Emirates NBD

Profitability Will Remain Resilient Despite Softer Economy and Competition From a New, Larger Rival

Summary

Emirates NBD (ENBD) lost its position as the largest bank (by assets) in United Arab Emirates (UAE) after the merger that created First Abu Dhabi Bank (FAB, Aa3 stable, a3), with $186 billion of assets and a 27% market share as of March 2017. Nevertheless, ENBD’s unique position as the Dubai government’s bank of choice, its large low-cost deposit base and healthy loan book will support its profitability as it negotiates the challenges of a more competitive environment, a weaker economy, and rising interest rates.

ENDB will retain its strong franchise despite softer economy and loss of market leader position. We expect ENBD to be resilient to these two challenges. The bank will continue to benefit from its role as house bank for the Dubai government. Competition with new rival FAB for corporate clients will also be softened by the limited overlap in corporate lending between Dubai and Abu Dhabi, where FAB is dominant. In addition, the bank’s wide product range in the corporate segment will support its market position. A large retail branch network, and early adoption of advanced digital technology also support the bank’s franchise in the retail segment. The solid retail franchise will also support the bank’s corporate business, since corporate clients value holistic banking relationships that include competitive offerings for their staff.

Loan book re-pricing and large low-cost deposit balances will offset pressure from rising interest rates. Rising US interest rates will pressure profits at UAE banks by driving up their deposit and market funding costs. Banks’ borrowing rates will rise, both for US dollars and for local currency, owing to the currency peg of the UAE dirham with the US dollar. ENBD’s large pool of low-cost current and saving deposit accounts will limit the deposit funding cost increase and offset higher market funding expenses to some extent, and we expect the bank to gradually increase its lending rates to support its yields. Over time, the gradual unwinding of more expensive time deposits, locked in conservatively when oil prices were lower and funding was tight in 2016, will also bring funding costs down.

Loan recoveries will limit loan-loss charges as delinquencies rise in the softer economic climate. Continued loan loss recoveries and write-backs of legacy bad loans dating from the 2008 global financial crisis will help to stabilise loan-loss charges. Recoveries from large corporate and government related issuers will moderate the impact of new delinquencies as the weaker economy hurts borrowers’ repayment capacity, particularly in the retail, and small and mid-sized corporate sectors.
ENBD will retain its strong franchise despite softer economy and loss of market leader position

We expect ENBD to be resilient to the softer economy and the loss of market leader position. Slower economic growth due to oil price weakness will subdue lending activity in the UAE over the next 12 months. We expect the deceleration in the non-oil economy to extend into 2017 followed by a gradual recovery from 2018 to 2020. Non-oil real GDP growth, which we expect at 1.9% in 2017, was 2.7% in 2016 down from 3.2% in 2015 and 4.6% in 2014.

We expect government expenditure to increase this year after two years of spending cuts. In Dubai, ongoing construction of major infrastructure projects in preparation for the World Expo, to be hosted by the city in 2020, will support banking activities.

The creation of a new and larger player - First Abu Dhabi Bank (FAB) - will tighten the competitive landscape. FAB, created from the merger of First Gulf Bank and National Bank of Abu Dhabi, is now the largest bank in the UAE, with $186 billion in assets as of March 2017, giving it a 27% market share. It has replaced ENBD as market leader.

ENBD’s solid franchise will support its lending volumes despite these challenges. The bank benefits from its role as the house bank for the Dubai government, its majority owner. We expect ENBD to continue to provide financing for World Expo megaprojects backed by the Dubai government. As of December 2016, 41% of the bank’s gross loans were extended to the Dubai Government (Exhibit 2).

We expect the limited overlap of corporate lending in the Emirates of Abu Dhabi and Dubai to limit the loss of lending volumes to its new, larger rival. Large banks incorporated in each Emirate, such as ENBD in Dubai and FAB in Abu Dhabi, tend to target corporates active in their respective Emirates.

In addition, ENBD’s wide product range in the corporate segment will support its market position. The bank, which historically was primarily a provider of financing to its large corporate clients, now provides more ancillary products along with financing, such as derivatives-based hedging solutions.

ENBD’s strong retail franchise will also support its lending volumes. The bank has the largest distribution network in the country, and is an early adopter of advanced digital technology. As of March, ENBD had 158 branches across the country, while FAB had 125 and No. 3 player by assets, Abu Dhabi Commercial Bank (A1 stable, baa3), had 48. ENBD also had a larger retail deposit base than FAB. ENBD’s high-tech platforms allow it to offer a wide retail product range, including mobile and online banking. It has also recently launched Liv., the UAE’s first digital bank targeted at millennials. The bank’s ‘DirectRemit 60 seconds’ remittance platform allows customers to send back money to their home countries quickly and at relatively low cost. The strong retail franchise will further support the corporate business, since corporate customers value holistic banking relationships that include competitive offerings for their staff.

* = measured in assets. ** = Industry structure as of year-end 2016, prior to the merger between National Bank of Abu Dhabi and First Gulf Bank completed on 30 March 2017.
Sources: Banks’ annual reports, Pillar III Disclosures, UAE Central Bank
Loan book re-pricing and large low-cost deposit balances will offset pressure from rising interest rates

The oil price recovery during the first part of this year had seen funding costs stabilise for UAE banks in 2017 so far. Since the government and its related entities exhibit a high reliance on hydrocarbon revenues and are large depositors in the banks, lower oil revenues tend to pressure deposit levels and increase funding costs. We however expect rising US interest rates to push market funding costs up over the next 12 months. Capital market borrowing and deposit borrowing will cost more both in US dollars and in UAE dirhams owing to the currency peg of the UAE dirham with the US dollar (Exhibit 3).

Exhibit 3
UAE banks’ funding costs will rise in line with US Federal Reserve interest rates

In our view, ENBD will be able to protect its profitability against rising funding costs by gradually lifting its lending rates. The gradual increase in gross yields on loans will reflect both the fact that floating interest rates on corporate loans are reset at pre-determined intervals of time and the competitive nature of the local market. The bank’s gross yields were stable year-on-year in 2016 at 3.5%.

The bank’s large pool of low-cost current and savings deposit accounts should also keep funding costs contained. Such deposits tend to exhibit stability and limited price sensitivity, given their transactional and operational nature. Furthermore, the diversity of ENBD’s deposit base should limit the proportion of low-cost deposits converting into more costly time deposits as interest rates rise. Current and saving deposit accounts accounted for 54% of the bank’s deposit base in December 2016, against a local average of 47%. This low-cost funding will become an increasing advantage for ENBD as interest rates rise, since many competitors rely more heavily on costlier time deposits and will have to reprice loans at a higher, less competitive level to compensate.

The gradual repayment of expensive time deposits that the bank locked-in in 2016 will also support the interest margin. The bank conservatively raised these deposits in Q3 2016 when oil prices were lower and funding conditions were tightening. These deposits drove up its funding costs, with interest expense increasing to 1.4% of average total funding in 2016, from 1.1% in 2015 (Exhibit 4).

Exhibit 4
Large Pool of Low-Cost Deposits Will Keep Funding Costs Contained
ENBD Deposit Breakdown (Time Deposits vs Current Account and Saving Deposits) over 2012-16, UAE Average at end-2016

Note: CASA stands for Current Accounts and Saving Accounts
Sources: ENBD’s annual financial statements, UAE central bank, Moody’s Financial Metrics
Loan recoveries will limit provisioning charges as delinquencies rise in the softer economic climate

We expect problem loans in the UAE to increase modestly to around 5.5% of total loans in 2017. The country's banks have benefited from a period of strong recovery in recent years, which drove delinquencies down to 5.0% at end-2016 from a peak of 10.6% in 2011. Our anticipation of increasing problem loans reflects the risk of rising delinquencies in the SME and retail segments, as the weaker economy makes loan repayments harder for borrowers. The impact will be softened by continued resolution of legacy problem loans.

At ENBD, we expect underlying problem loan formation to remain relatively high, as it has been over recent years (2012–16). This evolution reflects the material increase in problematic exposures in the Islamic segment, moderated by a gradual decline in the conventional segment, primarily corporates. The higher delinquencies in the Islamic segment reflect the relative immaturity of the portfolio (which makes it more volatile) and the weaker economy, which is hitting small businesses and individuals disproportionately. Nevertheless, the bank’s remediation efforts led to a decline in delinquencies from the Islamic segment during H1 2017 (Exhibits 5 & 6).

However, net loan-loss charges will stabilise after gradually declining over 2011–16 following the financial crisis, as continued recoveries and write-backs of legacy bad loans from corporates and government related issuers balance the new impaired loans formation. This formation, particularly in the consumer (individual) and Islamic (primarily individual and SME) segments, will be caused by slowing economic growth. The bank’s overall net provisioning charges declined from 2.3% of gross loans in 2011 to 0.8% in 2016 (Exhibits 7 & 8).
Peer Group:
» First Abu Dhabi Bank PJSC
» Abu Dhabi Commercial Bank
» Dubai Islamic Bank PJSC
» National Commercial Bank
» Qatar National Bank
» National Bank of Kuwait S.A.K.P.

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» Banks

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