UAE Equities: Is the Q1 Rally a Mirage?

A Report by Daman Investments PSC, June 2012

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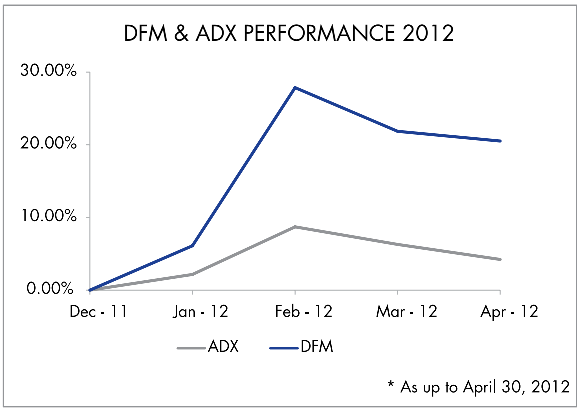
UAE Market Outlook

After the stellar run the UAE stock markets had in the first quarter of this year and thus far a lackluster Q2, investors are beginning to question the sustainability of the rally. Most market prognosticators had not predicted the strong market performance of the first quarter with most wagering on a second half market rebound.

Stellar Q1 rally



Source: Bloomberg, Daman Investments

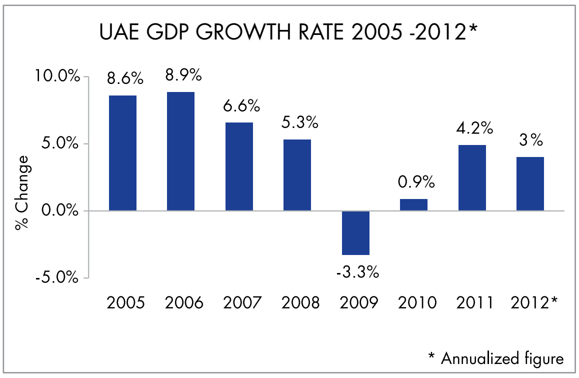
"Déjà vu"

The major worry preoccupying investors is whether we are in a case of Déjà vu when local markets rallied in the first half of last year only to retrace those gains and finish the year mired deeply in negative territory. We look to address this all important question and outline on the key factors for the markets and give some empirical basis and opinion as to whether or not markets still have some remaining upside and will end the year in the green. Or contrariwise, will the fabled investment thesis of "of sell in May and go away" prove apt again…

Déjà vu
Or continued positive run?

Macro Outlook continues to Improve

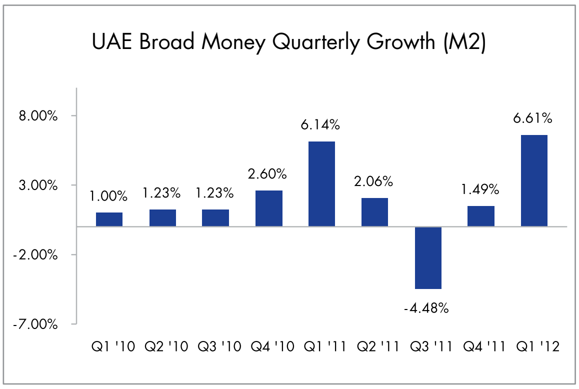
To see the progress made by the UAE economy its performance must be judged relative to the tough years of 2009 - 2010, when it was hit by the global credit crisis with the banking sector in particular coming under considerable duress (more on this later). The economy has pulled up significantly since then albeit at a lower rate of growth. This year the UAE Minister of Economy is forecasting a real GDP growth rate of 3% for 2012 which is slightly more optimistic than the IMF forecast of 2.3% for 2012.



Source: Bloomberg, Daman Investments

Monetary base

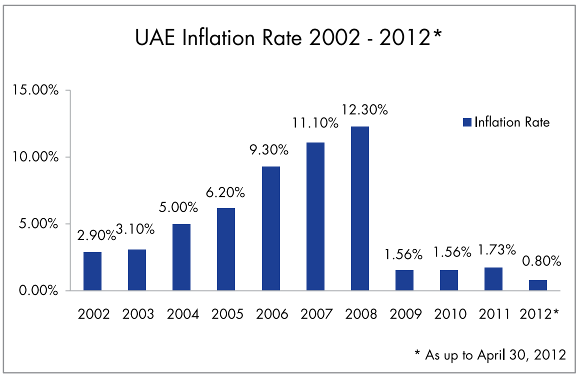
The stock of money continues to improve as is evident from the broad monetary aggregates. The first quarter M2 growth on a quarterly basis is the strongest since 2010.



Source: UAE Central Bank

However, given the high weighting of housing in the CPI basket (38% in Abu Dhabi and 43.7% in Dubai) which remains in a glut the outlook for inflation remains sanguine.

Macro remains benign



Source: Bloomberg

Banking Sector

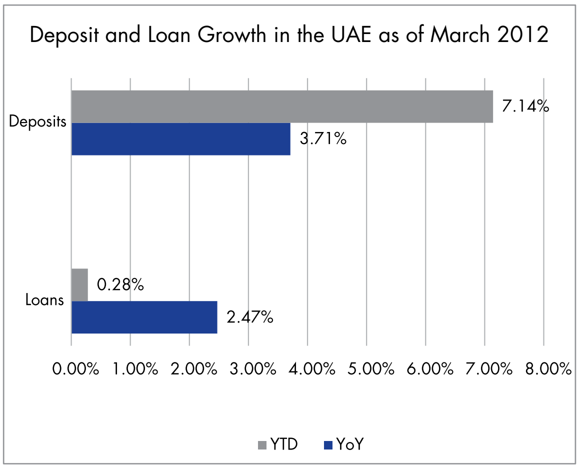
The Banking sector which was growing all of its aggregates at a strong double digit growth rate prior to the crisis was particularly hard hit during the crisis as reflected in the low single digit growth rates since 2009 onwards. However the trend rate of growth picked up substantially in 2011.

Evolution of Banking Aggregates

US$ million	2006	2007	2008	2009	2010	2011
Total Assets	234,057	327,375	396,515	413,642	437,195	455,521
% yearly growth in Assets	34.64%	39.87%	21.12%	4.32%	5.69%	4.19%
Total Deposits	141,268	194,968	251,191	267,550	285,800	291,075
% yearly growth in deposits	26.64%	38.01%	28.84%	6.51%	6.82%	1.85%
Total bank loans and advances	137,857	185,138	270,579	277,114	280,817	291,429
% yearly growth in bank loans and advances	35.98%	34.30%	46.15%	2.42%	1.34%	3.78%

Source: UAE Central Bank

A key statistic to keep an eye on going forward is the YTD loan growth figure which at present is barely positive, despite strong deposit growth, which suggests that banks are still rebalancing their books.



Source: UAE Central Bank

Liquidity is the key

The UAE market has witnessed a significant rise in the value traded this year. If we annualize the value traded up until month end March '12 we get close to the amount traded back in 2010. Also, if this current pace was sustained then it would mark the first year on year increase for the DFM since 2007 and 2008 for the ADX.

Value Traded Over The Years (in AED billions)

Date	ADX	YoY	DFM	YoY
2006	70.60	-32.57%	347.98	-14.10%
2007	175.34	148.36%	379.41	9.03%
2008	232.16	32.40%	305.20	-19.56%
2009	70.17	-69.78%	173.51	-43.15%
2010	34.58	-50.72%	69.66	-59.85%
2011	24.86	-28.10%	32.09	-53.94%
* 2012	29.08	16.97%	81.92	155.29%

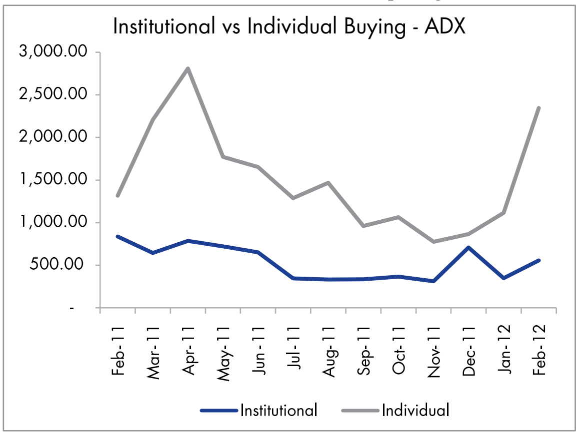
****Annualized figure based on value traded from Jan-Mar 2012***

Source: DFM, ADX & Daman Investments

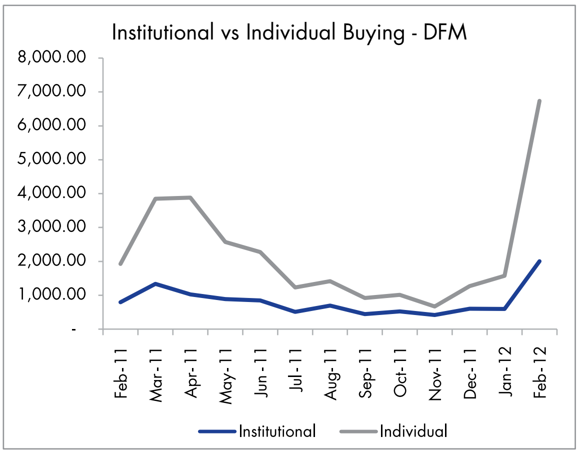
So let us now examine the source of this increased liquidity.

Institutional versus Retail Buying

Retail buying still dominates



Source: ADX Website



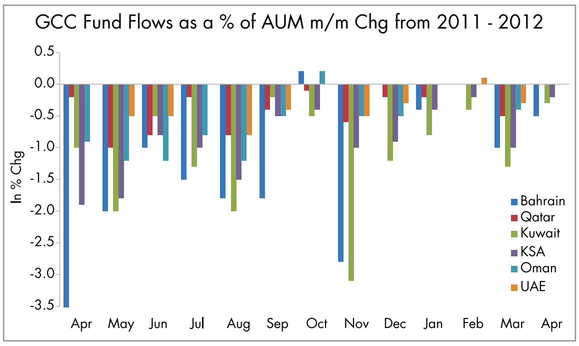
Source: DFM Website

The above charts depict the fact that retail investors have been 3.4x more active than the institutional investors on the DFM and 4.2x on the ADX. This is an important point note as the retail element tends to be fickle by its very nature.

Funds continue to shrink AUM's

Delving deeper, we find that the institutional element has not benefitted from the current market rally. If anything with the exception of the month of February '12 UAE funds continue to hemorrhage assets.

GCC Fund flows as % of Assets under Management



Source: EPFR

The chicken and egg

The question then becomes "what will entice the institutional element to return in size to the market?" An obvious short term catalyst is the MSCI announcement as to whether or not the UAE has managed to obtain MSCI emerging markets status from its current frontier classification.

The MSCI review

Much has been written about the potential MSCI classification to emerging markets status for both the UAE and Qatar from their current frontier status. However, we feel it is worth revisiting the key criteria for the upgrade at this juncture.

Quantitative selection criteria: The following table summarizes the key selection criteria and stocks that pass as of April month end.

UAE Index Members Tested Against Emerging Market Criteria

		(in millions)					MSCI CRITERIA			
Ticker	Free Float %	Market Cap	Free Float Adjusted Mkt cap (Mkt.Cap * Free Float%)	12m Value Traded	AVTR (Value Traded / FFAdj Mktcap)	Ownership Limit Ratio	If Mkt Cap > USD 846 Million	If FF Adj.Mkt Cap >= USD 423 Million	If ATVR>=15%	If Ownership>=20
DFM	20.37%	2,115	431	3,511	815.04%	49	PASS	PASS	PASS	PASS
DPW	19.55%	9,130	1,785	503	28.20%	100	PASS	PASS	PASS	PASS
EMAAR	68.78%	4,876	3,353	10,608	316.32%	49	PASS	PASS	PASS	PASS
FGB	83.95%	7,245	6,082	1,665	27.38%	25	PASS	PASS	PASS	PASS

Source: Bloomberg & Daman Investments

According to the rules, at least 3 stocks need to pass the minimum market cap & liquidity criteria for EM. Currently we have 4 cited in the preceding chart. Our hope would be to see a significant increase in the number of stocks passing the criteria.

MSCI short term catalyst

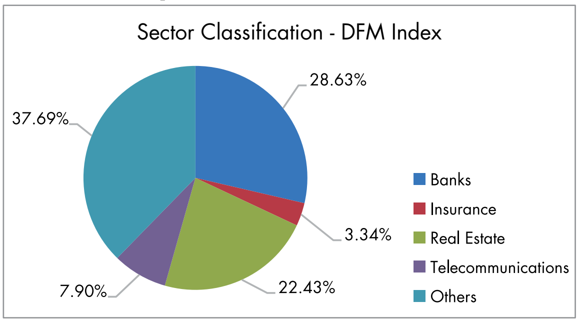
However, the main issue cited by MSCI in relation to the upgrade was the qualitative element of the criteria, namely, the feedback on DVP settlement. The main concern was that of trades done in error which could be sold by the broker without the owner's consent, which as of yet has not been resolved.

Impact of the potential upgrade?

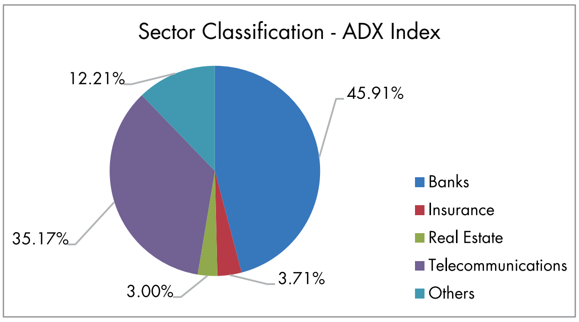
If the UAE was upgraded than its weight would be 0.147% in the index which would equate to ca. US$420m of passive money flowing into the UAE. Given the average daily value traded in the UAE markets during the month of April AED 352.6 Million or ca US$96 Million per day, this will equate to 4.4 days of trading turnover. Therefore, a potential reweighting would be at best a short term catalyst but not enough to send the UAE on a sustained positive upward trajectory.

Shallow Depth

Lack of market depth



Source: Bloomberg



Source: Bloomberg

The UAE market breadth has traditionally been shallow and is heavily concentrated in the real estate (22.43% in the DFM and 3.71% in the

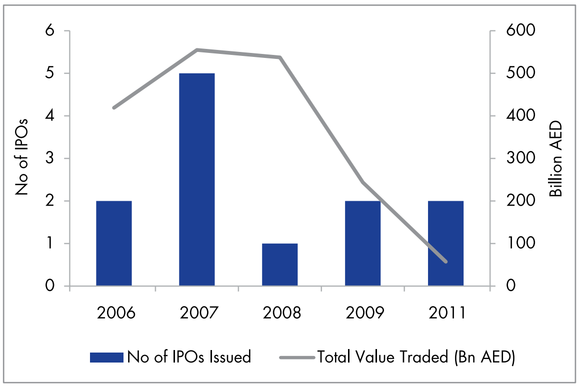
ADX) and banking sectors (28.63% in the DFM and 45.91% in the ADX). Hence, any new liquidity will inevitably gravitate towards these sectors in the absence of new IPOs and will not have a sustained positive effect on the broader market overall.

The return of the IPOs?

2 IPOs per year run rate

The Dubai market has been characterized by a dearth in IPO activities with the last IPO being that of Drake and Scull on Mar 16 2009. The ADX has shown signs of life of late with the last IPO there being Insurance House on June 20 2011.

In order for us to reach the height of the IPO market as witnessed in 2007 we would need a whopping 10 times increase in market value traded however, a more realistic target would be to have at least 2 IPO's per year.



Source: Bloomberg

In order to break free from the current moribund state of the IPO market, the government should once again play its traditional role of listing key government businesses and thereby triggering primary market activity. The last major government listings were in 2007 namely, DFM and DP World.

Earnings momentum

UAE stocks showed strong earnings momentum in Q1'12 and expectations for the Q2'12 are high which should support stock market performance.

Q1, 2012 Results

Strong Q1, 2012 results

ADX

Sector	Q1 2012 Net Profit/Loss (in millions)	Δ QoQ	Δ YoY
Banks	4,413	33%	14%
Insurance	163	185%	-15%
Real Estate	609	114%	110%
Telecommunications	2,543	90%	-4%
Others	1,270	286%	65%
Grand Total	**8,997**	**69%**	**16%**

Source: Bloomberg

DFM

Sector	Q1 2012 Net Profit/Loss (in millions)	Δ QoQ	Δ YoY
Banks	1,419	196%	-34%
Insurance	155	288%	19%
Real Estate	637	0%	20%
Telecommunications	333	-24%	62%
Others	465	107%	44%
Grand Total	**3,010**	**65%**	**-10%**

Source: Bloomberg

Dividends Surprise

A positive development of late has been the UAE companies renewed focus on paying dividends. UAE banks positively surprised on this front, however, the cynics may say that this is due to them being overcapitalized with minimal growth prospects. Real estate companies also chipped in with dividends. Importantly given the attractive dividend yield (see section on Asset Allocation), a re-energized class of yield hungry investors should be attracted to the market.

ADX

Valuations remains attractive

Ticker	Dividend Payout	Net Income 2011	Payout Ratio
ETISALAT	4,744	5,839	81.24%
NBAD	861	3,708	23.22%
FGB	1,500	3,707	40.46%
ADCB	1,119	3,026	36.99%
TAQA	607	744	81.54%
	8,830	**17,024**	**51.87%**

Source: Bloomberg

DFM

Ticker	Dividend Payout	Net Income 2011	Payout Ratio
EMAAR	609	1,794	33.96%
DIB	475	1,010	46.99%
ARTC	75	261	28.69%
DU	686	1,098	62.47%
ENBD	1,112	2,531	43.92%
ARMX	73	212	34.61%
	3,029	**6,904**	**43.87%**

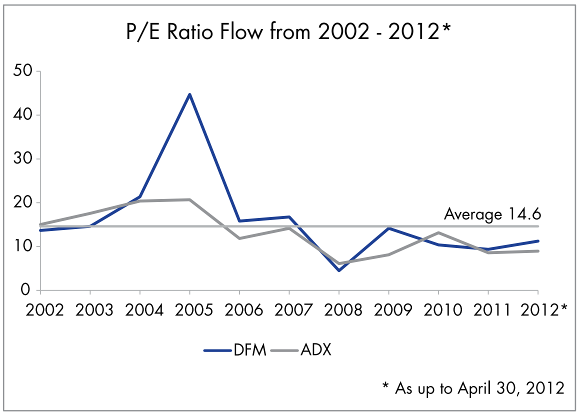
Source: Bloomberg

Valuations

Despite the strong run in our markets noted above, the market remains attractively valued from a historical P/E perspective and on a P/B versus ROAE basis.

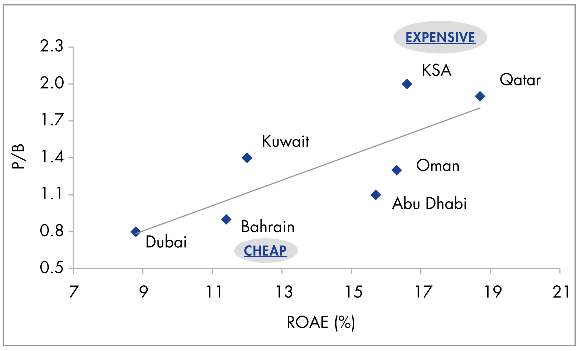
P/E still below long term average

Trailing P/E Ratio from 2002-12



Source: Bloomberg

PB Versus ROAE for the markets

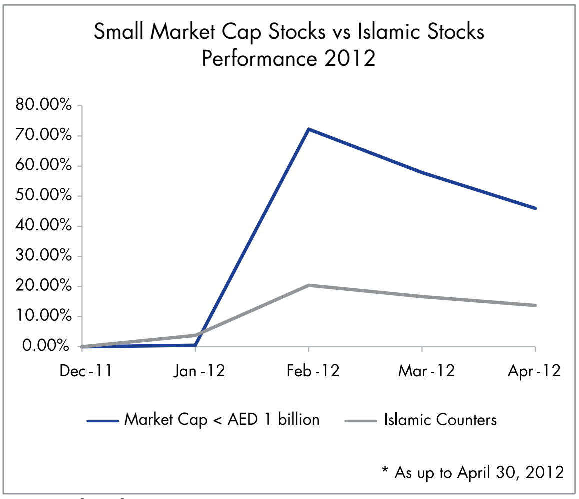


Source: Daman Investments

If we look at the above chart, we see that Dubai is still the cheapest market in the GCC on a price to book basis. Therefore the valuation case for Dubai continues to be an argument for further upward potential.

Rotate into Islamic stocks

The aforementioned retail dominance has meant that small and mid caps have significantly outperformed their larger and Islamic peers. Smaller Islamic counters did indeed rally in Q1 such as Tamweel, however, rather curiously large counters such as Etisalat & DIB lagged significantly and contributed to the underperformance of Islamic stocks vis-à-vis small caps. As has been the case in previous retail led rallies, rather perversely, stocks with the most challenging fundamentals have enjoyed the highest trading activity & subsequent price performance.

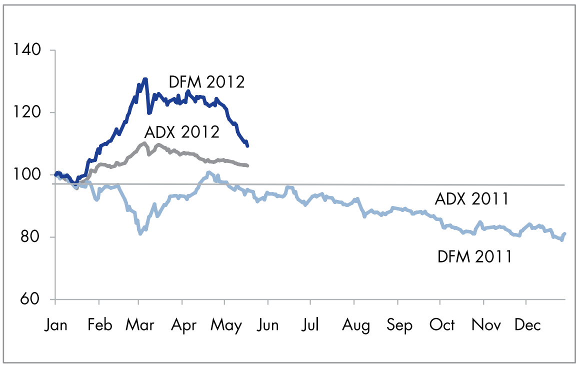


Source: Bloomberg

Islamic/Large caps to re-rate

With Islamic/large caps having underperformed we expect a re-rating to drive a second leg to this rally. The lead up to the June end MSCI decision and July earnings season is likely to provide a catalyst for this re-rating. However, the performance of this second leg is unlikely to exceed what we have seen this year already. However, we would be buyers on weakness.

Sell in May and Go Away?



Source: Bloomberg

There is a fear amongst investors that the adage "Sell in May & Go Away" will again work this year. The concern is particularly rife when looked at in a historical perspective as the strategy has worked consistently well since 2008 in the DFM and 2007 in the ADX.

DFM

	Before May		After May	
Year	3 Months	6 Months	3 Months	6 Months
2007	**-6.81%**	-15.58%	**-4.93%**	19.63%
2008	**3.55%**	8.77%	**-16.12%**	-65.40%
2009	**7.95%**	-45.43%	**1.93%**	3.32%
2010	**7.09%**	-16.21%	**-6.07%**	5.65%
2011	**5.48%**	-8.61%	**-4.33%**	-11.60%
*2012	**11.69%**	17.42%	**?**	

Source: Bloomberg

ADX

	Before May		After May	
Year	3 Months	6 Months	3 Months	6 Months
2007	**3.26%**	-9.25%	**-3.93%**	16.37%
2008	**9.96%**	15.74%	**-12.40%**	-44.90%
2009	**13.48%**	-24.05%	**8.13%**	-0.42%
2010	**4.21%**	-4.90%	**-4.06%**	4.83%
2011	**3.52%**	-4.01%	**-0.88%**	-7.36%
*2012	**1.57%**	0.34%	**?**	

Source: Bloomberg **** As upto May 01, 2012***

The data suggests that there is a consistent pattern of positive market performance in the first 3 months followed by significant periods of retracement thereafter.

So what features are currently in play that will suggest the contravention of this seasonality?

Asset Allocation

Equities continue to offer the best risk adjusted returns.

Equities still preferred

Investment	Yield	Inflation Adj Yield
Avg 12 months bank deposit rate	1.25%	0.45%
Equities Earning Yield - DFMGI	8.90%	8.10%
Equities Earning Yield - ADX	11.17%	10.37%
Dividend Yield - ADX	6.10%	5.30%
Dividend Yield - DFMGI	3.80%	3.00%
Bond Yield - Dubai	3.91%	3.11%
Bond Yield - Abu Dhabi	0.81%	0.01%

Source: Bloomberg, Daman Investments

Given the current high dividend yields in the two UAE stock markets and the relatively low deposit and Bond Yields available. We continue to be strategically & tactically over weight in equities, and would be buyers on weakness.

Buy on weakness

In Sum

Was the Q1 rally a mirage?

Factors in play	Positive	Negative	Ambiguous
Institutional versus individual activity			😐
Dividend Payment	☺		
Institutional Fund flows		☹	
MSCI Upgrade Debate	☺		
Low IPO activity		☹	
Q1, 2012 Performance	☺		
Big Overperformance of small caps		☹	
Islamic stocks underperformance in Q1, 2012	☺		
General Macro Environment	☺		
Rotation into lagards	☺		
Asset Allocation	☺		

Source: Daman Investments

Given that 7/11 of the above mentioned factors come out positive, this leads us to believe that the markets will end the year in the green, although the major gains for the year may already be behind us.

We therefore, conclude that the rally was not a mirage but a lot of good things need to happen in order for it to be sustainable.

Equities to finish the year in the green