divergence in scale should also allow the bank to grow unconstrained, as the economic cycle picks up.

Chart 21: UAE Market share of loans as at 2Q22



Source: Al Ramz Investment Research, Company data

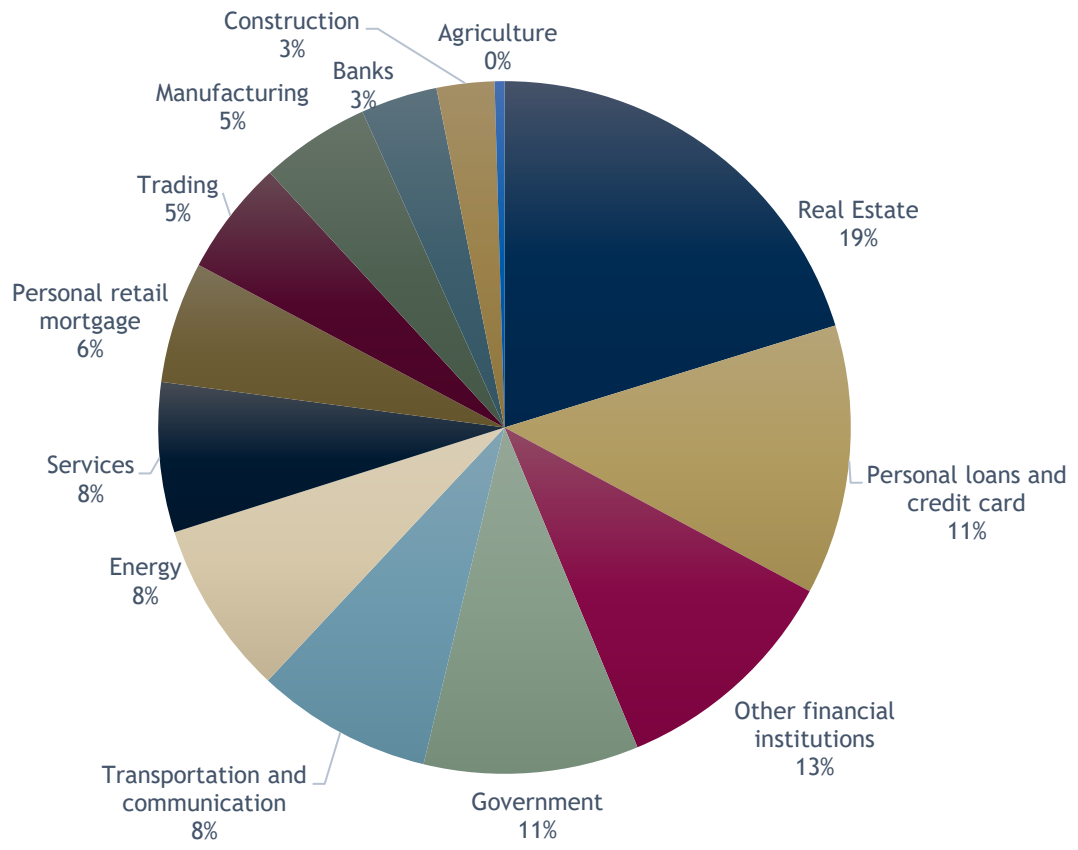
A well-diversified loan book

FAB's current lending operations are largely skewed to the home market. This is one reason why it is actively looking to geographically diversify its portfolio.

In fact, FAB is surprisingly home-centric for a franchise of this size, and we understand and appreciate the strategic intent -and difficulty- to grow outbound.

Looking at the segment breakdown of FAB's lending book, we note that this is where the true diversification lies – By Industry. As a true, full-fledged retail and corporate bank, it is present in every representative industry of the UAE's economic fabric.

Chart 22: Loan book breakdown by industry at end 2Q22



Source: Al Ramz Investment Research, Company data

We also note that real-estate represents 19% of the total, which is high considering the GDP contribution of this sector: 5.5% on average over the past ten years. This current over-representation of Real Estate in the loan books of banks is typical of the local economy.

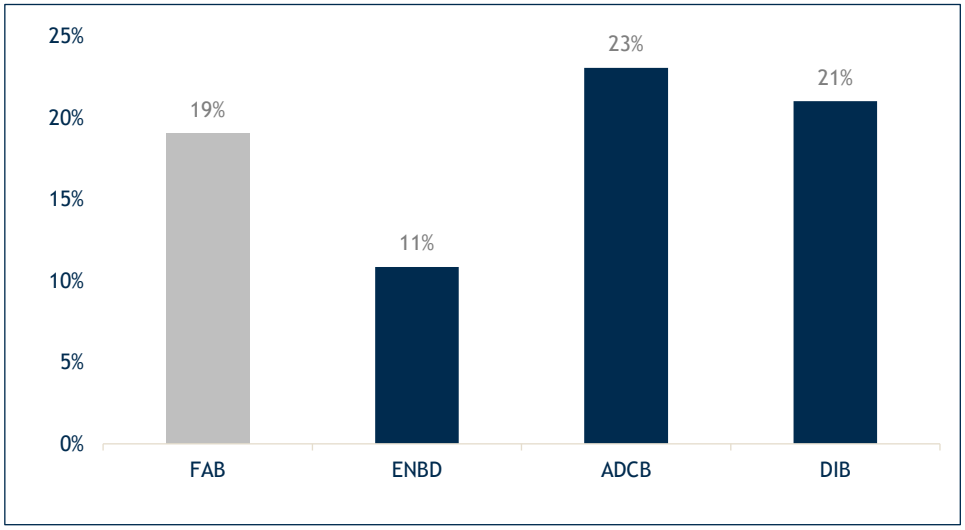
The sector has been growing to renewed dynamism, after the lows of the pandemic. Property prices have also recovered. This cyclical froth has translated into a larger Real Estate appetite from investors. In turn, this has resulted into higher lending to this sector from banking institutions.

Overall, we highlight that UAE lending institutions remain largely within the regulatory framework set by the Central Bank, where banks are required to limit their real estate exposure to 20% of deposits. In December 2021 this limit was changed to 30% of Credit Risk Weighted Assets (CRWA) and set as a tentative and temporary soft cap for 2022.

Our concern about the cyclicality of the real estate sector, and the commensurate exposure of banks to it, is seemingly shared by the regulator. This is captured by a single statistic: As per FAB, 45% of its Non-Performing-Loans at the end of June 2022 belonged to the Property sector (Investor Presentation, 28 July 2022).

Overall, considering the size and quality of FAB's balance sheet, we would not consider its sector exposure to the property market as a main factor of risk at this stage in the cycle.

Chart 23: Real-estate lending-book exposure of main UAE lenders



Source: Al Ramz Investment Research, Company data

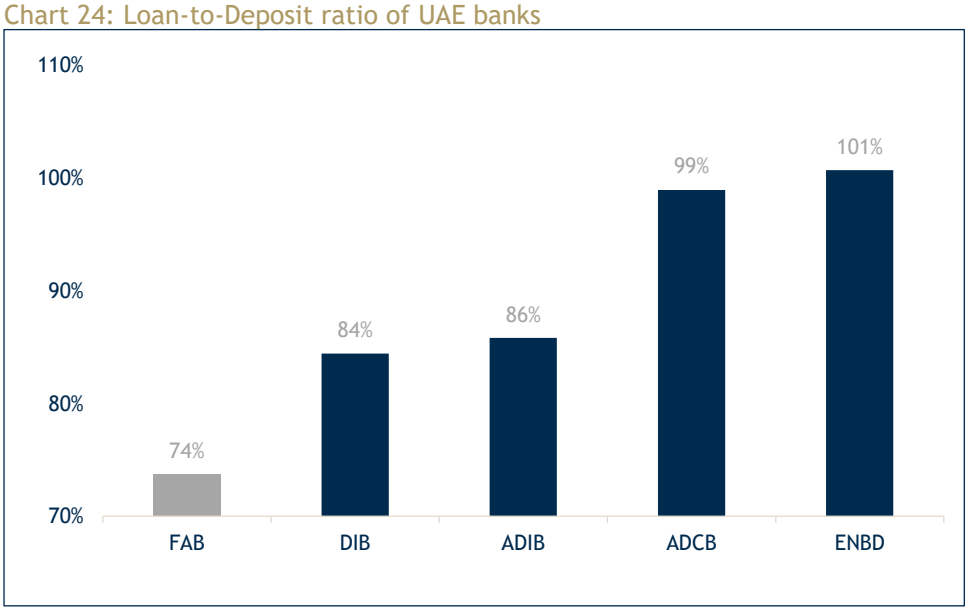
Moderate loan-to-deposit ratio should help loan growth

We assess the potential for FAB to tap into the growth opportunity brought about by the expected and upcoming credit cycle revival. To do this, we look at the bank's liquidity as expressed by its loan-to-deposits (LDR) ratio.

FAB's LDR stood at 74% at the end of the second quarter of this year, significantly lower than the industry average of 91% and slightly lower than its own recent historical average. This is mostly due to two factors.

Firstly, the bank has been quite conservative in growing its loan portfolio and has mainly focused on growing high-quality assets. This is evident through its low NPL ratio, the lowest in the country. Secondly, the bank has been able to continue to grow its deposit-base by hosting most GRE deposits.

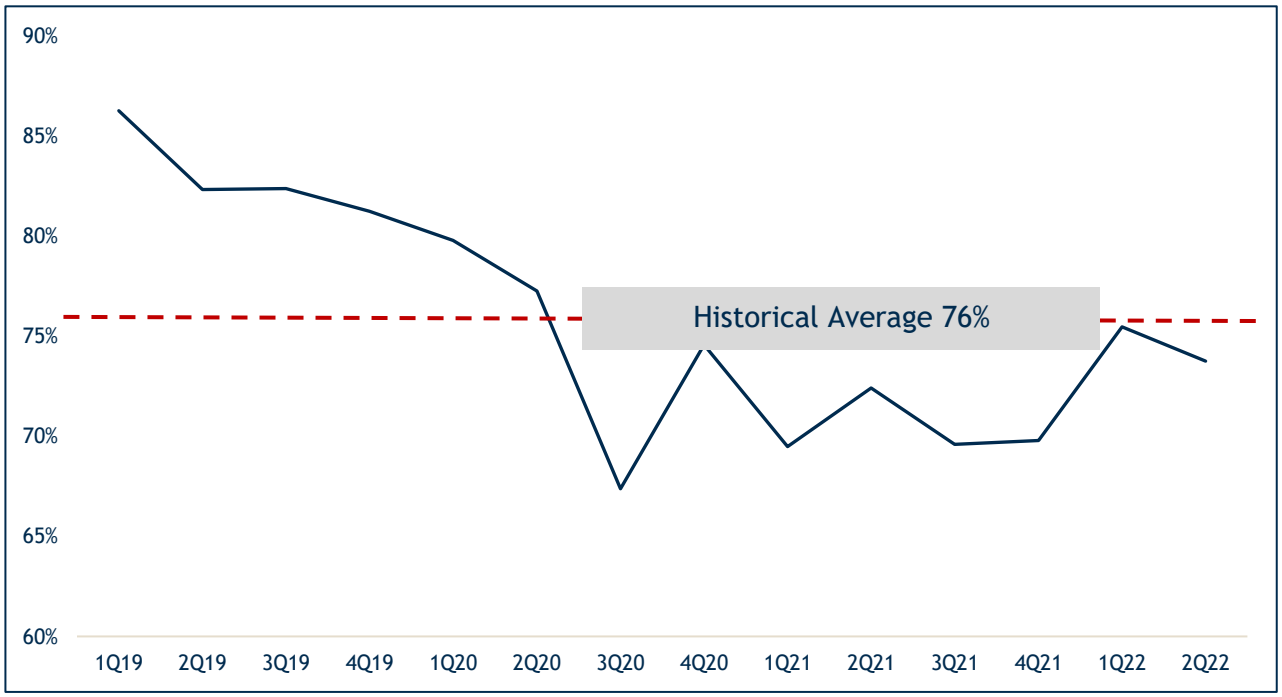
Chart 24: Loan-to-Deposit ratio of UAE banks



Source: Al Ramz Investment Research, Company data

As growth picks up and loan growth follows in the context of the cyclical pickup, the LDR ratio should also mechanically expand. Coming from a lower LDR base than its peers, FAB should be able to expand its lending business more safely and more rapidly than the sector in the coming quarters.

Chart 25: Historical quarterly evolution of LDR at FAB



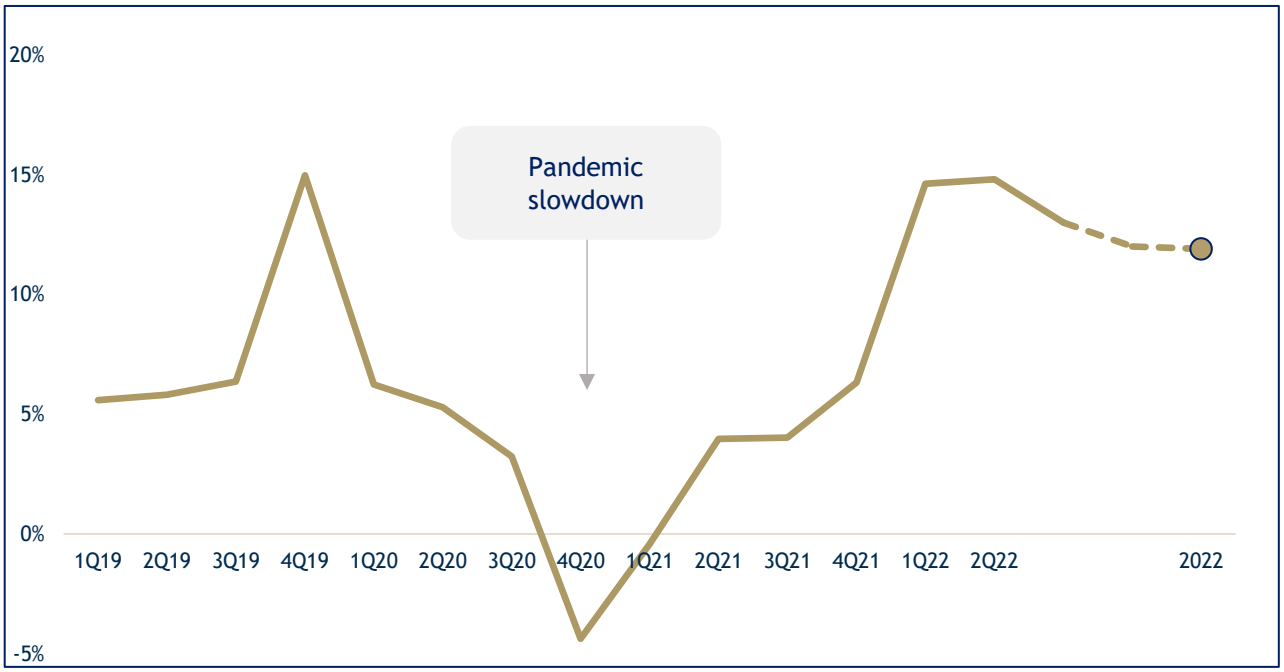
Source: Al Ramz Investment Research, Company data

Faster growth than local peers

FAB's lending activity grew at an average of 5.6% between 2017 and 2021, significantly outpacing the peer average of 2.5% for the period. Loan growth slowed understandably during the pandemic, as the bank was reluctant to lend and private sector demand for credit melted away.

We note a swift recovery of the lending portfolio since early 2021. This accelerated further into 2022, with a mid-double-digit surge in loan growth of +14.8% in the second quarter of this year compared to the same period last year. For the full year, we see loan growth nearing 12%, slightly higher than management guidance of high-single-digit loan-book expansion.

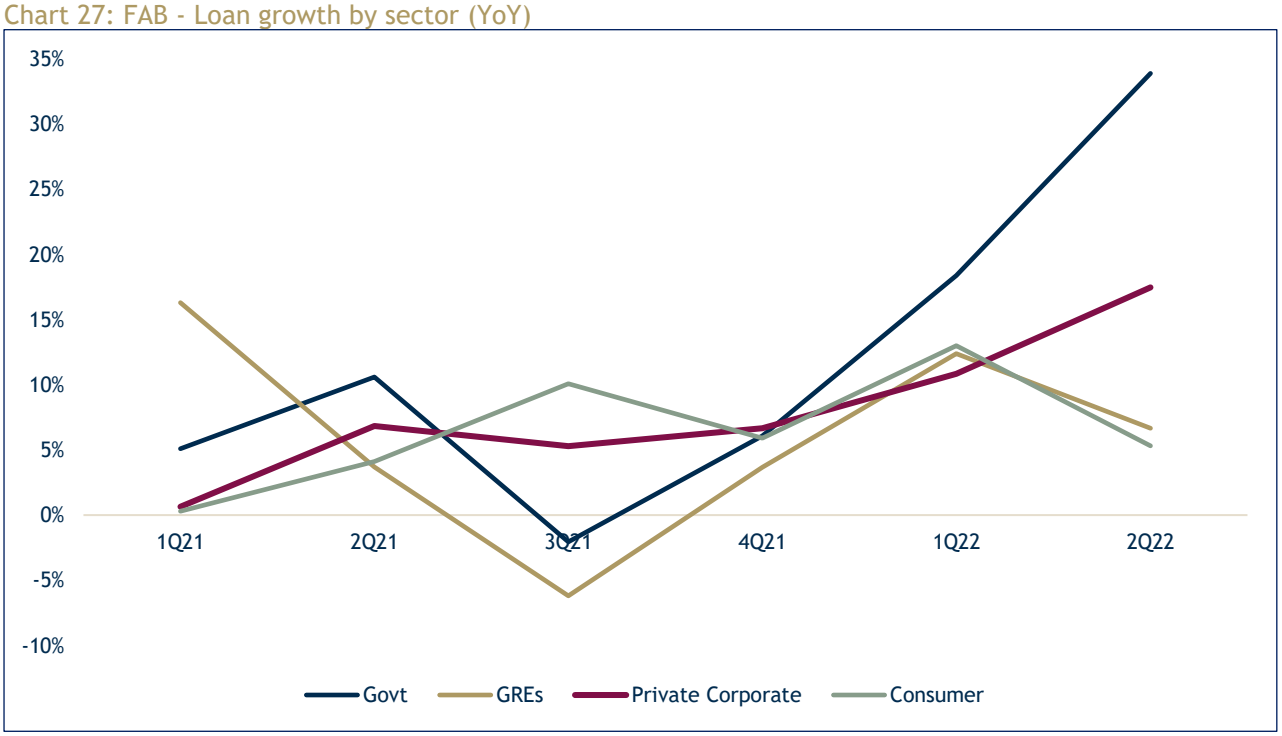
Chart 26: FAB loan growth



Source: Al Ramz Investment Research, Company data

Drilling down into lending activity by segment, we currently see growth across business segments, from Government lending, or Government Related Enterprises (GREs), and all the way to Retail. Looking forward into year-end and into next year, we expect this loan momentum to continue and to be driven by all segments equally.

Chart 27: FAB - Loan growth by sector (YoY)

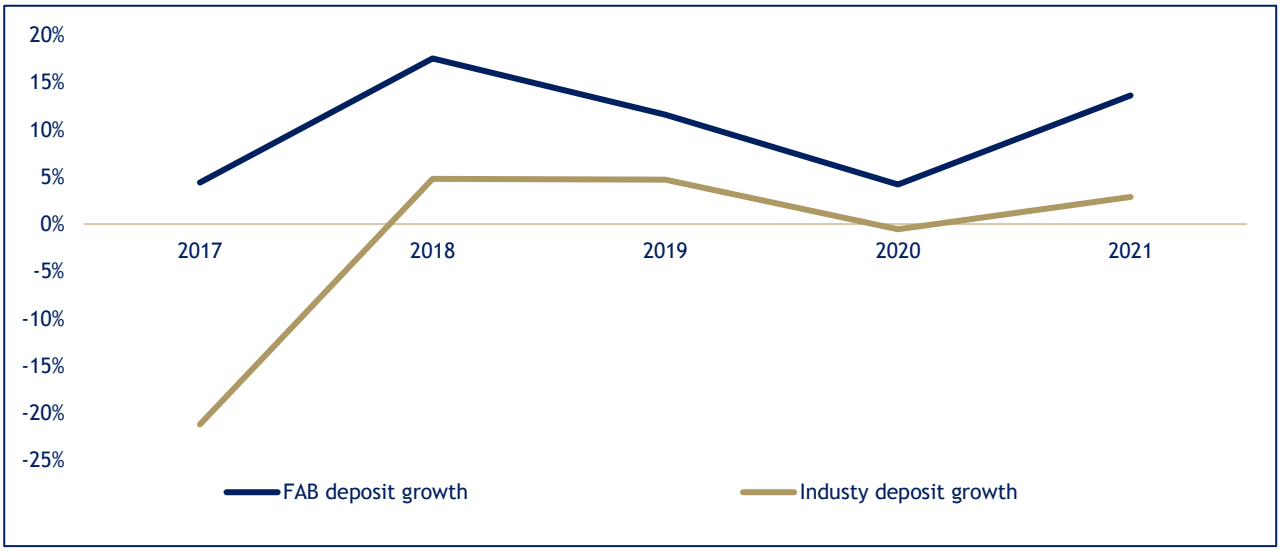


Source: Al Ramz Investment Research, Company data

Healthy deposit growth

FAB is a structural outperformer, growing its deposit base at a CAGR of 11.6% between 2017 and 2021 and beating the industry average four-fold. This significant growth in deposits did not have a commensurate negative impact on margins as one would expect. This is because FAB focused on growing its current account base, a source of low-cost funding. We discuss this point in greater detail in the next section.

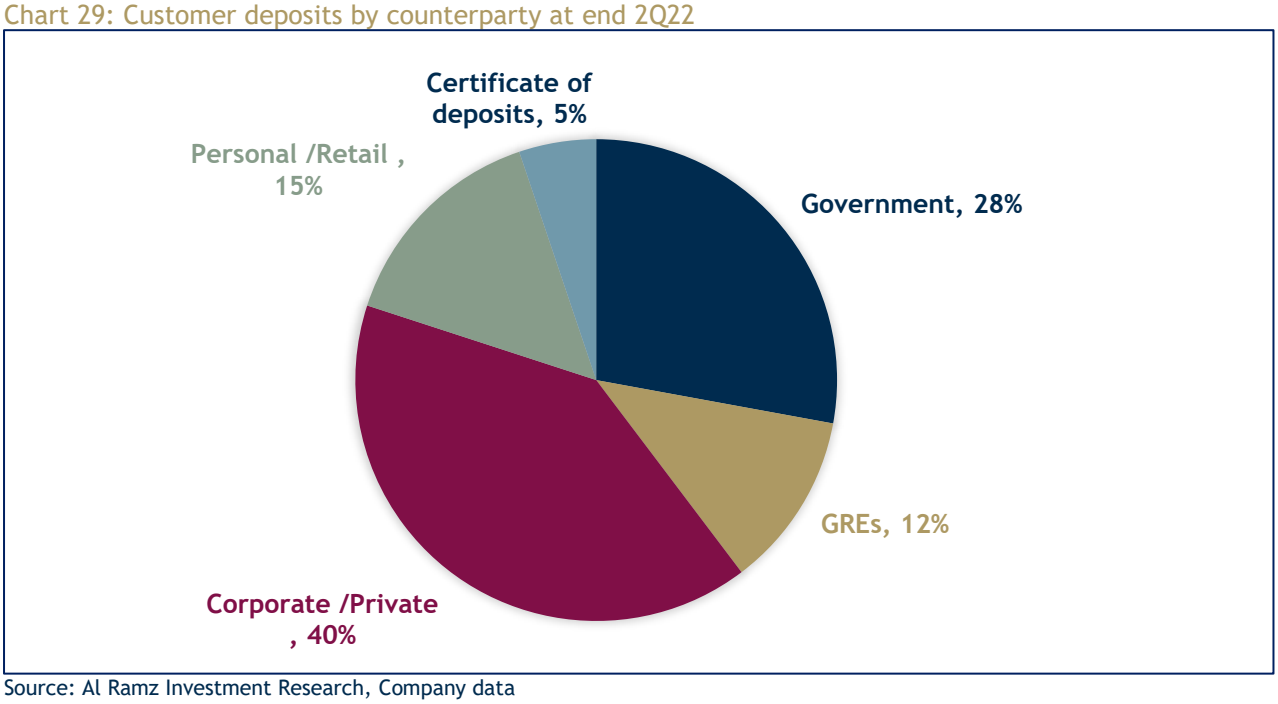
Chart 28: FAB deposit growth compared to industry



Source: Al Ramz Investment Research, Company data

Going forward, we expect FAB's deposit base to continue to grow at a sustained level, on the back of a rising interest-rate environment. We include in our estimates a CAGR of 8.9% between 2021 and 2026.

Chart 29: Customer deposits by counterparty at end 2Q22



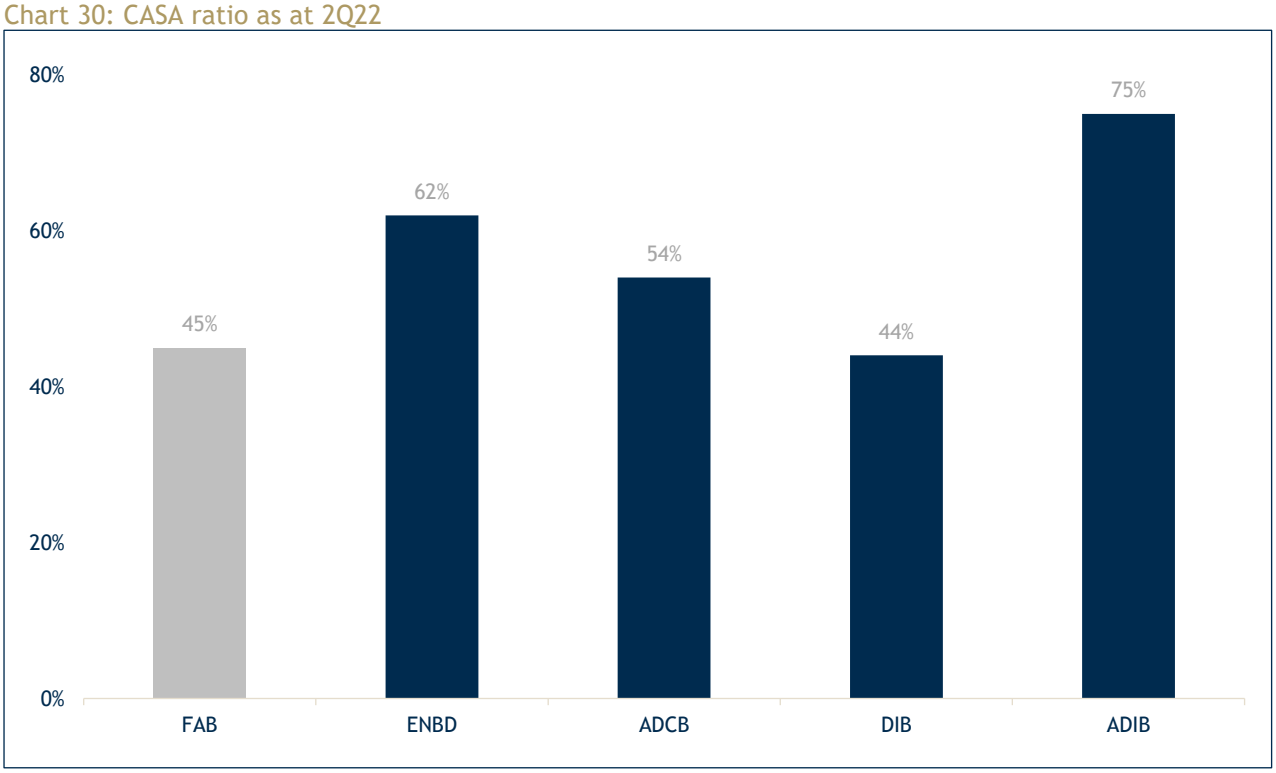
Source: Al Ramz Investment Research, Company data

Favorable deposit mix

FAB's CASA deposits grew at a CAGR of 29% over the past three years. This is the fastest growth among local sector peers. Consequently, the CASA base of the bank totaled AED 291bn at the end of 2Q22.

The resulting mix shows a clear skew for FAB towards CASA (45%). This brings further credence to the fact that FAB has a comparatively highly cost-effective deposit mix.

Chart 30: CASA ratio as at 2Q22



Source: Al Ramz Investment Research, Company data

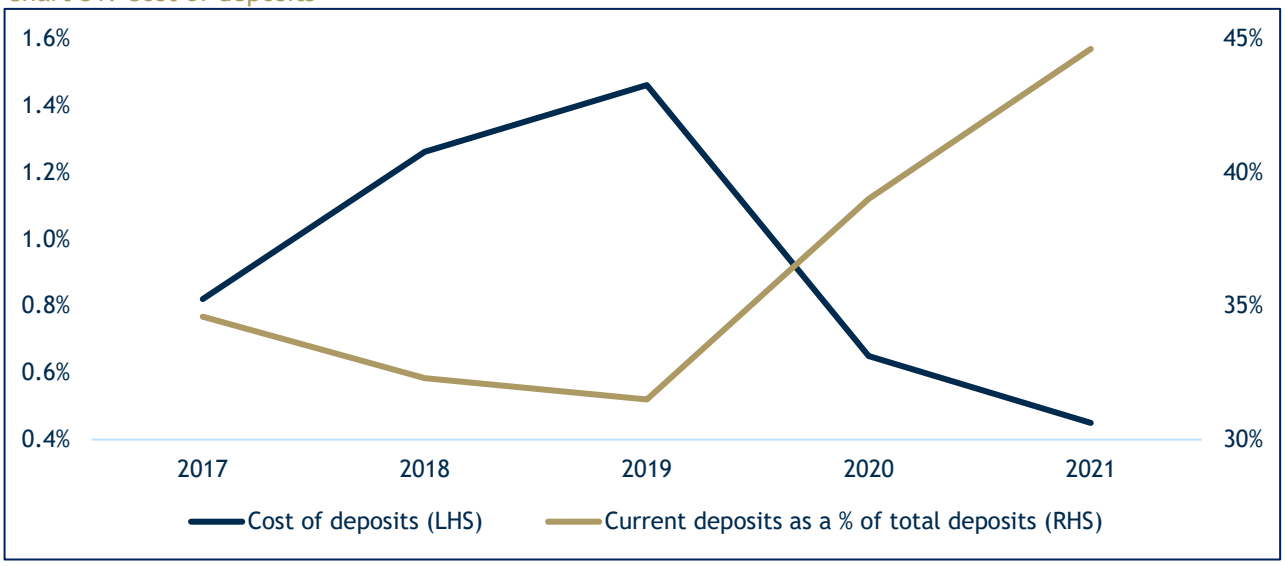
In a rising rate environment, we would expect a gradual shift in demand from CASA deposits to fixed deposits as customers opt to invest in the latter for a higher compensation. This could impact the deposit mix going forward.

According to management, however, the bank is continuously bringing in corporate CASA via attractive payment and cash-management facilities, which should help keep such deposits at the current level.

Exposure to low-cost deposits such as CASA is one of the most effective ways for a bank to protect its margins. This is what FAB successfully achieved as it continues to grow its CASA base.

This strategic focus coupled with low interest rates has contributed to reduce the bank's cost of deposits from 1.41% in 2019 to 0.41% in 2021. We believe this leaves FAB in a favorable position to benefit from any potential, upcoming interest rates rises.

Chart 31: Cost of deposits



Source: Al Ramz Investment Research, Company data

Margin recovery in progress

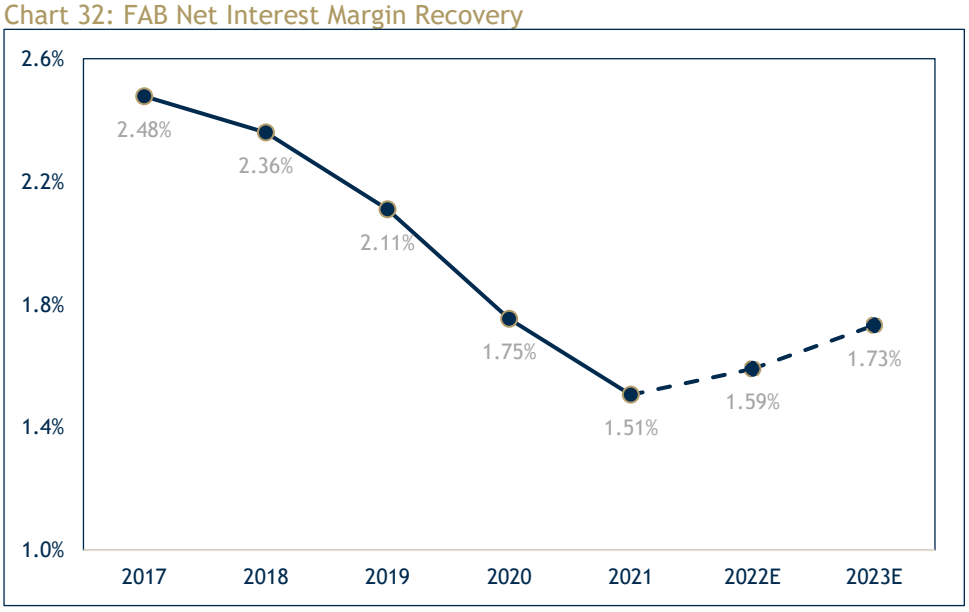
We expect NIMs to increase slightly by 8bps to 1.59% in 2022 and to expand by 14bps in 2023, in line with the expected yield-curve steepening, corresponding deposits/loans repricing, and as discussed previously.

FAB forecasts a positive impact of AED 578mn on its NII, equivalent to a positive impact of 5% on net profit, for every 50bps rate increase. This confirms our margin forecast.

One caveat to the margin expansion scenario in the context of rising rates, is the uncertainty brought about by the volatility of the Investment Banking business of FAB, and more particularly its exposure to capital markets and the impact this might have on investment gains.

We ask if the tailwinds of any interest-rate hikes could be partially or even entirely offset by a potential reduction in investment revenues.

Chart 32: FAB Net Interest Margin Recovery



Source: Al Ramz Investment Research, Company data

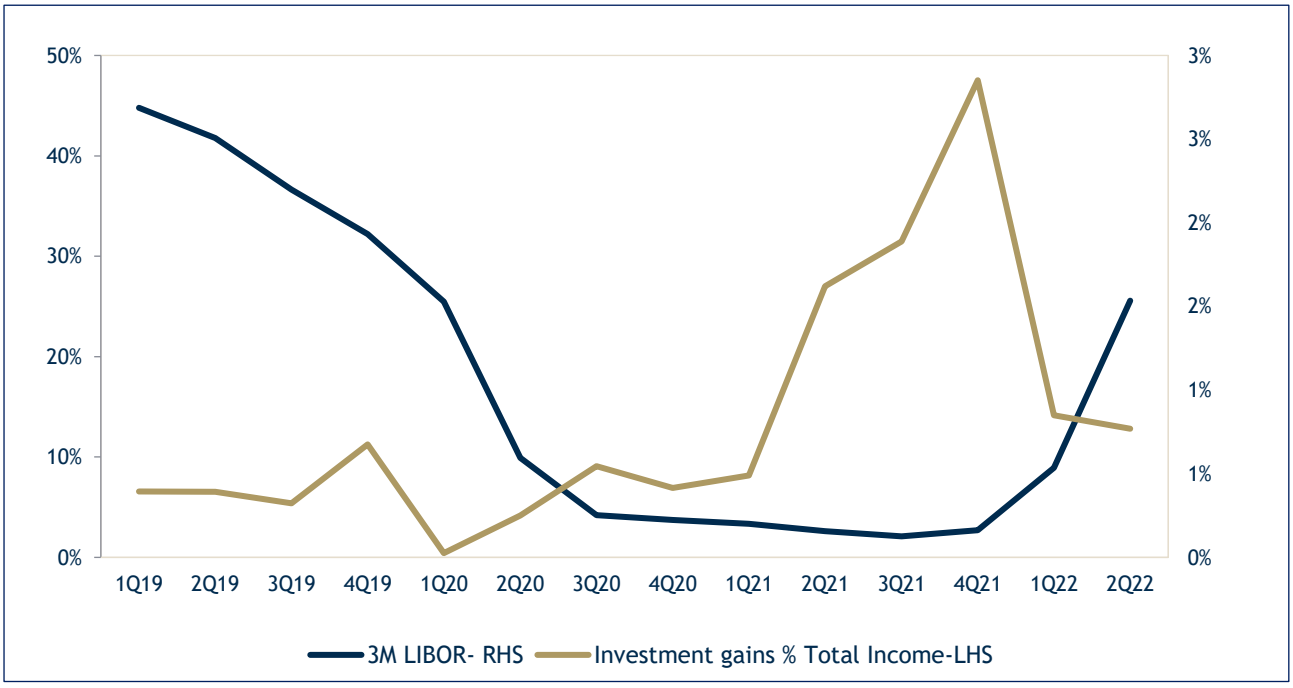
Investment gains normalization expected

FAB maintains a sizeable investment portfolio of AED 185bn, nearly entirely dedicated to fixed income securities (94% of total). The performance of such instruments is inversely correlated with interest rates, and FAB was appropriately positioned to benefit from the steep rate cuts and liquidity through the GFC and into the pandemic.

Consequently, extra-ordinary investment gain of AED 6.5bn were recorded in 2021 on the back of the benign liquidity and investment environment and accounted for an outsized 30% of total income.

As rates begin to pick up in the current inflationary environment, we question whether the stellar performance of last year on the investment portfolio is likely to be repeated. The chart below suggests otherwise.

Chart 33: Investment gains against interest rates

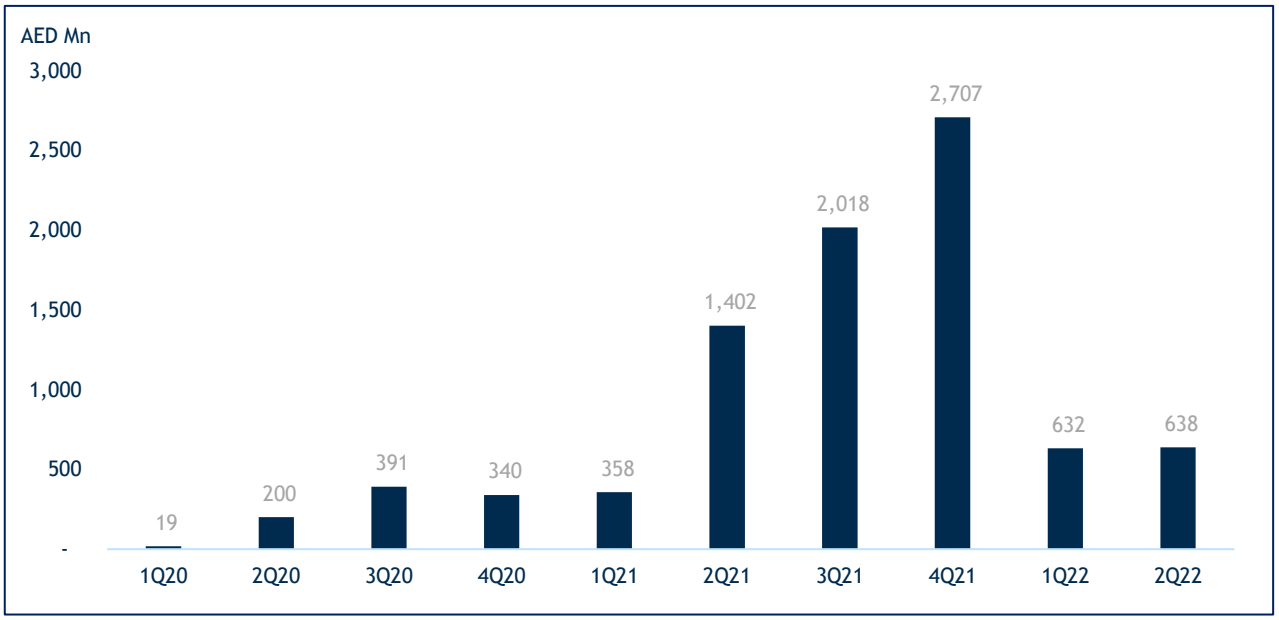


Source: Al Ramz Investment Research, Company data

In the second quarter of this year, FAB displayed a sharp decline in investment gains, down 55% to AED 638mn from AED 1,402mn in the corresponding period last year.

We expect investment gains to continue to face headwinds going forward, and to consequently weigh on the bottom-line of FAB until interest rates stabilize. We highlight this as one of the main risks to our numbers, potentially even outweighing any margin benefit from the steepening of the yield curve.

Chart 34: Evolution of investment gains



Source: Al Ramz Investment Research, Company data

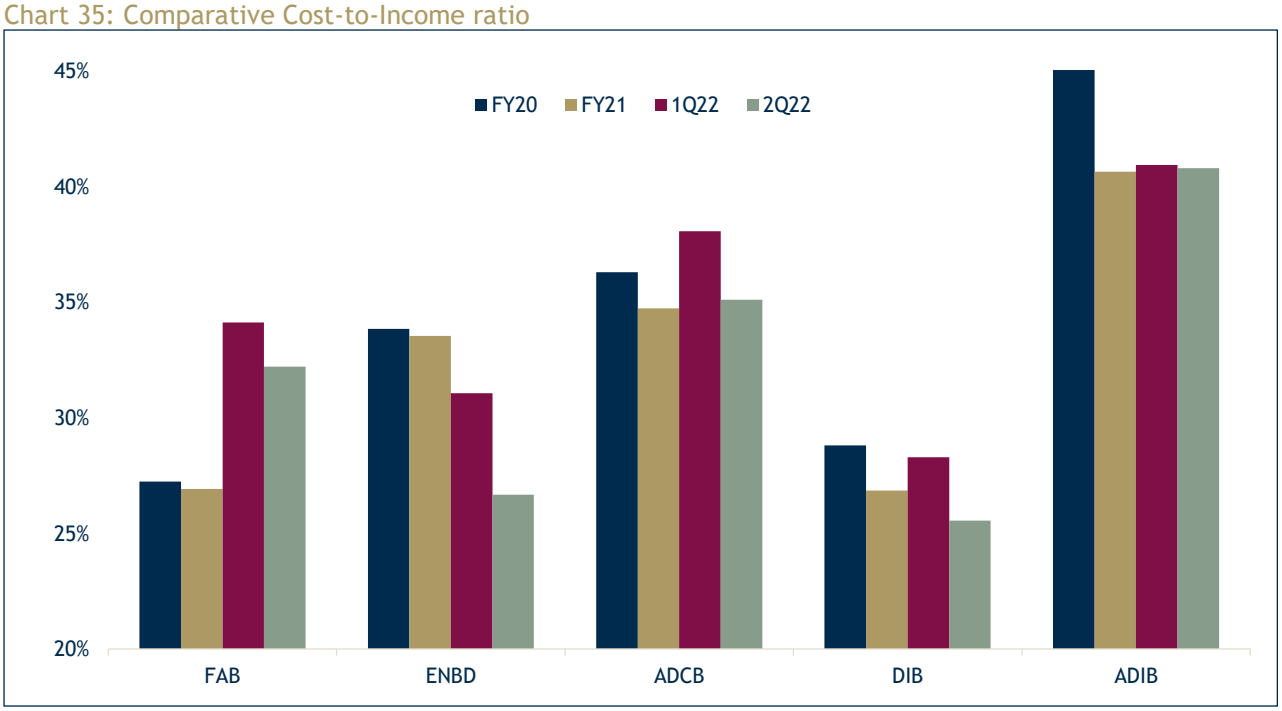
Superior cost efficiency

Dynamic external growth activity at FAB has allowed it to achieve scale with corresponding cost synergies. This is one of the ways in which the bank has been able to maintain the lowest cost-to-income ratio (C/I) in the UAE.

Referring to chart 20, the numbers show a clear sub-par cost efficiency for international operations. We assume this is mostly due to BAE having yet to achieve full synergies. We expect better cost efficiency overall at FAB, when such integration synergies take place.

We note a visible jump in the C/I ratio to 34% in the first quarter of this year. We expect the slight efficiency pullback experienced in the second quarter to be temporary. Overall, we believe cost-efficiency improvements should continue going forward, and that FAB should remain a UAE cost leader.

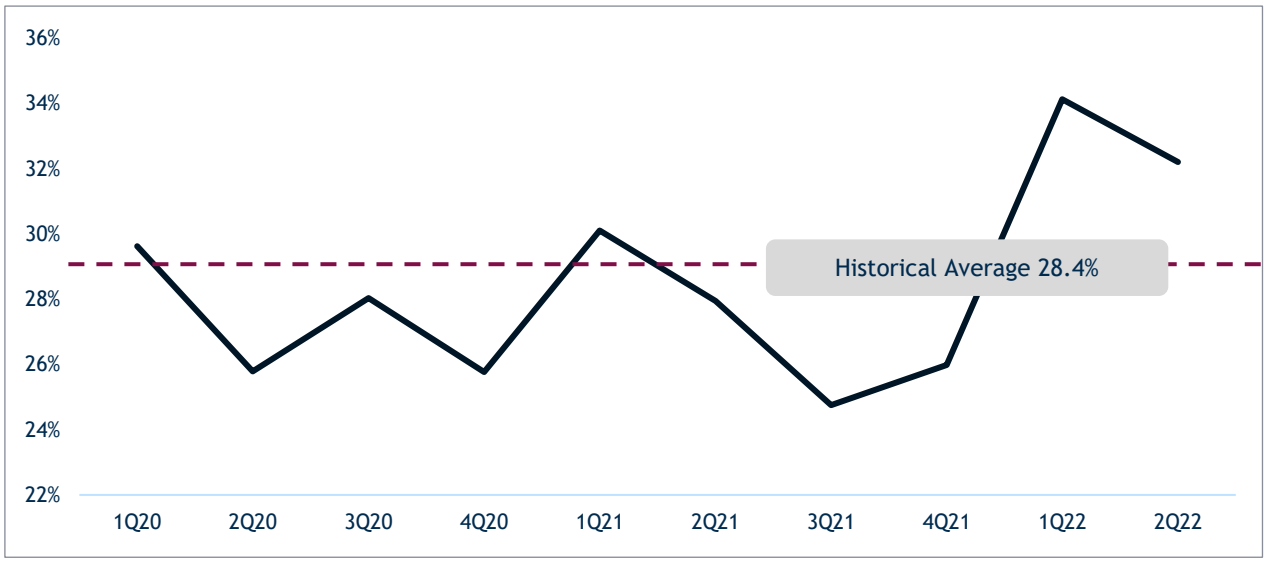
Chart 35: Comparative Cost-to-Income ratio



Source: Al Ramz Investment Research, Company data

Management expects that its cost-to-income ratio should progressively migrate back towards its historical level "below 30%". We expect and forecast that C/I should be back below 30% next year and should average 29.9% until 2026.

Chart 36: Cost to income ratio

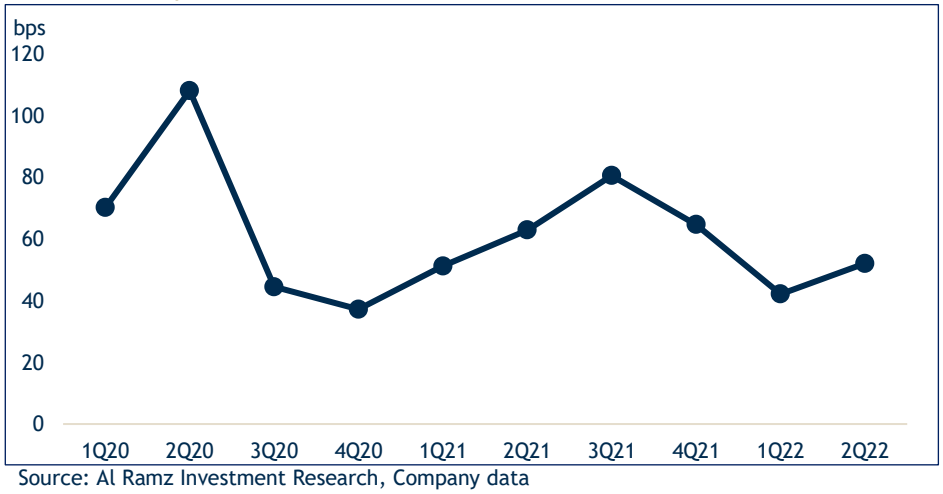


Source: Al Ramz Investment Research, Company data

Improving Asset Quality

The Cost of Risk (CoR) has been trending down since 3Q21. However, we saw a marginal pickup of 10bps in the second quarter of this year. In the context of rising macro uncertainties, we expect CoR to continue to trend marginally upwards from here. This increase is not concerning in our view, as the bank made sufficient provisions over the previous quarters.

Chart 37: Sequential evolution of the cost-of-risk for FAB

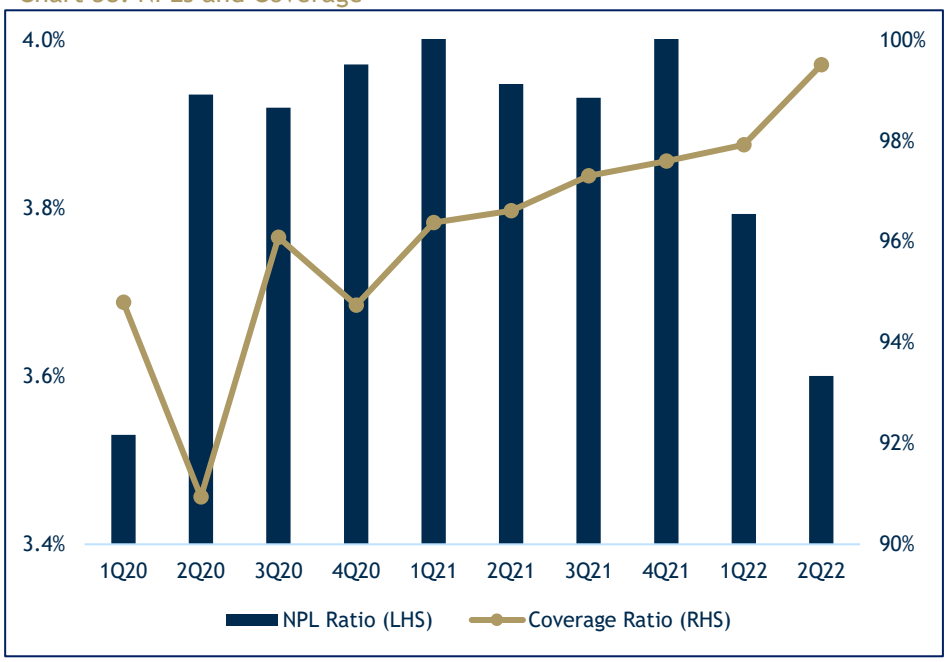


Source: Al Ramz Investment Research, Company data

FAB's lending book mainly comprises high quality loans (Government and GREs). This has allowed it to maintain below average NPLs. All the while, Coverage hovers around the comfortable 100% level, above the industry average of 97.7%.

Even in economically challenging periods such as the pandemic years when loans tend to perform poorly, FAB was able to maintain a stable ratio of non-performing loans as it bucked the industry trend. We expect FAB to maintain stable NPLs at the current level, along with its sector leadership in this regard.

Chart 38: NPLs and Coverage



Source: Al Ramz Investment Research, Company data

Three main risks to our rosy outlook

All-in-all, we feel that the environment is still rather benign for UAE banks in general, and for FAB.

This is due to a combination of healthy macro drivers including solid foreseeable macro-economic growth in the UAE, an elevated price for oil, strong balance sheets for the banking sector overall, and a visible pick up from the low points of the pandemic.

However, we also note that this encouraging environment has been deteriorating somewhat, on the back of the global interest rate and inflation situation. We identify essentially three risks to the growth scenario for First Abu Dhabi Bank.

A reversal in the macro-economic outlook

The familiar precursors of a recession have started to show: An inverted yield curve, rising interest rates on the back of high inflation, the first innings of a technical recession in the United States, and continuing disruptions caused by Russia's invasion of Ukraine. The longer inflation persists, the more likely we are to enter a sticker shock requiring the Fed to raise rates even more aggressively.

We already have two consecutive quarters of negative growth in the US, and the likelihood of a prolonged recession is increasing, even though this is not the central scenario of the IMF. If a recession should properly materialize, the main question will be to assess the contamination potential to the UAE.

Any such contamination would be potentially detrimental to the growth picture and to the shape of the yield curve, both strong determinants of banking growth and profitability.

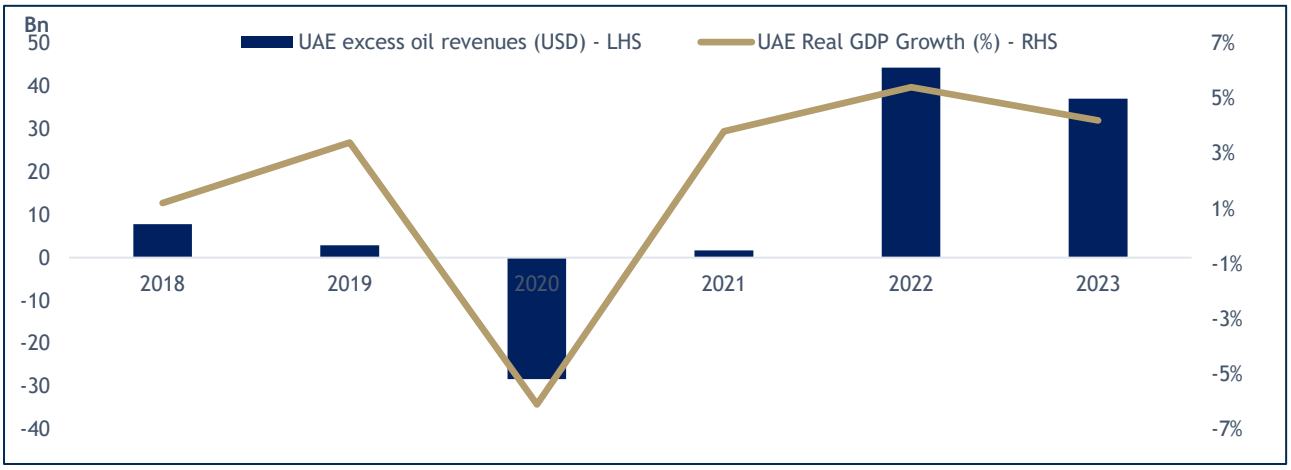
A reversal in the oil price

The UAE economy is heavily dependent on oil prices. With a nominal GDP of AED 410bn in 2021 (IMF), an average price of Brent oil at $70 per barrel in the same year, and assuming a daily production of 2.7mb, the oil contribution to the GDP of the UAE comes out to 46%. As we wrote before, Tellimer Research sees this contribution as high as 75% depending on the oil price.

The US Energy Information Administration (EIA) expects crude oil prices to decline to $70 per barrel in 2022 and to $63 per barrel in 2023. Such levels would still be considered supportive to our central growth scenario.

However, a reversal in the price of oil from the current elevated levels would materially impact the growth of the UAE. This would in turn change our scenario and the visibility of the future earnings of the banking sector and FAB.

Chart 39: UAE GDP growth vs excess oil revenues



Source: Al Ramz Investment Research, OPEC+, Statista, EIA, S&P Global Commodity Insights, CBUAE, FRED Economic Data

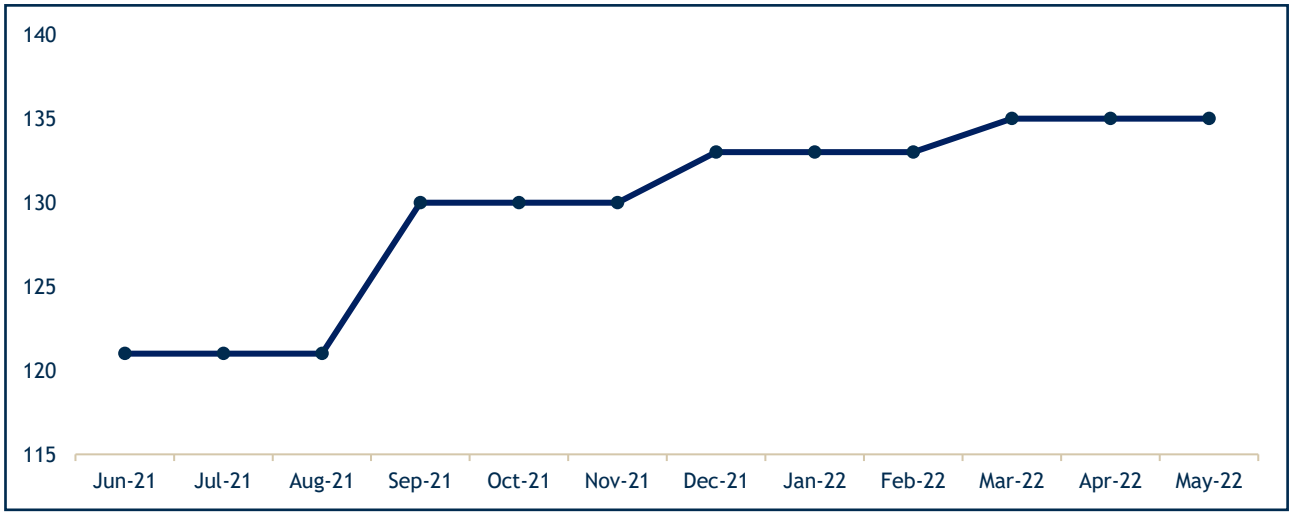
A reversal in UAE consumer trends

At the end of 2Q22 and in the space of a single quarter, UAE consumer confidence jumped by two points to 135. Confidence in prosperous future economic conditions in the UAE reflects the current expansion and feel-good factor which comes with higher oil prices.

However, current inflationary pressures could progressively dent this confidence. Consumption would eventually be impacted and banks, including FAB, would suffer.

The Arab Monetary Fund (AMF) expects Inflation in the Arab countries to reach approximately 7.5% this year, compared to 5.7% in 2021. This could weigh-in on consumer confidence and ultimately on consumption.

Chart 40: Consumer Confidence Index



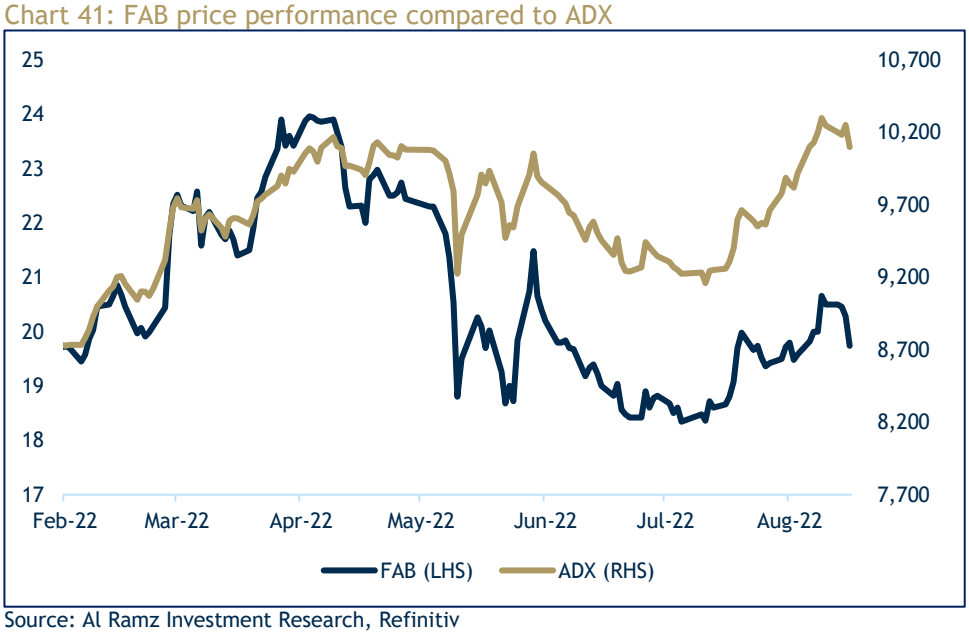
Source: Al Ramz Investment Research, OECD data

The growth is mostly priced in

FAB was a stellar performer in 2021, clocking +46%. The stock is off to a good start this year, being up +6.0% to date. In relative terms, however, FAB underperforms its home index by 13.0%, making its performance to date less than glorious.

This performance is unsurprising to us. As we look at the valuation from three different angles, we arrive at a blended fair value of **AED 18.40 per share** and conclude that the stock is currently fully valued. We initiate our coverage with an **equal-weight** recommendation. We detail our valuations and conclusion below.

Chart 41: FAB price performance compared to ADX



Source: Al Ramz Investment Research, Refinitiv

Three valuation methodologies to confirm our findings

We use three methodologies to value FAB: Dividend Discount Model (DDM), Residual Income Model (RIM) and Relative Valuation. We assign an equal weight to each method to arrive at the fair value for the stock. We summarize our findings in the table below.

Blended valuation summary

Valuation method	Weight	Target Price
Dividend Discount Model	33.3%	17.42
Residual Income Model	33.3%	17.76
Relative Valuation	33.3%	20.10
Blended fair value		18.40
Last Closing price		19.74
Up/downside to fair value		-6.8%

Source: Al Ramz Investment Research, Company data

Growth and return assumptions

We detail below the assumptions used in our valuation models.

- **Risk Free Rate (Rf)** - We approximate the risk-free rate using the current 5-year yield of the Abu Dhabi Government bonds as provided by our Fixed Income desk.
- **Beta (B)** - Our beta is based on the regression of daily price changes against the local index (ADX) over the past 5 years. Daily prices are sourced from FactSet.

- **Equity Risk Premium (ERP)** - We source our Equity Risk Premium (ERP) from Aswath Damodaran, a Finance professor at the Stern School of Business of New York University who has become a global reference in the calculation of ERPs and in stock valuations.
- **Cost of equity** (r) - We derive our cost of equity using the Capital Asset Pricing Model (CAPM): Rf + (Beta x Equity Risk Premium), where Rf is the Risk-Free Rate as defined above.
- **Terminal growth** (g) - We assume that FAB's earnings should grow to perpetuity in line with the long-term real GDP of the UAE. Our terminal growth rate is based on the historical average of UAE real GDP growth from 1980 to 2021.
- **Sustainable ROE** - Our sustainable ROE is derived from our financial model and forecasts.
- **Justified P/B ratio** – This ratio is determined by the differential between the ROE and the cost of equity, (ROE-g)/(r -g).

Valuation Assumptions

Valuation parameter	Assumption
Risk free rate (%)	3.13
Beta	1.23
Equity Risk Premium (%)	5.25
Cost of Equity (%)	9.6
Terminal growth rate (g) (%)	3.4
Tangible Sustainable ROE (%)	16.3
Justified Tangible P/B multiple	2.1

Source: Al Ramz Investment Research, Company data

Dividend Discount Model: AED 17.4/Share

We value FAB at AED 17.4 based on a two-stage Gordon Growth valuation model which is made up of future dividend distributions for the forecasting period and a terminal P/B thereafter.

The Terminal P/B is detailed in the assumptions above. We use it to derive terminal book value, which is then discounted back to its present value at the cost of equity.

Dividend Discount Valuation Summary

		2022	2023	2024	2025	2026	After 2026
Net profit		13,356	13,462	14,120	15,490	17,454	
Dividend Payout Ratio (E)	x	50%	57%	63%	64%	63%	
Dividends (E)	=	6,629	7,733	8,838	9,943	11,048	
Discount factor	x	n/a	0.91	0.83	0.76	0.69	
PV of dividends	=	6,629	7,057	7,358	7,554	7,659	
Terminal P/B (Exit multiple)							2.1
Tangible book value	x					107,674	
Terminal value	=						225,074
Sum of PV of dividends		36,257					
PV of Terminal Value	+	156,046					
Total equity value	=	192,303					
No of shares outstanding (mn)	/	11,041					
Fair value per share (AED)	=	17.4					

Source: Al Ramz Investment Research, Company data

Sensitivity analysis of our DDM valuation

The table below provides the sensitivity of our DDM valuation to the model inputs.

Sensitivity on DDM Valuation

		Cost of Equity									
		7.0%	7.5%	8.0%	8.5%	9.0%	9.6%	10.0%	10.5%	11.0%	11.5%
Growth Rate	2.0%	24.8	22.4	20.5	18.9	17.5	16.1	15.2	14.2	13.6	12.7
	2.5%	26.3	23.6	21.4	19.6	18.0	16.5	15.5	14.5	13.8	12.9
	3.0%	28.2	25.0	22.5	20.4	18.7	17.0	15.9	14.8	14.1	13.1
	3.4%	30.2	26.4	23.5	21.2	19.3	17.4	16.3	15.1	14.3	13.2
	4.0%	34.0	29.1	25.4	22.6	20.3	18.2	16.9	15.6	14.8	13.5

Source: Al Ramz Investment Research, Company data

DDM is best suited for companies with a stable cash flow and distribution. FAB's dividend policy has changed significantly during its history as a public company. Its payout has ranged from 7% to 79% and averaged 39% since 2005. It paid dividends consistently every year with DPS ranging from 7 to 74 fils per share. Since the merger in 2017, the payout has been more consistent.

We conclude that the dividend distribution profile of the bank makes its stock eligible for a dividend valuation methodology, but we prefer to validate our DDM with the residual income valuation method below.

Residual Income: AED 17.8/Share

We value FAB at AED 17.8 per share based on residual income valuation which assumes that the value of the company is the present value of the excess returns (net profit – equity charge). Equity charge is the required rate of return multiplied by the shareholders' equity.

Residual Income valuation summary

		2022	2023	2024	2025	2026	After 2026
Net profit		13,356	13,462	14,120	15,490	17,454	
Beginning value of equity	+	82,619	85,728	90,883	96,076	102,338	
Cost of equity	x	9.58%	9.58%	9.58%	9.58%	9.58%	
Equity charge	=	7,917	8,215	8,709	9,206	9,807	
Excess equity return		5,439	5,247	5,411	6,284	7,647	
Discount factor	x	n/a	0.91	0.83	0.76	0.69	0.69
Present value of excess return	=	5,439	4,788	4,505	4,774	5,302	
Terminal value of excess return							127,899
Sum of PV of excess return	+	24,809					
PV of Terminal value of excess return	+	88,674					
Tangible equity invested	+	82,619					
Total value of equity	=	196,101					
No of shares	/	11,041					
Fair value per share (AED)	=	17.8					

Source: Al Ramz Investment Research, Company data

Relative valuation: AED 20.1/Share

Here, we look at the regional peer group of FAB to assess its relative valuation. Our sample of comparative banking institutions includes the largest 30 banks listed in the GCC.

We source the ten-year average P/B valuation for the sample GCC peer-group, and for FAB. We do so by calculating the valuation ratio at the end of every quarter using latest published book value and last trading price at the end of each quarter, for the full ten years. We then derive the average values for the period under study.

We conclude that FAB has historically traded at a very small discount of 4% to its largest regional peers. We apply this discount to the current peer P/B valuation of 1.97x and use our estimated book value per share of AED 10.62 for 2022 to arrive at a relative fair value of AED 20.1/share for FAB.

Peer Valuation summary

Average long-term P/B valuation for the peer group		1,52
Average long-term P/B valuation for FAB	/	1.46
Historical premium/discount of FAB vs. peers	=	-4.0%
Current P/B peer valuation	x	1.97
Implied P/B valuation for FAB	=	1.89
Book value per share (2022E)	x	10.62
Fair value per share (AED)	**=**	**20.1**

Source: Al Ramz Investment Research, Refinitiv

Technical perspective: The cherry on the investment cake

This 360-degree view of FAB and its stock value would be incomplete if we did not mention our house technical view and some index implications.

Technically: Neutral

Our technical desk believes that the stock could show some strength above the AED 20 level. More generally, however, our technical view remains neutral for the medium term, in line with our fundamental recommendation and fair valuation. A medium-term technical view assumes a six-month investment horizon.

Index balancing: A non-event

MSCI index inclusions and rebalancing exercises have proven to be significant movers of UAE stocks in cases of major index changes. For this reason, we track such changes closely to anticipate any significant moves.

At this stage, it looks to us that the MSCI rebalancing story is behind us for now, as far as FAB is concerned. The latest rebalancing exercise was announced on August 11 and should take place effectively at the end of the month. Our assessment is that it should only trigger marginal outflows equivalent to less than one day of average trading value.

In other words, the index picture is equally aligned with our neutral technical and fundamental views.

Summary financials and metrics

Income Statement, AED mn	2019	2020	2021	2022E	2023E	2024E
Net interest income	12,775	12,256	11,658	13,826	16,700	17,883
Non-interest income	7,474	6,317	10,023	6,662	8,244	9,515
Operating income	20,249	18,574	21,681	20,489	24,943	27,399
One-off gains (losses)				3,094		
Operating expenses	(5,499)	(5,060)	(5,836)	(6,524)	(7,256)	(7,982)
Total provisions	(1,843)	(2,620)	(2,658)	(2,604)	(2,967)	(3,236)
Profit before tax	12,907	10,894	13,187	14,455	14,720	16,181
Taxes and others	(387)	(338)	(655)	(583)	(589)	(1,456)
Net profit after tax (before Tier 1 interest)	12,520	10,555	12,531	13,872	14,131	14,725
Net profit after tax (diluted)	11,959	10,129	12,175	13,356	13,462	14,120

Balance Sheet, AED mn	2019	2020	2021	2022E	2023E	2024E
Customer loans	407,903	386,644	410,155	460,825	501,648	546,674
Investments	134,744	152,840	191,048	201,274	217,026	237,709
Total assets	821,968	919,061	1,000,343	1,094,136	1,184,590	1,265,273
Customer deposits	519,162	540,882	614,459	670,913	728,276	792,364
Total shareholder equity	107,607	108,675	112,814	117,281	124,214	130,601

Key metrics	2019	2020	2021	2022E	2023E	2024E
EPS (AED)	1.08	0.92	1.10	1.21	1.22	1.28
DPS (AED)	0.74	0.74	0.49	0.60	0.70	0.80
BVPS (AED)	9.78	9.88	10.22	10.62	11.25	11.83
Tangible BVPS (AED)	7.01	7.12	7.48	7.76	8.23	8.70
Yield on earning assets	4.0%	2.7%	2.3%	3.1%	3.4%	3.1%
Cost of funds	1.7%	1.0%	0.7%	1.4%	1.8%	1.6%
Net Interest spread	2.3%	1.7%	1.5%	1.7%	1.6%	1.6%
Net Interest Margin (NIM)	2.1%	1.8%	1.5%	1.6%	1.7%	1.7%
Return on Equity (ROE)	11.1%	9.4%	11.0%	9.4%	11.1%	11.1%
Return on Assets (ROA)	1.5%	1.2%	1.3%	1.0%	1.2%	1.2%
Net advance to deposit ratio (ADR)	78.6%	71.5%	66.8%	68.7%	68.9%	69.0%
Investment to deposit ratio (IDR)	25.4%	27.9%	29.6%	28.6%	28.5%	28.7%
NPL ratio	3.2%	3.9%	4.0%	3.8%	3.9%	3.9%
NPL coverage ratio	93.0%	94.7%	97.6%	96.8%	98.0%	98.6%
Cost-to-Income ratio	27.2%	27.2%	26.9%	31.8%	29.1%	29.2%
Cost of risk	0.5%	0.6%	0.7%	0.6%	0.6%	0.6%
Tier 1 ratio	15.7%	15.4%	14.7%	14.5%	13.9%	13.6%
Capital Adequacy ratio (CAR)	16.9%	16.5%	15.8%	15.5%	14.9%	14.5%

Growth	2019	2020	2021	2022E	2023E	2024E
Customer loan (net)	15.6%	-5.2%	6.1%	12.4%	9.0%	9.0%
Customer deposit	11.6%	4.2%	13.6%	9.2%	8.5%	8.8%
Net interest income	-2.0%	-4.1%	-4.9%	18.6%	20.9%	7.1%
Non-interest income	16.5%	-15.5%	58.7%	-33.5%	23.4%	15.4%
Operating income	4.1%	-8.3%	16.7%	-5.5%	21.7%	9.8%
Operating expenses	3.2%	-8.0%	15.3%	11.8%	11.2%	10.0%
Earnings (diluted)	4.1%	-15.3%	20.2%	9.7%	0.8%	4.9%

Source: Al Ramz Investment research, Company data, Note – ROE and ROE for 2022E is adjusted for the sale of Magnati business

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Overweight

A stock is rated “over-weight” when Al Ramz Investment Research believes that its fair value lies 15% above the current market price and the stock is likely to reach such fair value within the next 12 months.

Equal weight

A stock is rated “equal-weight” when Al Ramz Investment Research believes that its fair value lies between -15% and +15% of the current market price and the stock is likely to remain within this range during the next 12 months.

Underweight

A stock is rated “under-weight” when Al Ramz Investment Research believes that its fair value lies 15% below its current market price and the stock is likely to reach such fair value within the next 12 months.

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