

Credit Opinion: National Bank of Fujairah

Global Credit Research - 23 Mar 2015

Fujairah, United Arab Emirates

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	Baa1/P-2
Baseline Credit Assessment	ba1
Adjusted Baseline Credit Assessment	ba1

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Key Indicators

NATIONAL BANK OF FUJAIRAH (Consolidated Financials)[1]

	[2]12-14	[2]12-13	[2]12-12	[2]12-11	[3]12-10	Avg.
Total Assets (AED million)	24,586.3	21,458.2	17,544.6	14,913.4	12,916.6	[4]17.5
Total Assets (USD million)	6,693.8	5,842.2	4,776.6	4,060.2	3,516.5	[4]17.5
Tangible Common Equity (AED million)	2,835.2	2,507.0	2,247.1	2,061.0	1,847.0	[4]11.3
Tangible Common Equity (USD million)	771.9	682.5	611.8	561.1	502.9	[4]11.3
Problem Loans / Gross Loans (%)	4.4	4.7	7.6	10.8	11.6	[5]7.8
Tangible Common Equity / Risk Weighted Assets (%)	12.6	13.6	14.1	14.8	–	[6]13.8
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	20.3	20.7	32.6	44.6	43.5	[5]32.3
Net Interest Margin (%)	2.9	3.0	3.1	3.0	2.9	[5]3.0
PPI / Average RWA (%)	3.0	3.2	3.2	3.0	–	[6]3.1
Net Income / Tangible Assets (%)	2.0	1.8	1.7	1.9	1.3	[5]1.8
Cost / Income Ratio (%)	38.1	36.9	36.9	39.4	35.6	[5]37.4
Market Funds / Tangible Banking Assets (%)	5.9	8.5	10.1	9.8	10.5	[5]9.0
Liquid Banking Assets / Tangible Banking Assets (%)	27.2	29.2	21.9	19.7	21.3	[5]23.9
Gross Loans / Total Deposits (%)	92.7	94.1	108.1	113.4	103.0	[5]102.3

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel II; IFRS [3] Basel I; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel II & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

Moody's assigns Baa1 issuer ratings to National Bank of Fujairah (NBF). These ratings are underpinned by the

bank's overall standalone credit strength (reflected in a standalone baseline credit assessment or BCA of ba1) and by our view of the high likelihood of systemic support if needed.

NBF's standalone BCA reflects its (1) solid capitalization metrics underpinned by stable profitability and (2) solid liquidity and funding metrics despite rapid asset growth. These strengths are moderated by (1) NBF's improving, but still relatively weak, asset quality and (2) limited retail franchise and high balance sheet concentrations.

NBF's Baa1 issuer rating incorporates a high three notches of uplift from the bank's BCA, which reflects Moody's assessment of a high likelihood of UAE government support in the event of need. Moody's view is based on (1) its 40% ownership by the Government of Fujairah and (2) the UAE's strong track record of supporting banks in times of stress.

NBF'S RATINGS ARE SUPPORTED BY A STRONG- MACRO PROFILE

UAE banks are supported by the country's very high economic strength, which stems from high levels of economic wealth and large fiscal and external surpluses derived from the country's sizable hydrocarbon reserves. Other strengths include the UAE's sound policy framework and the strong growth in the UAE's non-oil hydrocarbon sector that is driving economic diversification. The country remains moderately susceptible to event risk, owing primarily to geopolitical tensions in the region and Dubai's open economy coupled with its overall leverage appetite. Our view of UAE's operating environment also incorporates (1) substantial public spending plans, particularly in Abu Dhabi, that will continue to drive both public and private-sector economic growth (2) ongoing recovery in Dubai's more diversified private sector and (3) risks of prolonged oil price declines, which may hurt economic confidence and dampen the country's long term growth prospects. Despite substantive sovereign wealth fund buffers, a marked reduction would likely reduce public spending, weaken economic confidence and ultimately moderate the country's long-term growth prospects. UAE's Aa2 sovereign rating has a stable outlook.

Rating Drivers

- A [strong-] macro profile supports the bank's ratings
- Relatively weak asset quality compounded by a limited retail franchise and high balance sheet concentrations
- Solid capitalization underpinned by stable profitability
- Solid liquidity and funding metrics despite rapid asset growth
- Our assessment of a very high probability of systemic support from the UAE authorities underpins the bank's deposit ratings

Rating Outlook

All ratings assigned to NBF carry a stable outlook

What Could Change the Rating - Up

Upward pressure on NBF's ratings could develop from a combination of the following: (1) an expansion and diversification of the business in retail as highlighted by our BCA scorecard [Qualitative] adjustment; (2) a material reduction in the single-name borrower and deposit concentrations, as mentioned in the BCA scorecard [Asset Risk and Funding Structure] adjustments; and/or (3) improved asset quality and capitalization metrics.

What Could Change the Rating - Down

Downwards pressure on NBF's ratings could develop from: (1) material weakening of franchise leading to a decline in profitability; (2) material weakening of financial fundamentals; or (3) rapid loan growth that would exert pressure on liquidity and asset quality metrics.

DETAILED RATING CONSIDERATIONS

RELATIVELY WEAK ASSET QUALITY COMPOUNDED BY A LIMITED RETAIL FRANCHISE AND HIGH BALANCE SHEET CONCENTRATIONS

Although NBF's asset quality and concentration levels have materially improved since 2011 and are expected to remain on an improving trend, they are still both weaker than global peers with BCAs of ba1.

Established in 1984, National Bank of Fujairah (NBF) is amongst the smallest banks in the UAE holding circa 1% market share in terms of assets, loans and deposits. There is very limited geographical asset diversification as 98% of its funded and unfunded exposure is located in the UAE, with the majority of the balance sheet growth originating in Dubai. As a result, and in line with some other UAE banks, NBF was exposed to troubled Dubai government related entities, causing asset quality to deteriorate rapidly between 2008 and 2010, with the non-performing loan ratio (NPL) peaking at 11.6% in 2010.

A new, stronger management team was put in place in 2009 and refocused NBF towards its core strengths in corporate and commercial banking, particularly in the fast growing and resilient trade finance area. This focus has resulted in high loan growth (albeit from a low base) of 16% CAGR between 2009 and 2014, compared to UAE average of 5% over the same period. Since 2009, NBF has also strengthened its risk management framework through enhanced infrastructure combined with stricter controls and processes.

Driven primarily through a combination of write-offs, restructurings, recoveries and loan growth, the reported NPL ratio has declined materially in recent years to 4.4% in 2014, which compares favorably to UAE expected average of 6% and to the 2.4% median of global banks with a ba1 BCA. Although the bank continues to present some large exposures to Dubai government related parties, we note that the most recent restructuring of the Dubai World Group (DWG)'s debt, which was agreed by a large majority of the creditors in January 2015, is credit positive for UAE banks such as NBF (please see Moody's report "Dubai World's Second Debt Restructuring is Credit Positive for the UAE Banking System and Emirates NBD", published in February 2015). We expect problem loan levels to continue to moderate in line with loan growth and further recoveries.

NBF's rapid growth reduces loan book seasoning and thus leaves asset quality more vulnerable to future pressures. However, the risk is partially mitigated by the fact that bulk of credit growth has been directed towards the resilient trade and manufacturing sectors, which together comprise 62% of gross loans as of year-end 2014 (46% as of year-end 2009), while NBF's exposure to more volatile sectors, such as real estate, has historically remained limited compared to the other UAE banks (8% of gross loans as of year-end 2014).

The improvement in risk management, coupled with the fast growth experienced over recent years has also resulted in a reduction in both asset and deposit concentration levels below UAE average (our estimate is that the banks' exposure top 20 borrowers represent on average around 200% of Tier 1 capital for the UAE rated universe). Nonetheless - compounded by the lack of a granular retail book - these levels are still high relative to global medians. Related party deposits have continued to materially increase, up 14% in 2014, after a 22% increase posted in 2013, and represent now 26% of total customer deposits, which leave the institution more vulnerable to event risks, although they have historically proven stable and the bank is implementing a number of internal caps aimed at reducing such risks. NBF has also posted a significant improvement in the coverage ratio to 121% as of year-end 2014, from 54% as of year-end 2011, well above local average and global peers, which again stems from NBF's commitment to dedicate part of the current profitability to reserves.

SOLID CAPITALIZATION UNDERPINNED BY STABLE PROFITABILITY

We consider that NBF has built up solid capital buffers in recent years, reflecting its stable profitability and retention policies. This places the bank on a solid foundation for future growth.

NBF's income structure benefits from a significant fee and commission contribution of around 25% of operating revenues compared to 21% UAE expected average. This is increasingly driven by the provision of treasury services to its corporate clients and the profitable trade finance focus of the bank, which has supported consistent and healthy net interest margins around 3% over the last four years, above the 2.8% UAE expected average. Besides the success of the cross-selling strategy of NBF in recent years, the bank's focus on productivity and cost control have also contributed to the steady improvement of the cost to income ratio from 41.4% in 2009 down to 38.1% as of year-end 2014, which still remains above the 34% UAE expected average. Additionally, the reduction in cost of risk in line with the aforementioned improvement in asset quality has further supported NBF's profitability as net impairment charges consumed 21% of pre-provision income as of December 2014, compared with 55% as of December 2010.

With consistent profit retention in excess of 60% (in 2014, 32.6% of profit is distributed of which only 50% in cash), NBF generates significant internal capital that, combined with the issuance of AED 500m Tier 1 perpetual notes in 2013, has strengthened its Tier 1 ratio to 14.6% as of year-end 2014, from 13.6% as of year-end 2012. Despite being below UAE expected average of around 16%, Tier 1 capital ratio remains well above the 12% median for global banks with same BCA. Following the additional issuance of AED 500 million Tier 1 capital in March 2015, we expect that this metric will remain stable despite the planned loan growth and also note that the bank's

capitalisation metrics remain resilient under Moody's adverse scenario analysis.

SOLID LIQUIDITY AND FUNDING METRICS DESPITE RAPID ASSET GROWTH

Despite experiencing rapid asset growth since 2009, NBF has gradually improved its liquidity risk profile and developed solid liquidity buffers that are in line with its UAE peers, thanks to the implementation of a conservative liquidity risk management and deposit gathering capabilities. The bank has built various layers of liquidity buffers, such as AED 4.3 billion of cash (17% of total assets) with the UAE central bank, AED 1.9 billion of cash and placements with various banks and high-quality securities investments representing 2% of total assets as of December 2014. Liquid assets therefore increased to a sound 27% of total assets as of December 2014 from 20% in 2011.

Demonstrating the capacity of the bank to attract deposits in excess of the asset growth, the net loans to deposits ratio has decreased from 113% in 2011 to 91% in 2014 and is now in line with local peers. Customer deposits fund 73% of total assets as of year-end 2014, compared with 62% in 2011, 75% of which are term deposits that - when coupled with the short-term nature of its trade financing book - help reduce the sizeable asset-liability maturity mismatch prevalent across all GCC banks.

Nevertheless, as reflected in our BCA scorecard adjustments, the sound funding structure metrics of the bank are mitigated by (1) the large deposit concentration and limited retail franchise (15 branches across the UAE) which limits its ability to diversify its funding sources rapidly (as of December 2014, corporate and commercial banking businesses represent 75% of its net income and 93% of its deposits) and (2) the material off balance-sheet committed liabilities representing 30% of total assets, which could exert pressure on the bank's liquidity in a downturn.

Going forward, even if sources of liquidity are expected to be diversified, loan growth should continue being mainly funded through customer deposits and liquidity metrics should remain stable and within the liquidity risk management framework defined today by the bank.

Notching Considerations

GOVERNMENT SUPPORT

NBF's Baa1 issuer rating incorporates a high three notches of uplift from its ba1 standalone BCA. This reflects Moody's assessment of a high likelihood of systemic (government) support in case of need. The rating agency bases this view on (1) the 40% ownership of Government of Fujairah and 15% of other government related parties and (2) the UAE's strong track record of supporting banks in times of stress.

SOURCE OF FACTS AND FIGURES CITED IN THIS REPORT

The system averages quoted in the report are published in the banking system outlook and based on available audited system metrics. The Global medians quoted in the report are as of December 2013 due to unavailability of audited interim financial statements for the complete universe of Moody's rated banks. Unless noted otherwise, data related to system-wide trends is sourced from the central bank. Bank-specific figures originate from the bank's reports and Moody's Banking Financial Metrics.

About Moody's Bank Scorecard

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Rating Factors

National Bank of Fujairah

Macro Factors	
Weighted Macro Profile	Strong -

Financial Profile						
Factor	Historic Ratio	Macro Adjusted Score	Credit Trend	Assigned Score	Key driver #1	Key driver #2
Solvency						
Asset Risk						
<i>Problem Loans / Gross Loans</i>	5.6%	ba1	↑	b1	Single name concentration	Loan growth
Capital						
<i>TCE / RWA</i>	12.6%	baa2	← →	baa2	Expected trend	
Profitability						
<i>Net Income / Tangible Assets</i>	1.9%	a2	← →	a3	Loan loss charge coverage	
Combined Solvency Score		baa2		baa3		
Liquidity						
Funding Structure						
<i>Market Funds / Tangible Banking Assets</i>	5.9%	a2	← →	baa2	Term structure	Deposit quality
Liquid Resources						
<i>Liquid Banking Assets / Tangible Banking Assets</i>	27.2%	baa2	← →	baa2	Stock of liquid assets	
Combined Liquidity Score		a3		baa2		

Financial Profile

baa3

Qualitative Adjustments
Business Diversification
Opacity and Complexity
Corporate Behavior
Total Qualitative Adjustments

Adjustment
-1
0
0
-1

Sovereign or Affiliate constraint

Aa2

Scorecard Calculated BCA range

baa3 - ba2

Assigned BCA

ba1

Affiliate Support notching

0

Adjusted BCA

ba1

Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency rating	Foreign Currency rating
Deposits	0	0	ba1	3	Baa1	Baa1

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