

Maintaining our buy on Egypt (for now)

EMEA Strategy, 11th September 2012

Carry on: EGP-USD likely to be kept stable, offers 15% 1-5 year T-bills/bonds with yields still high despite CDS and currency forwards contracting. We anticipate a 4-500bps contraction.

Reserve reversal: Reserves now ticking up on economic recovery (Suez Canal, remittances, tourism) and significant foreign aid after being drawn down to protect the currency. Qatar is leading the way with \$20bn committed over 5 years, ~33% of external funding needs and will look to support the Muslim Brotherhood as their main backers, but total FDI and prospective aid thus far is more than we have seen in prior years with the momentum sustaining the EGP

Stability: Infrastructure largely intact, security situation increasingly stable, a highly pragmatic government that has made peace with the army and a new parliament/constitution soon

Our main concern: Food inflation a concern and subsidy reform needed, but any shortfall will be more than matched in the coming year (thereafter more of an issue)

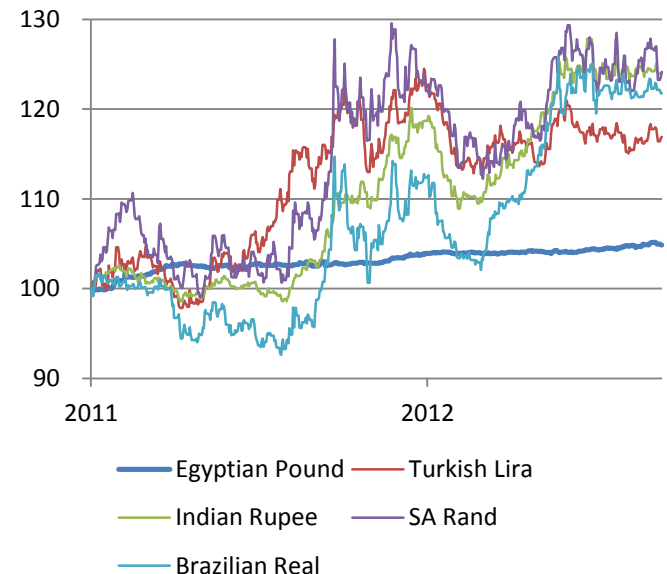
Equity option: Equity market has done great ytd (+54%), but there is still (in our opinion) 35-40% potential upside in select names with Commercial International Bank, Telecom Egypt, Talaat Mustafa Group, Centamin and Orascom Telecom in our model portfolio (+43% ytd). Only OCI looks fully valued and we remove it completely as it hits our price target pre de-merger.

Participation to increase: Foreign investors still hugely underweight awaiting 20-30% devaluation that is unlikely. Rest of sell-side (finally) upgrading Egypt, missed most of the move but decent upside remains as investors rotate out of South Africa (consumer valuations rich, materials scary), Turkey (great run, slowing) and continue to avoid Russia (because it's Russia)

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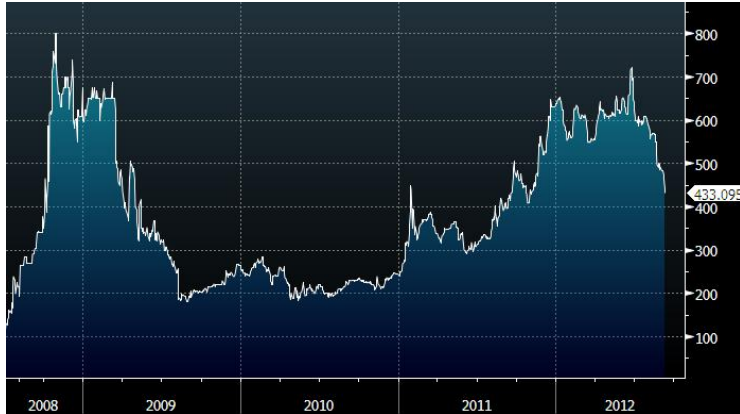
The Egyptian pound has been rather stable



Source: Religare Noah, Bloomberg

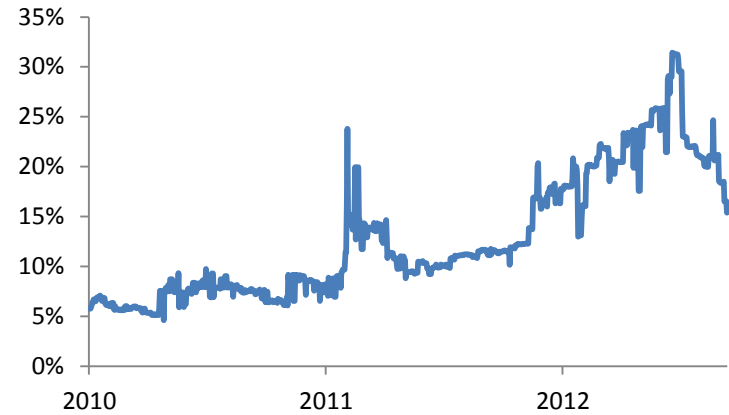
Disconnect between sentiment and local fixed income pricing

Egyptian 5 year CDS have been coming in sharply..



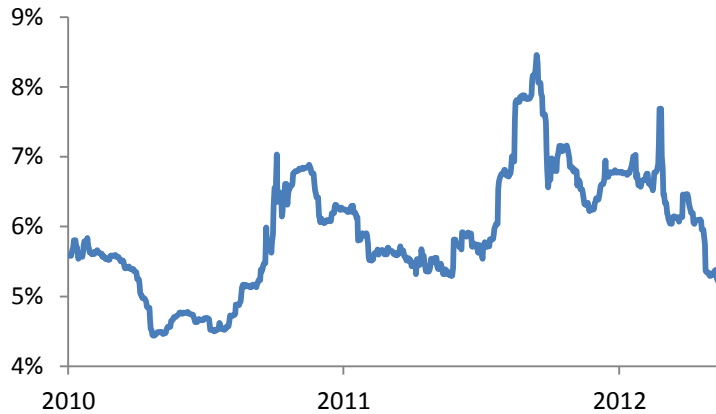
Source: Bloomberg

..as has level of expected devaluation (12m NDFs)..



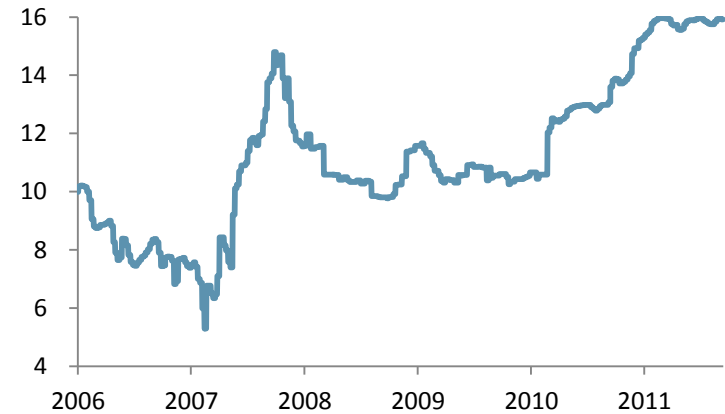
Source: Bloomberg

..and USD 2020 government bond yields..



Source: Bloomberg

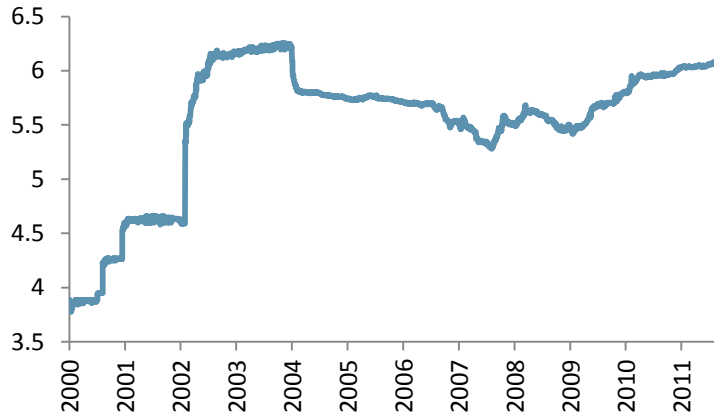
..but local currency yields remain high (12m T-bills %)



Source: Bloomberg

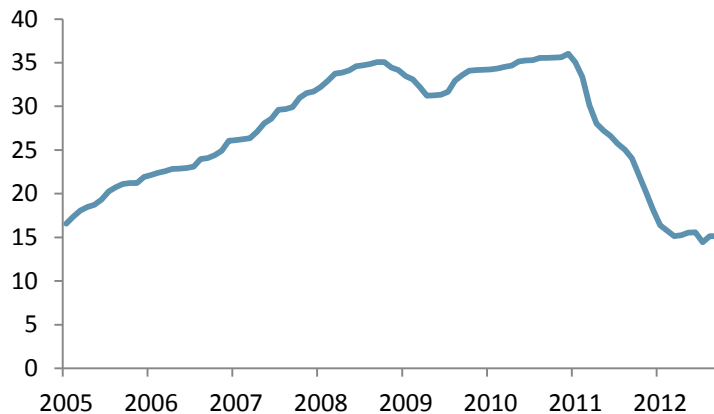
Pressure on the pound easing as economy recovers, aid comes in

Egyptian pound over the last decade or so



Source: Bloomberg

Egyptian foreign exchange reserves (\$bn)



Source: Religare Noah, Egyptian Central Bank

- **EGP is a managed float:** After a sharp devaluation in 2003 when Egypt moved from a peg to a managed float after a sharp disconnect between official and unofficial rates, the pound has remained stable since then, aided by significant FDI inflows and increasing tourism revenues
- **Drawing down on reserves:** Most foreign investors fled Egypt in the wake of uncertainty, with the Central Bank defending the stability of the currency by drawing down on foreign exchange reserves. Many investors were (and are) awaiting a 20-30% devaluation in the currency as conditions appeared the same as other currency crises on capital flight
- **The representativeness heuristic:** We have maintained Egypt is not like these other currency crisis instances. Firstly, capital flight was not as a result of an overheating and increasingly uncompetitive economy funded by foreign cash (hence a devaluation restores competitiveness).. Secondly Egypt's geopolitical importance meant that it would attract significant US dollar support from its friends, as it is now doing from the GCC, USA and China, who own most of the world's dollars. Having friends in currency markets is great, as can be seen by contrasting it with Iran, where the Rial continues to fall. Economic models tend to fail when politics get involved as it is seldom "rational".
- **Bouncing reserves:** Foreign exchange reserves arrested their decline and have started to bounce as tourism and remittances begin to recover (albeit with still a way to go), outflows slow and foreign capital returns both in markets and through aid and FDI announcements
- **Managed devaluation:** We anticipate a gradual devaluation of the Egyptian pound to be implemented in the middle of next year of ~5% per annum to maintain competitiveness with inflation at 6-7%. The government does not want to devalue now due to concerns over domestic unrest if food and energy prices spike, even with subsidies.

Political stability on its way, inexorable march to democracy

President Morsi, Rocket Scientist



Former President Mubarak taking a nap



Source: AFP

- **Original coup:** We viewed the original Egyptian revolution as a coup against Mubarak. Prior to the revolution the key question everyone had was whether Hosni's son, Gamal, or the army would take over. During the unrest Mubarak asked the army to suppress the protestors violently and they decided not to given their high place in public perception and control over significant portions of the Egyptian economy
- **Letting go is hard:** By positioning themselves as the saviours of the Egyptian people and promising elections the army backed itself into a corner in terms of actually controlling the country. Elections have been largely transparent and fair, but the army made several moves to curb what they saw as too much power for the Muslim Brotherhood (the main organised party due to their social work), muddling politics until..
- **President Morsi:** The confirmation of President Morsi at the end of June signalled that the political system was working with old establishment candidate Shafiq defeated. Our take on Morsi is that he is not a politician looking to get re-elected or rich, but someone who does want to try to fix Egypt, which led to..
- **The counter-counter-coup:** The army body in charge of transition, the SCAF, had given itself new powers to curb Morsi's control upon reaching the Presidency, as they had dissolved parliament and he was due to become head of the new constitution-writing body and the SCAF. There were clear moves to undermine the new government and this came to a head with the forced retirement of Generals Anan and Tantawi, leaders of the SCAF, in early August, with the next generation of army leaders coming to a compromise with Morsi & co whereby they would no longer interfere in domestic issues as they were finally promoted
- **Now:** New constitution imminent followed by parliamentary elections. Interim government has sufficient power/support for aid receipt

Muslim Brotherhood is pragmatic, supported by Qatar in particular

Shaykh Al-Qaradawi (middle)



Source: Gulf times

PM Qandil, Qatari FM Sh al-Thani & Pres Morsi

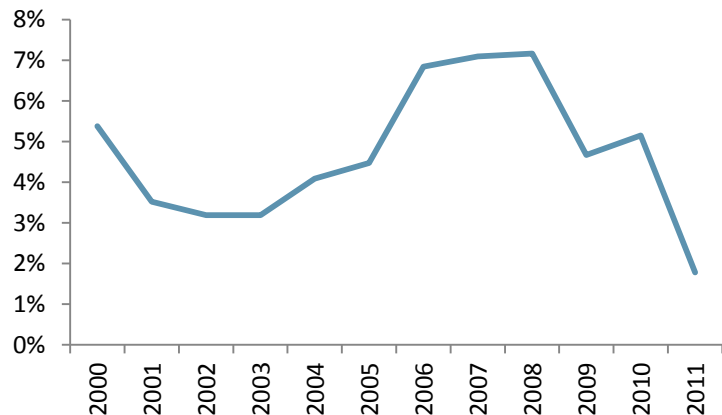


Source: Gulf times

- **MB in charge for now:** With the Presidency (although Morsi has technically stood down from the party and a quiescent army, the Muslim Brotherhood has effective control of Egypt for now and is working to stabilise the country. This will change slightly in parliamentary elections as inexperienced liberal and secular parties should gain ground, but the MB will remain a powerful force
- **Open for business:** President Morsi has actively courted foreign investment making trips through the GCC, Iran and China as well as hosting hundreds of US companies last week with Prime Minister Qandil promising an open business environment with continuation of current projects such as Qualified Free Zones (duty free exports to US as long as goods have Israeli components), although energy subsidies will go
- **A pragmatic Islam:** While an Islamic party, the spiritual guides of the Muslim Brotherhood, such as Qatar-resident Shaykh al-Qaradawi (left) emphasise the importance of “public interest” as a principle of Islamic law. Islamic law seeks to codify the links between the eternal Qu’ran and the temporal life of the Prophet Muhammad () utilising a few different sets of basic axioms and derived principles to do so (four major sets for Sunnis, known as “schools of thought”) to make rulings relevant for today. The balance of these differs between groups , as can be seen by protests from Salafist groups (backed by Saudi) over the Islamic legitimacy of an IMF loan vs the MB accepting it as a necessary evil
- **Qatar splashing cash:** Qatar has committed at least \$20bn to Egypt thus far (\$2bn deposit over 8 years, \$18bn in FDI committed over 5 versus ~\$12bn external funding requirements), with state companies also making moves in M&A such as QNB on NSGB, QInvest on EFG-Hermes. Qatar has been the major financial backer of the Muslim Brotherhood and this looks set to continue as they protect their investment.

Lots of dollars on the way to feed into an intact infrastructure

Egypt Real GDP YoY %



Source: Bloomberg

GSCI Agricultural Index

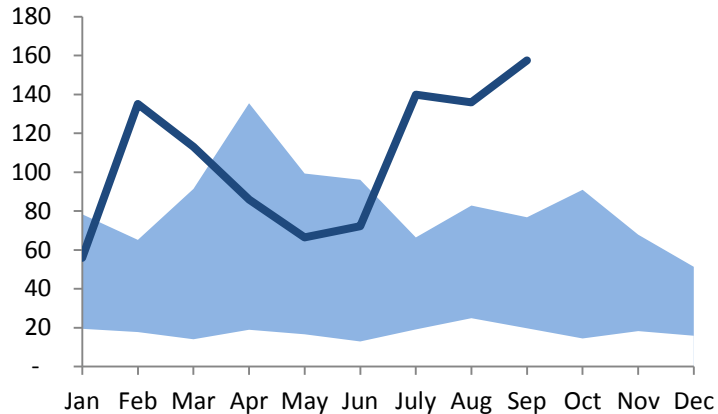


Source: GSCI, Bloomberg

- **Smooth transition:** The Egyptian revolution was relatively bloodless in comparison to most (although every death is regrettable) as the army switched sides in one fell swoop. Most of Egypt's infrastructure (Egypt-Israel gas pipeline aside) has remained relatively intact, with real GDP falling as the country ground to a halt for three months last year, tourists were scared away and businesses were unsure about the outlook- for example net FDI was only \$440m 1Q 11/12 (July-Sept) versus \$1.6bn 1Q 10/11. We think more FDI may come in now than if the revolution had not happened, with \$40bn worth of projects currently mooted.
- **IMF loan the key:** The much-vaunted IMF loan of \$4.8bn over 5 years at 1% with a 39 month payment holiday looks to be finally approaching completion, with the government in agreement over its necessity to help fill the \$12bn in external funding requirements for the Egyptian budget this year (10% total deficit on \$200bn economy, 2.5% primary deficit, 60% debt/GDP). This is likely to be followed by a \$1bn World Bank loan and open up access to additional foreign aid from the West such as the \$20bn promised by the G20 for the Arab Spring
- **Geopolitical jostling:** While Qatar as previously mentioned leads the way, we expect continued aid from the USA and Saudi Arabia in particular following the rapprochement between the Muslim Brotherhood and the Saudi government earlier in Spring. Kuwait has been relatively quiet about additional investment, as has the largest FDI provider the UAE, and expect more to come from both.
- **Subsidy reform required:** Food prices have spiked and continued drought could drive them even higher. Plans being introduced to cut energy subsidies (\$20bn/yr, unlikely to increase) and food subsidies (\$5.5bn/yr, may gap). Any shortfall will be filled by additional aid for the next year, but thereafter it is dicey for a net calorific importer like Egypt.

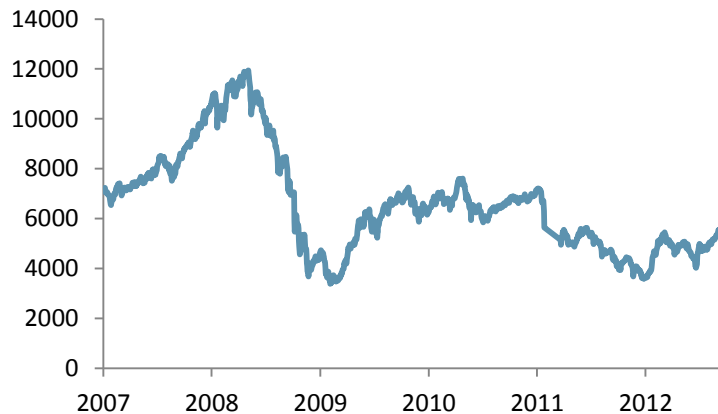
Egyptian equity market probably has 20% upside

EGX30 volume versus 5 year range



Source: Religare Noah, Bloomberg

EGX30 index has recovered somewhat

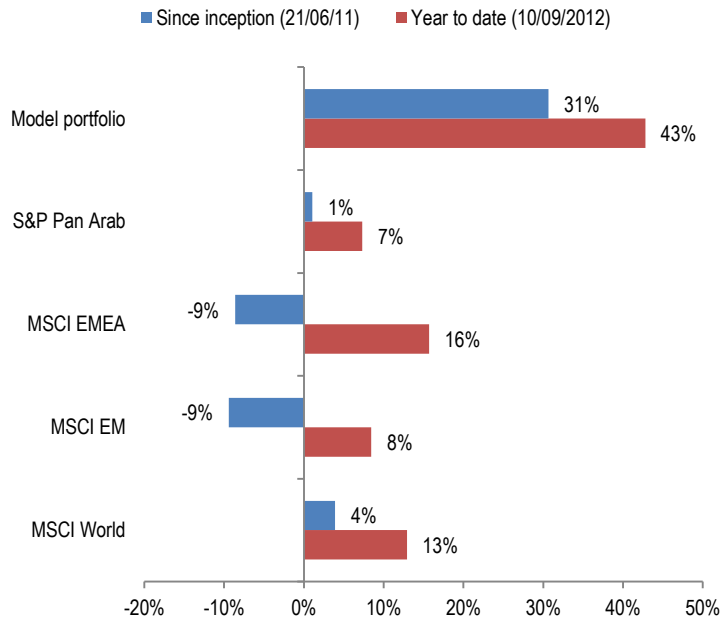


Source: Egyptian Exchange

- **Everyone still underweight:** After the revolution, equity investors typically moved to a 0% allocation for global EM funds (versus ~0.6% of index) and 3% underweight allocations for dedicated funds (~10-12% of index), with US dollar earning stocks such as Orascom Construction preferred. This contrasted with solid overweights prior to the revolution of around 40-50bps for EM funds and 3-4% for dedicated funds due to Egypt's superior growth profile. The sharp spike in volume and market performance in recent months has been as a result of local buying with foreigners still net sellers.
- **Investment options:** For foreign investors looking to gain access, direct access is always best and we can help with that, but there is also a US-listed ETF (EGPT US) and multiple GDRs, although only Orascom Telecom and Construction have decent liquidity. Orascom Construction (OCIC EY, ORSD LI) is about to undergo a demerger of its fertiliser and construction divisions and we think it is approaching full value at these levels. This is important as it makes up ~25% of the EGX30 index with the majority of its operations now outside of Egypt, although prior demergers in Egypt have led to sharp pops in overall market capitalisation of the two entities we don't see investors rushing to buy the likely undervalued construction arm with new inflows.
- **Increasing M&A speculation:** The Egyptian market is attracting increasing levels of M&A interest, with EFG-Hermes investment bank entering a deal with Qinvest investment bank from Qatar and NSGB bank (owned by Soc Gen) receiving an approach from Qatar National Bank. We would expect this trend to continue, with rumours that Qatari real estate developer Barwa Real Estate is looking to acquire one of the smaller Egyptian developers and a potential privatization or acquisition of Eastern Tobacco (5x PE, 9% dividend yield) by an multinational tobacco company.

MENA model portfolio and Egypt stock picks, 35-40% upside

Total return since inception and year to date



Source: Religare Noah

- MENA model portfolio:** Launched last June, our MENA model portfolio is aimed at replicating a standard UCITS III, SICAV part 2 Luxembourg long-only MENA fund with an original nominal value of \$100m to take into account liquidity issues, with updates only when notes are published. This is a paper portfolio only and we do not as a house do proprietary trading. Since inception the portfolio has outperformed its benchmark, the S&P Pan Arab Composite, by 30%. The portfolio is at 8.4x forward earnings with a 6% dividend yield and we see 35% absolute upside into the end of 2013.
- CIB (COMI EY, CBKD LI):** Top bank in Egypt, great management. Despite revolution in 2011, grew its loan book 17%, earnings dropped 20% (on provisions) and NPL formation was under 1% thanks to a book made largely of MNCs. Minimal wholesale funding with a low loan/deposit ratio and no forex mismatch on its books. We're looking for 20%+ growth in its bottom line in an Egyptian market with retail lending at only 8% of GDP. Traded above 3x PB before revolution, now at 2x 2012 book, 10x PE. We see 40% total return potential to the stock as the top play on the Egyptian economy and a foreign favourite
- Telecom Egypt (ETEL EY, TEEG LI):** Only local telco left on the Egyptian market, with a 11% dividend yield at 8x PE. Either you get the landline operations cheap or Vodafone Egypt for a significant discount to the likes of Vodacom SA. We see 40% total return potential
- Talaat Mustafa Group (TMGH):** Building a new town next to Cairo, trading at a third of book despite operations holding up and a good balance sheet. We see 30% upside from here.
- Centamin (CEY LN):** Rapidly expanding gold producer, cost per tonne has moved up on fuel and pay rises, but good momentum. 45% upside.
- Orascom Telecom (ORTE EY, OTLD LI):** Algerian special sit, 33% upside

MENA model portfolio constituents, 31st August 2012

Name	Last Price	ADVT (\$m)	Perf Avg	Perf YTD	PE 12	PE 13	PB 12	PB 13	ROE 12	ROE 13	DY 12	DY 13	Downside	Upside	Consensus	#Estimates	Weight	
Top Picks																		
Telecom Egypt	14.10	1.4	12%	7%	8.7	8.8	0.9	0.9	11%	11%	10%	11%	12	18	17.889	12	9.9%	
CIB	30.09	6.0	10%	69%	9.8	8.3	1.8	1.6	21%	22%	4%	4%	25	45	30.64	13	9.9%	
Qatar National Bank	134.10	3.1	1%	-3%	10.9	9.4	1.9	1.7	19%	19%	3%	4%	130	180	171.65	10	9.6%	
First Gulf Bank	9.54	1.8	8%	22%	7.3	6.3	1.2	1.1	17%	18%	6%	7%	8.5	14	11.8	13	8.6%	
CBQ	72.70	2.2	4%	-14%	9.1	8.1	1.2	1.2	14%	15%	8%	8%	70	100	99.53	11	8.2%	
Top Picks Average					9.1	8.2	1.4	1.3	16%	17%	6%	7%						
Mid Picks																		
Cantamin	79.50	4.5	19%	-4%	7	5.2	0.8	0.7	21%	21%	0%	0%	60	120	106.7	16	7.4%	
TMG Holding	4.63	2.6	15%	61%	11.6	8.9	0.4	0.3	4%	5%	0%	0%	3.3	6.5	6.36	6	6.6%	
Al Rajhi Bank	73.75	20.1	1%	6%	13.7	11.7	3.2	2.9	24%	25%	5%	6%	90	100	86.57	12	6.0%	
Orascom Telecom	2.93	3.9	13%	63%	9.3	7	0.2	0.2	15%	15%	4%	8%	2.2	4	3.92	8	5.5%	
Orascom Construction	44.95	3.0	6%	36%	14.5	10.3	0.5	0.4	20%	26%	5%	5%	40	50	48	0	5.1%	
Emirates Nbd	3.03	0.3	11%	4%	7.1	5.3	0.5	0.5	9%	11%	7%	8%	2.8	4	3.16	4	4.8%	
Qatar Islamic Bank	78.00	1.2	0%	-7%	12.5	11	1.5	1.5	12%	13%	6%	6%	70	100	87.53	5	4.8%	
Qatar Electricity and Water	136.30	0.6	1%	-3%	9.5	8.8	2.6	2.3	33%	30%	6%	6%	130	180	173.44	8	4.8%	
Samba	48.10	1.7	3%	3%	9.2	8.2	1.4	1.3	16%	16%	4%	5%	45	75	62.43	12	4.4%	
Zain	690.00	2.9	0%	-22%	9.7	9.3	1.5	1.4	14%	13%	9%	9%	650	1000	720.85	7	4.3%	
Cash																	0.1%	
Overall Portfolio					9.8	8.4	1.3	1.2	17%	17%	5%	6%				<i>Total</i>	<i>99.8%</i>	

ADVT represents the 30 day average daily traded value in US dollars for the stock. Year to date performance is US \$ performance year to date.

PE, PB, ROE and DY (Dividend Yield) represent consensus estimates for the respective years. Weighted average numbers are weighted by the Weight column (our recommended portfolio weight)

Downside and upside numbers are our expected range for the stock to trade – it may trade below the downside number, but we do not expect it to do so for long

The Estimates column is the number of analysts providing numbers for the Consensus estimates and price target in the Consensus column.

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