



Lebanon Economic Performance

2012





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I. Summary

Rather a passive year for the country, 2012 affirmed the transition of Lebanon to an economic slowdown, whereby it contemplated contracted growths in most sectors. The war in Lebanon's only recognized bordering country, Syria, had made it into its second year against earlier bets of a quick resolution, therefore installing uncertainty in the eventual outcome of the crisis and opening the door for extreme scenarios. In fact, as each quarter unfolded, estimates for Lebanon's real GDP growth were being revised down. Expectations fell from 3.5% to 1% as the Syrian crisis exhibited no signs of near solution, while the scattered domestic reactions endangered the perceived resilience of the country.

In theory, such an exogenous shock was surely expected to stifle tourism and trade. But in practical, the repercussions bypassed those to real estate growth as well as to capital and investment inflows. The whole region lost appeal and Lebanon's neutral policy failed to restore the lost grounds. Capital inflows declined and were insufficient to cover for Lebanon's twin deficits. As a result, the current account deficit worsened, and the balance of payments remained negative at \$1.5 billion despite a small recap from 2011's level. In the meantime, the usual tools to manoeuvre crisis, fiscal and monetary policies, were constrained by other challenges. The fiscal policy in Lebanon is highly dependent of the political reign, which is rarely at a consensus, and the monetary policy is constrained by the peg of the domestic currency to the US dollar. Nevertheless, the monetary authorities and the banking sector succeeded in maintaining the stability of the financial system, and even launched several initiatives to promote economic growth.

While this is not Lebanon's first crisis and previous experiences have proven an exceptional resilience

in absorbing shocks, this time looked different. The uncertain aspect and the impracticality of predicting the duration of the current war in Syria have put Lebanon in the face of multiple scenarios that need mitigations rather than adopt a wait-and-see mode. The government faced the difficult task of containing the budget deficit increase in order to maintain its past success in controlling the country's high debt-to-GDP ratio. The latter had risen back in 2012 for the first time since 5 years.

Spillovers from the intensifying war in Syria became particularly pronounced in the summer of 2012. Trends bottomed during the third quarter when the assassination of a top security general exposed the fragile stance towards the Syrian crisis. However, a quick reaction from market participants followed in order to isolate the effect of this incident, calling to take action against the slide of the economy. The positive rally fueled market sentiment towards the end of the year, and the financial markets were the first to translate this proactivity leading BLOM Stock index to pick up 5% during the last 2 months of the year.

2013 slowly revealed the magnitude of the coming challenges. Consecutive months of political unrest and a paralyzed political decision continue to weigh on the economy. Elections were postponed by extending the term of the current parliament, and the government awaits still the formation of a new cabinet. The private sector and the market players are trying hard to shift focus towards solutions, but a political accord to defend the economy remains inevitable. The social complications are not to be ignored. The influx of displaced Syrian citizens to Lebanon and the extension of the crisis in their homeland create additional social and economic pressures on Lebanon, whereby unemployment and healthcare expenditures are only few of the concerns to consider.

II. Real Sector

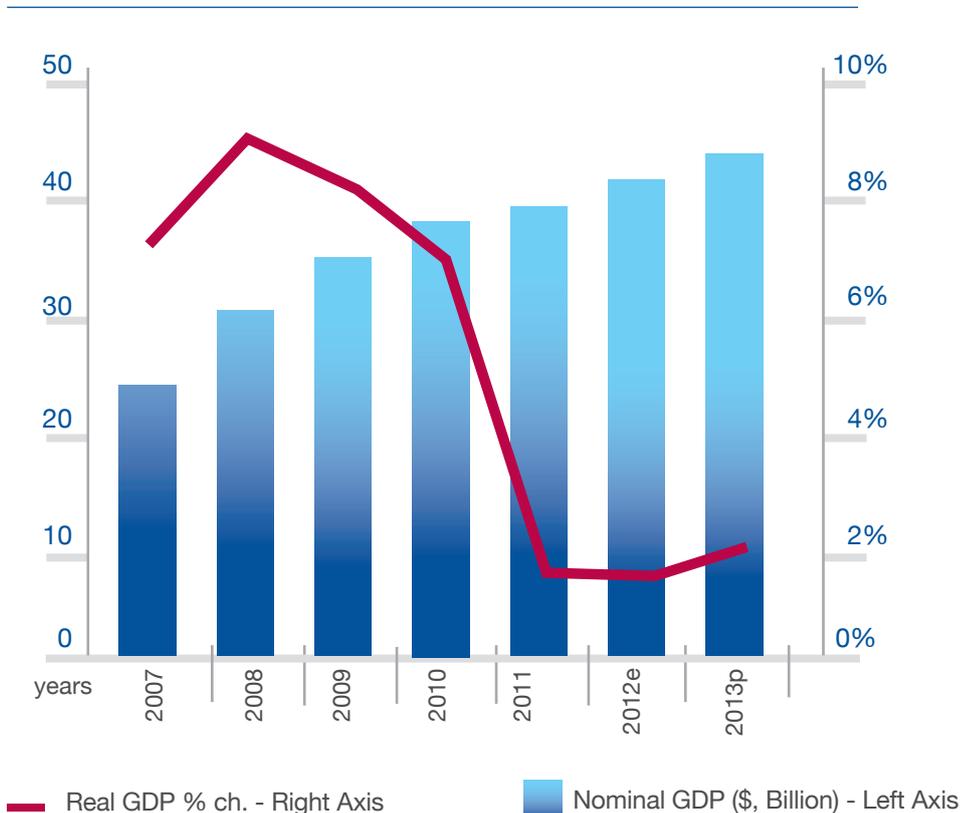
Lebanon’s economy slowed to 1.4% during 2012, down from a frail growth of 3% in 2011 following the break of war in Syria (Figure1). 2012’s growth rate is the lowest recorded since 2006, the year when July War destroyed the infrastructure. The second half of 2012 was particularly worrisome posting 2 consecutive quarters of negative growth for the first time since 2007, a general concession of a recession.

A. Inflation

The Consumer Price Index figures revised by Blominvest’s research department denote an inflation of 4.7% during 2012, slightly higher than the previous year’s 4.13%. As for the official figures released by the Central Administration of Statistics, inflation surged during the year to 10.1% compared to 3.1% in 2011 (Figure 2).

As a matter of fact, the official figures include a 44.1% adjustment made to the housing index to reflect the rise in prices during the previous 3 years. This increase in houses prices was incorporated in July 2012 leading to the 10.1% hike in the CPI. Blominvest’s research department spread the entry over the three years period, using the trends strolled by the real estate price transactions as a proxy to reproduce the actual monthly changes in the housing index during the period. As such, the approximated path of inflation during the year appears to have moderated in 2011 and 2012 when compared to 2010’s 6.2%.

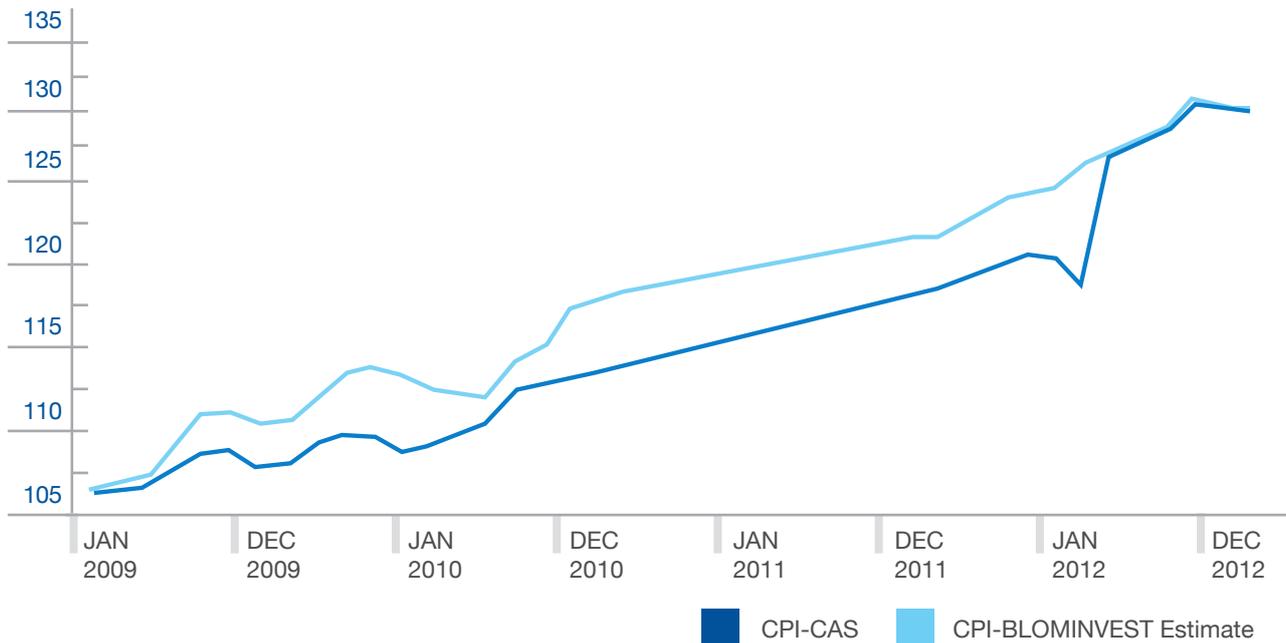
Figure 1: Lebanon’s nominal GDP & real GDP growth



Source: International Monetary Fund



Figure 2: Consumer Price Index



Source: The Central Administration of Statistics (CAS); Blominvest Research Department

B. Consumption & Demand

On the demand side, consumption and business spending were subdued leaning towards a more cost-rationalizing approach. Meanwhile, the few registered rises were either inflated by the emerging Syrian demand in Lebanon, or by the fleet of demand towards lower tag products.

Local consumption nurtured by newcomers

The refugees' continuous inflows to Lebanon raised imported merchandises at Port of Beirut and deviations from unsafe ports in Syria increased containers activity as well. The former added 8.20% to reach 7.23 million tons during the year, and the latter rose by 8.5% to 634,969 Twenty-foot Equivalent Unit.

A 21.4% rise in new cars registrations, the proxy for durable goods purchases, actually described the population's switch to lower cost/fuel consumption cars in addition to an increased demand from the newly displaced Syrian citizens to Lebanon. Meanwhile the fall in registered commercial cars reflected cuts in corporate budgets and car rental companies' difficulties. Further red flags appear when looking at cleared checks trends.

Despite nudging down only by 0.1% to \$71 billion, returned checks have increased by 3.5% to \$1.5 billion signaling greater liquidity gaps faced by merchants.

Business less than usual

Business environment and investment incentives were also hindered by uncertainty, leading credit to the resident private sector to decelerate to \$39.6 billion by the end of 2012, despite lower market interest rates. As a result, a 10.2% growth was recorded in 2012 compared to past rates of 13.25% and 24.40% in 2011 and 2010 respectively. Kafalat loans' total value also dropped 16.4% to \$138M during 2012, and the number of guarantees fell by 19% to 1,025. The agricultural sector lost 46% and the industrial sector retracted by 37%, with most regions seeing a drastic lack of interest in acquiring new loans with the exception of Mount Lebanon. Worth noting that loans to the private sector in Lebanon are almost of the same size of the country's GDP, 95% to be specific, as reliance on credit remains one of the most efficient options to boost the economy.

As for the real estate sector, the slowing expansion and selective demand were reflected through a slight decline of 0.84% in the number of construction permits issued during 2012 as well as the through the construction area per permit that narrowed by 10.85%.

On the supply side of the real sector, tourism was the first to take the hit. The latter had fallen as Egypt, Jordan and Syria were experiencing social and political unrests. Lebanon's position as a touristic hub was jeopardized by repeated security clashes and high suspicions of eventual spillovers from the region and especially Syria. GCC warning their citizens against landing in Lebanon also cost tourism a loyal share. Interest in real estate diminished as long term investments become unfavorable in fuzzy times. As for the productive sectors, shield segments such as industry suffered from increasing costs and the loss of competitiveness.

C. Tourism

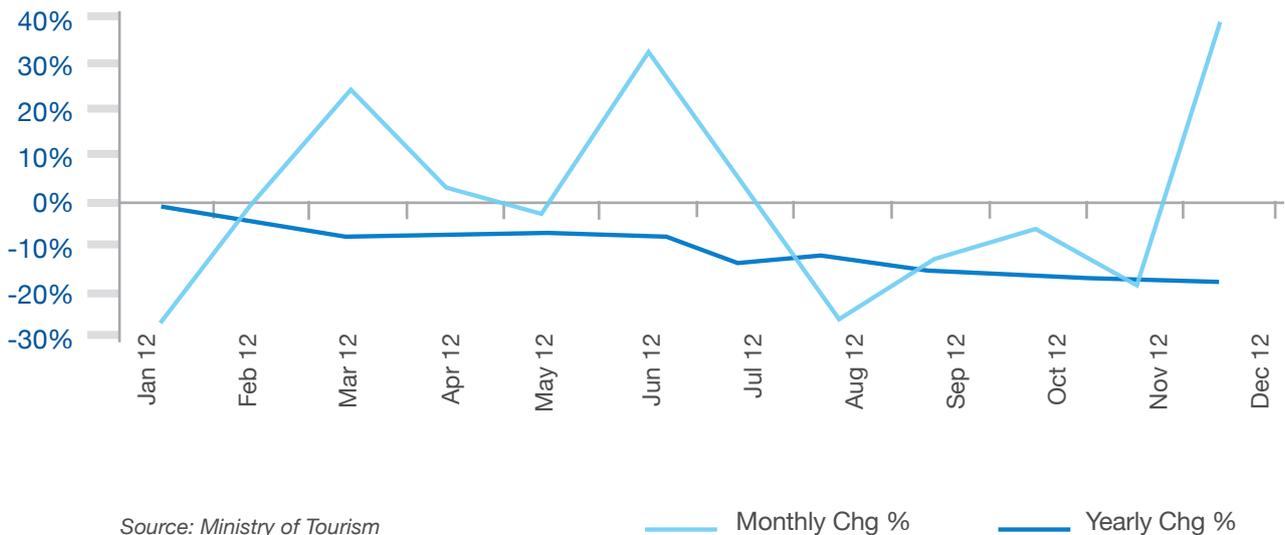
This sector was undoubtedly the largest loser in 2012, owing to its high sensitivity to the regional and domestic breakdowns, and the immediate translation of effects on collected revenues.

Unsurprisingly, Tourism to the region witnessed severe deterioration since the rise of Arab springs and revolutionary protests, only to further dampen with the prolonged crisis in Syria and the outbursts in Egypt and Jordan, not to mention the decades-long instability threats from wars in Palestine. The Levant thus had a bad year, and Lebanon was no exception.

From 2.17 million to 1.33 million in 2 years

Despite the double digits declines registered throughout 2011, 2012 continued to post even lower levels as spillovers from Syria were erupting in local Lebanese cities and associated events spurring in the eastern and northern sides of the country. Visitors to Lebanon totaled 1.36 million in 2012, down 17.51% from 2011's when they recorded 1.65 million, and 37% from 2010's 2.17 million visitors (Figure 3). The single highest drop was seen in November as tourists during this month shied away by 38.8% yoy, with the agitating situation in Lebanon reaching a pinnacle following the assassination of General Wissam El Hassan during October.

Figure 3: Monthly & annual variations for tourists during 2012





Palette of tourists changes colors

The palette of tourists in Lebanon changed colors with the number of Arab tourists, mainly from GCC countries, declining the most. Visitors from Arab countries dropped by an annual 21.24% in 2012 to 458,069 visitors and almost by half, or exactly 48.8% compared to 2010's level of 894,724. Arab tourists were intimidated by the fragile situation and more by warnings from their governments to avoid the country for potential security threats. Jordanian tourists also stepped away affected by rising complications in their own country and a distressed social welfare. Meanwhile visitors from Iraq increased as trade and business activity was flourishing between Lebanon and emerging cities in Iraq.

Comers from the Americas, generally acknowledged as visiting expats, maintained their holidays' schedule, posting constant figures in 2012 compared to 2011 and recording 221,174 visitors. The American tourists accounted for 16.2% of total arrivals by the end of 2012 compared to 13.45% in 2011, partially offsetting the decrease in Arabs' share from 35% in 2011 to 33.5% in 2012.

A mixture of expatriates, tourists and business travelers, European visitors witnessed a limited decline, accounting for 32.58% of total arrivals in 2012 compared to 29.35% in 2011. European tourists dropped 8.42% from 2011's level to 444,824, and by 19% compared to 2010.

The Asian community posted a severe decline accounting for 9.32% compared to 14.83% in 2011, as tourism from Asia is still linked to business travel rather than entertainment and leisure. The diminishing potential for business and the frail security environment discouraged Asian workers from heading to Lebanon leading to a limited number of 127,290 visitors in 2012.

Another source to measure tourism is the recorded arrivals and departures at the Lebanese Airport. Released figures by Rafic Hariri International Airport showed a 5.5% yoy growth in total passengers reaching 5.96 million during 2012. However, this growth was brought by a higher figure of departures, which increased 8.53% to 3.02 million against a smaller rise in total arrivals by 2.83% to 2.89 million. Most probably,

the expatriates stand behind the increase in the number of arrivals in 2012. In addition, the number of tourists in transit fell 18.74%.

Less tourists, less touristic shopping

The drop in tourism naturally resulted in lower tourist spending, which fell by 6% compared to 2011. Particularly, the number of VAT refund transactions revealed a decrease of 11% due to respective declines of 25% and 24% in transactions made by Saudi and Kuwaiti visitors. Refund transactions by Jordanians also fell 23%. However, the Arab visitors remained the main spenders in Lebanon headed by Saudi Arabians at 17% of total refund transactions, and followed by Emiratis and Kuwaitis at 13% and 8% respectively.

..And less hotel bookings

Lebanese hotels' bookings revealed volatile trends, having witnessed one of the largest variance in occupancy rates over the year compared to other MENA markets, especially in terms of average room rate and room yield. The occupancy rates in Lebanon were backed by the Syrian influx which marginally corrected the falling bookings, leading the year's average to slightly fall to 54% from 58% during 2011. Nevertheless, this figure covers only selected 5-stars hotels located in the capital, and thus doesn't reflect the status of the global industry. The real impact can be seen on the level of room yields, which despite remaining high by the regional standards, have declined by 19% in 2012 to post \$106/room compared to \$131 in 2011, as the average rent per room was lowered from \$223 to \$193 by the end of 2012.

The Syrian paradox

Separate attention can be given to the Syrian citizens' case in Lebanon, especially as the above tourists' figures exclude the check ins and outs of Syrians in accordance with the simple border-crossing formalities between the two countries. Since March 2011, date of the eruption of war in Syria, and until the end of 2012, an estimated figure of over 265,000 refugees is recorded by the United Nations High Commissioner for Refugees, most of whom face deteriorated financial and health situations, with around 14,000 newcomers

¹ According to Global Blue

² According to E&Y MENA Hotel Benchmark Survey report

to Lebanon registered every week. The government had approved a \$370 million comprehensive plan for the refugees, financed by aid donations raised during an emergency conference in Kuwait held to deal with the Syrian crisis., but the cashing procedures remained slow.

On the other hand, financially satisfied citizens fleeing the violence in Syria contributed into partially compensating for the diminishing revenues from tourism, even if this partial trade off doesn't justify the social and economic threats of the Syrian exodus.

SPOTLIGHT: TOURISM'S CONTRIBUTION TO GDP

A pillar sector for Lebanon, Tourism directly contributed to 9.3% of Lebanon's GDP in 2012, or \$4.12 billion, according to World Trade and Tourism Council. Its total contribution represented 25.1% of GDP or \$11.13 billion, down from 35.2% of GDP or \$14.9 billion in 2011. The latter takes into account investment, supply chains, income and employment. This compares highly with the World's averages of direct and total tourism contributions to GDP standing at 2.9% and 9.3% respectively.

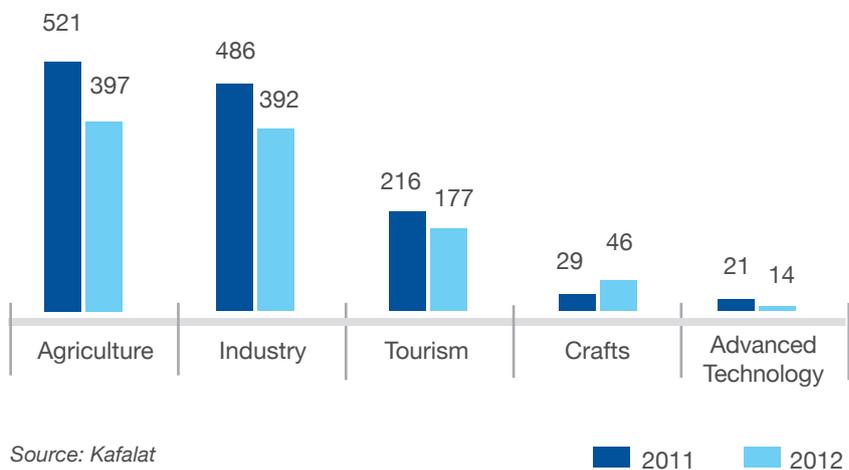
Tourism contribution to GDP is not only worth its value in terms of spending receipts: Direct touristic businesses provide 125,000 jobs or 9.4% of total employment in the country, while the wider scale tourism sector employs about 448,500 people or 33.4% of the labor force.

Touristic projects stifled by uncertainty

Investment in the field was pressured by the general lack of interest in project initiations. In 2012, touristic investments totaled \$1.3 billion, equivalent to 10% of total investments, and were mainly led by the private sector. As for the public investment in tourism which encompasses sites protection and maintenance, it remains understated, and is expected to lag behind on the government's priority list despite considerable potential returns.

A look at Kafalat's posted results shows the slowing of tourism-related projects, with 177 projects approved during 2012 compared to 216 projects in 2011 (Figure 4). Yet, this represents a rather steady share of 17.27% of total projects during 2012, compared to 16.98% in 2011, noting that the pre-crisis level in 2010, stood at 207 projects accounting for 14.74%, which enhances the views of a positive long-term interest in the industry.

Figure 4: Number of Kafalat loans by sector



Finally, pressures on tourism receipts persisted into 2013. Several steps have been taken by the private sector to revitalize tourism flows, including stimulus packages and intensified advertising campaigns. International media documentaries highlighting Lebanon as a continuously

safe destination for expatriates also shortly reinstalled a good vibe in the traveling community. Yet, the news media coverage has a large impact in determining the international tourists' trends, and currently it is not in favor of the Middle East.



D. Construction & Real Estate

The Lebanese real estate sector processed the impact of hostilities in neighboring Syria at a slower pace, delivering a flimsy performance in 2012. The sector had already entered the slow phase of its cycle by 2011, following the rush of 2008-2009, when the external pressures joined to tune down its performance. While expatriates remain the last to be discouraged by the adverse developments on the local scene, international demand was already exploring more stable ends for investments, and even looking to reduce its exposure in Lebanon. Most real estate indicators revealed contractions, even though prices maintained their levels, mostly believed to hold up thanks to the fleeing liquidity from Syria. The latter was supposedly invested in local real estate to escape the international sanctions on Syrian depositors in the banking system.

Major developers hold up through the crisis

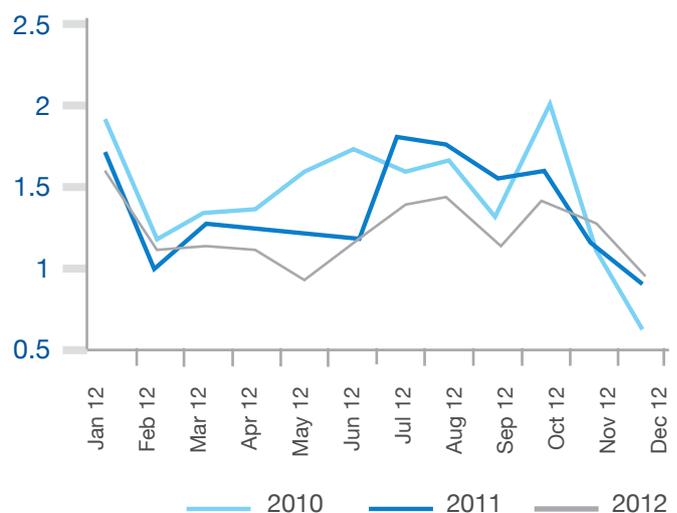
One of the sector's lead forces is its market participants. Excluding developers freely riding the cyclical waves of the sector, real estate remains dominated by large operators who are moderately leveraged and holding diversified portfolios of lands. The repeated history of reconstruction in Lebanon has set grounds for the rise of these skilled developers with sufficient cash bases. The Central bank's rigid conditions further raised the barriers to entering the sector for un-experienced developers or highly leveraged investors. As a matter of fact, rules imposed by the central bank stipulate that a maximum of 60% of any construction project or land acquisition can be financed by banks, and typically against mortgage. This has limited speculation in the real estate market and inflation of prices outside the demand rushes. Hence, most developers operating in the Lebanese market are perceived to sustain the market's bear cycles, even though prolonged pressures can jeopardize revenues under mildly tight scenarios.

Real Estate supply adjusts to local taste

The developers' activity in 2012 was slowly backing, but was spared a severe halt. Rather than face stagnation, supply was being tailored to meet segmented demand. As such, developers turned to satisfy local tastes and abilities in order to partially substitute the fading sales to Arab nationals and Lebanese expatriates, who both previously contributed to a sprint in the sector.

The first indicator to the market's envisioning of real estate activity is the issued number of construction permits, where a slight decrease of 0.84% to 18,193 permits is observed. However, the more pronounced decrease was on the level of Construction area Authorized by Permits (CAP), which plummeted by 10.85% to 14.68 million sqm in 2012 following a 6.5% fall in 2011 (Figure 5). This would imply the spreading of projects over lower sized investments, and the shift of supply to serve a more selective demand. Mount Lebanon appeared as the top location for new constructions in 2012 as expansions were possible at lower costs, capturing 45.4% of total activity in terms of projects' number, while the least favored was Beirut reporting 5.4% of total projects. It is worth mentioning that Lebanon ranked low on the World's bank "doing business" in dealing with construction permits, standing at 172 in 2013 out of 185 countries, down from 161 in 2012.

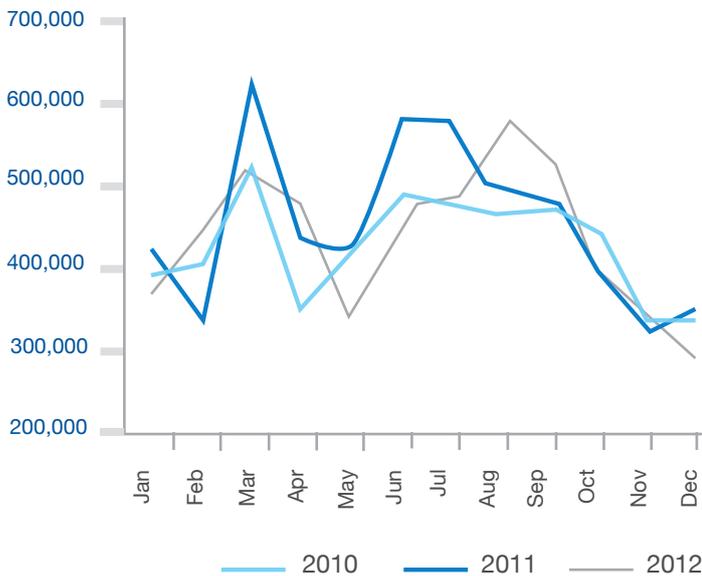
Figure 5: Authorized Construction Area by Permits (In millions of sqm)



Source: BdL, Blominvest Research department

The second indicator, cement deliveries, which reflects the ongoing real estate activity during 2012, posted a decline of 4.35% after having recorded consecutive rises of 6.18%, 6.72% and 16.07% in 2011, 2010 and 2009. Total registries in 2012 were 5,308,550 tons compared to 5,549,769 tons in 2011, surely pointing to the slowing of construction activity (Figure 6). Nevertheless, with a population of 4.2 million, the cement consumption per capita in Lebanon was still judged to be good at 1260 kg/capita.

Figure 6: Cement Deliveries (in tons)



Source: BdL

..And considers alternative markets

Some of the other options for developers to hedge the year's events were the diversification of revenues through residential/commercial projects, and alternation between sale and rental projects. Hence, and even though investments in commercial projects require substantial capital, and despite the fragile situation in Lebanon, several new malls have seen the light in the outskirts of Beirut and in different regions of Lebanon, relying on defensive sectors such as food and beverage and fashion clothing, and creating long term boosting prospects for urbanization in their region. But in parallel, locations like Downtown Beirut saw a flight from occupiers and a multitude of foreclosures brought by the high rents charged by the developers as well as by the competition from malls. According to Cushman and Wakefield, Beirut was ranked 36th most expensive retail location in 2012 among 62 countries, compared to 37th in 2011, ahead of Luxembourg (37th) and Dubai (40th) and behind New Zealand and Sweden, with a rent price of Euro 1,576/sqm yearly against an average rent in Middle East and Africa of Euro 1,140/sqm.

Regarding office rent and sales, Ramco, Lebanese real estate advisers, expected the flourishing of this long disregarded branch that holds substantial potential, noting that around 25,000 sqm of offices were available on the market as of December 2012. Office rents were particularly hit by the shying away of international companies or relocations outside of Lebanon following the worsening situation in the country, however, more capitalization can be made on local demand.

Sales transactions to foreigners plunge

Amidst all of the above, the Lebanese real estate market recorded a 10.14% lower number of transactions amounting to 74,569, but a 3.8% higher total value of transactions reaching \$9.17 billion. This followed a more acute drop of 11% in 2011, leading the average value of a real estate transaction to increase to \$123,051 in 2012 compared to \$106,533 in the year 2011. The main support is widely attributed to the acquisitions made by the Syrian citizens fleeing their country which supported the real estate transaction prices. In all cases, sales to foreigners registered a sharp decrease of 8.9% in the volume of sales affected by the withdrawals of GCC citizens following repeated warnings from their governments to avoid Lebanon.

Prices hold, but negotiable leeway expands

With little regard to the indicators' performance in 2012 and the ongoing complications domestically and behind the borders, land prices and residential units listed prices remained and are expected to remain stable. However, a negotiation leeway of 10 to 15% was observed on the residential units. As for office prices, mixed results were posted depending on their location while the retail element showed high turnover. Price sustainers were namely the scarcity of land versus the attractiveness of the location, injections of Syrian cash into illiquid real estate to preserve value outside the banking sector, and the financial resilience of developers. In 2013, prices are expected to maintain 2012's trend despite the vacant spaces and the availability of stocks, noting some price incoherence between sellers and buyers partly stemming from incorrect valuations for second hand locations. In fact, proper valuations for real estates in Lebanon are limited, with essential indicators such as the capitalization rates, estimates of operating income and future flows remaining highly volatile and subject to overnight political or legal changes.

New round of relieved interest rates on house mortgages

Efforts to motivate demand were not spared during the delicate times. The Central Bank of Lebanon conducted a series of stimulation packages for housing loans targeting low to middle class citizens through the Housing Institute (HI), the Housing Bank and the Lebanese commercial banks. Previously installed packages allowed commercial banks to decrease their legal reserves at the Central bank by 90% when granting housing loans with preferential rates. For further accessibility, the loan ceiling of HI was raised to LBP270 million and in late 2012, it was raised again to LBP500 million with commercial banks allowing for extended maturities of housing loans, in hope of encouraging middle income citizens to re-enter the real estate market.



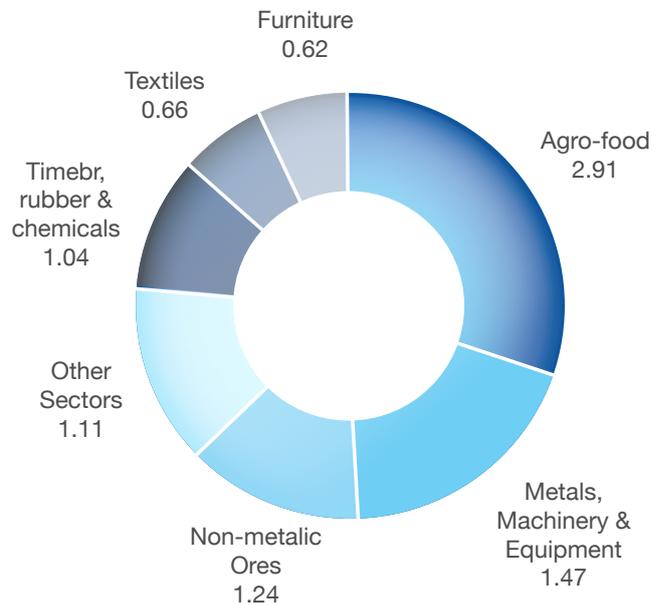
Finally, the real estate sector has not shown signs of fundamental distress, and the shedding of market participants is normal to any sector during stressful times, however the question of long-term sustainability, not to mention growth, remains legitimate especially in an environment that has not shown sufficient transparency or stability. Jones Lang LaSalle Global Real Estate Transparency Index for 2012 ranked Lebanon in 66th place among 97 countries and markets worldwide and fifth among 15 Arab countries and markets included in the survey. Urban planning has not been a clear part of any government's plan, and lack of statistics and documented planning data blur the vision for the sector, however bets remain on stability in Lebanon and the region and the roll of the economy into a higher growth which would boost local demand and restore foreign interest in the country.

E. Industry

Commonly known as a shield sector, industry in Lebanon felt the rising challenges during 2012 as export roads were blocked and became expensive due to high risks entailed by the war in Syria. The competitiveness of Lebanese products was compromised by the rising energy costs following the aggravation of power cuts during the year. Nevertheless, some industries found a new market in the swift of demand from Syria and benefited from shortages of supply and halts of production to compensate for Syria's regular imports and/or exports. Also, influx of immigrants to Lebanon partially limited labor costs in light of the new abundant low-cost supply. The net result was short gains on the Syrian front, but a loss of an important trading partner and essential transit routes. Meanwhile, the relocation option outside of Lebanon remained unattractive for most industries given the agitation in Egypt, a usual best alternative for low-cost production next to Saudi Arabia.

Despite lack of updated official data regarding the sector's added value in 2011 and 2012 (Figure 7), compiled data for the sector's exports and imports during the period along with other indicators tracking the sector's activity detailed later, reveal a continuing decline in its performance. Heaviness was noted on two wings: the slower market growth due to the deterioration of the Lebanese and regional political and security situations, and the translation of increased "crisis costs" on the level of production into a perceived loss of competitive advantages.

Figure 7: Output of Industrial Sub sectors, in \$B



Source: Lebanon's National Accounts 2010

Higher costs mute competitiveness

During 2012, labor costs augmented in parallel to higher living costs in Lebanon, and energy expenditures surged pulling the strains on the sector's competing space. While having alternative power generators already adds to the bills of industrialists eating up the sector's profit margins, additional cuts experienced during 2012 that reached around 60% of the time compared to 38% in 2011 pushed costs even higher. Domestic consumption of locally manufactured goods is not at its best and varies across sub-sectors, witnessing hefty competition from imported brands in absence of a clear pricing differentiation. Cost of shipment has also dramatically increased following the events in Syria as the latter is the only available land transportation route for Lebanese exporters.

Investments slow as industrials eye narrowing margins

The expressed interest in starting industrial firms, seen through the licenses' approvals given during 2012, declined starting the second half of the year with the security situation in Syria rising to the alarming level of war. A drop of 7% was recorded in industrial licenses in 2012 compared to the previous year, with 349 approval decisions granted, compared to 375 in 2011. To note that geographically, Baouchrieh had the largest share with 16 licenses, followed by Bourj Hammoud with 7 new licenses and Dekwaneh and Chiah with 5 licenses each. Most licenses were related to food and

beverages, accounting for 28%, tracked by manufacturing of construction material (6.6%) and chemical products. Most of the licenses were for the double purpose of construction and investment (121 licenses) showing the financial the readiness of investors.

International trade for industrial products declines

Regarding the sector's exports and imports during 2012, the figures fell within the general performance of the economy, showing decreases of 11.5% and 10.2% respectively compared to 2011. Concretely, the Lebanese industrial exports decreased by 11.5% to \$2.95 billion in 2012 compared to \$3.33 billion conveyed during 2011, and by 8% compared to 2010. In fact, regular increases of exports were being recorded but only up to the month of April, the first month to witness a sharp decrease of 21.8% that continued to compound for all the following months leaving the net change for the year in red.

Industrial imports/exports, in figures

Top industrial exports during 2012 were machinery and mechanical appliances accounting for 16.15% of total industrial exports or \$434 million. Customs figures for the whole year show an ending total of \$478 million plummeting by 7.86% compared to 2011, in parallel to a drop in their imports by 2.67%.

Whole year figures from Customs also show a severe drop of 10.41% to \$470 million in exports of Base metals and articles of base metals, the second division in importance, compared to a stagnating level of imports of \$1.52 billion.

Pearls, precious or semi-precious stones represented 14% or \$378.2 million of total industrial exports, noting that according to Customs, exports for this division reached \$1.72 billion, rising by 15.56% compared to 2011's, while their imports decreased by 26% to \$1.58 billion. However, Customs figures encompass all-purpose exports and are not limited to the industrial sector.

Prepared foodstuffs represented 13.18% or \$354 million of total industrial exports. Meanwhile products of the chemical which represented 12% dropped 10.74% to \$342 million during 2012.

Regarding imports of machines and industrial equipment during 2012, they totaled \$288.1 million compared to \$321 million during the same period of 2011, a decrease of 10.2%. Top exporting countries to Lebanon in 2012 were Italy (22%), China (16.8%) Germany (12.8%), the USA (6.4%) and Turkey (5.3%).

The contraction of the sector's figures led to a spur of initiatives to raise awareness and boost prospects, of which the recent BdL incentive promoting low-interest financing to productive sectors, industry included. The sector failed to escape the general gloom of the economy, and figures from BdL and Kafalat mapping the credit to industry show a decline in investments in 2012, consistent with the general downturn of new projects in Lebanon during the year, although industrial loans continue to account for the highest share of subsidized loans.

SPOTLIGHT: AGRIBUSINESS LEADS

A quick round up over the sub sectors of industry based on output levels, shows that one of the highest prolific sub-sectors is the agro-industrial, contributing to 32% of total industrial output. The sector employs an estimated workforce of 20,607 people which accounts for 24.9% of the Industrial sector workforce, making it the 3rd largest employer in the industrial sector with the Paper sub-sector ranking 1st and the Wood and Furniture sub-sector ranking 2nd.

The agro-industry relies to a big extent on the output of Agriculture, which is subject to seasonal successes, but it retains great potential, especially as 80% of Lebanon's food is imported, costing around \$1.5 billion yearly. Larger investments and improved government support to this division might enhance Lebanon's food security and reduce its price sensitivity to imports, notably in a global trend where food demand is expected to increase 35% by 2030 with the global population growing by more than 1 billion.



BdL data shows that industry grabs the lion's share in total subsidized loans with more than \$3 billion worth of loans granted between 1997 and 2012, almost 59.3% of total subsidized loans, and of which \$573 million are guaranteed by Kafalat. However total subsidized financing to Industry declined by 23.6% during 2012 going from \$ 485.6 million in 2011 to \$371 million. Kafalat loans to the sector deteriorated 19% with 449 new loans guaranteed in 2012 compared to 555 loans in 2011 and 599 in 2010. In comparison, total subsidized loans for touristic projects were the most hit retiring by 30.6% in 2012 while loans accorded for agricultural projects fell by a lesser 14.2%.

On a brighter side, and while the whole country suffers from inadequate infrastructure, the industrial sector organized itself, with multiple private and public initiatives such as IDAL aiming at neutralizing the sector's operations against security fluctuations and preserving its safety. Many associations and representative bodies remain very active in the promotion of the sectors' products. The establishment of industrial zones, fiscal incentives in the form of reduced customs duties and tax exemptions, the presence of investment encouraging associations with high linkages to the Lebanese diaspora as well as to key international markets, have all assisted the sector in holding its grounds so far.

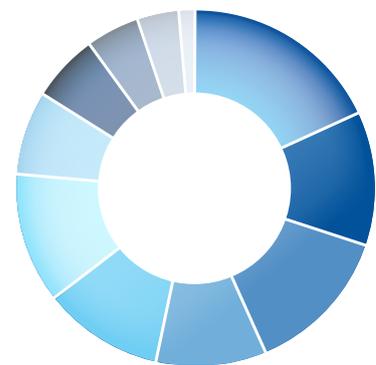
Examples of financial facilities provided by the government are a 50% exemption on tariff duties at export, 2% custom duties for machinery, equipment, spare parts and building material imported for the setting up of new industrial firms, and 0% custom duties for textiles, semi-manufactured goods and raw materials. Fiscal exemptions granted by IDAL can run up to 100% exemptions on corporate income tax for a period up to 10 years for industrial companies, where on the other hand, multiple bilateral and multilateral agreements enhance market access for Lebanese exports to external markets. Nevertheless, Lebanon ranked 111th out of 185 countries in starting a business according to the World Bank's report "doing business" in 2012.

Industry in Lebanon has many hands to deal yet. Quality and safety standards are in check and earning international recognition for the Lebanese products. Technology alignment and resilient spirits among Lebanese industrialists, as well as their openness to new markets and flexibility to changing trends, reinforce their management expertise and ensure their going concern. Moreover, governmental support persists, to the possible extent given the rolling political climate in Lebanon, and was recently proven through the maintaining of a VAT rule permitting industrialists to recuperate VAT paid on raw materials upon the sale of their final products. Many sub sectors relying on limited workforce are possible to expand, of which generic drugs, but require further policy level government support.

What the Lebanese Industry looks like

With a rather under-diversified aspect and virtually wholly private owned, a total of 3,123 industrial firms currently operate in Lebanon, according to the guide of Lebanese exports and industrial establishments, mostly concentrated around food and beverages.

Distribution of firms across industries



- 556 Firms, Food & Beverages
- 411 Metal Products
- 386 Glass & Porcelain
- 351 Furniture
- 345 Paper, related Products & Printing
- 299 Textile
- 259 Chemical & Plastic
- 202 Machinery & Equip.
- 178 Wood & Carpentry
- 82 Leather & Footwear

Geographical distribution of industrial firms.



- 375 Firms in Beirut
- 232 South Lebanon
- 208 Bekaa
- 31 Nabatieh
- 21 Akkar
- 13 Hermel
- 1,718 Mount Lebanon
- 522 North Lebanon

Moreover, the recent discoveries of oil and gas will attract capital intensive industries, and even though limited domestic expertise exists, both output and employment for industry will inflate. For this new sector, transparency is crucial to frame away corruption and waste of added value. Expected revenues could be used to reduce public debt and subsidies to EdL thus freeing up resources to develop infrastructure and public spending benefiting all sectors. Nevertheless, discoveries of oil and gas should not limit diversification of the Lebanese industrial sector, and investments need to maintain flows towards the protection of its long-standing segments as well as its under-developed aspects, all the while encouraging the tapping of untraditional divisions and regions.

F. Information Technology

Even though rebuilt many times, Lebanon's laid infrastructure lacks the long-term envisioning that would otherwise allow modernization instead of reconstitution. Urban planning is hardly a concern and ecological considerations are only selectively adopted. However, Information Technology is one division of infrastructure that managed to keep afloat thanks to an imposing demand that spurred the development of the sector.

The information technology sector has therefore witnessed a rather quick transformation, compared to other segments of infrastructure, racing on track along international evolutions and smart processors.

Encompassing hardware and software items, internet generation, capacities and reach, the IT sector did alright during 2012 and remained safe from the impediments of neighboring wars. It also happens that the telecom administration is one of the few prolific public/private partnerships, a fact that has helped support and finance investments in the field.

Broadly speaking, the size of the IT market in Lebanon as forecasted by Business Monitor International (BMI) was near \$364 million in 2012. This figure is broken down to hardware sales (62%), software sales (12%), and IT services (26%). BMI identifies the major obstacles to growth within this sector as being humble infrastructure as well as the high cost of communications. However, the IT market also depends on a far more fundamental issue, the internet availability.

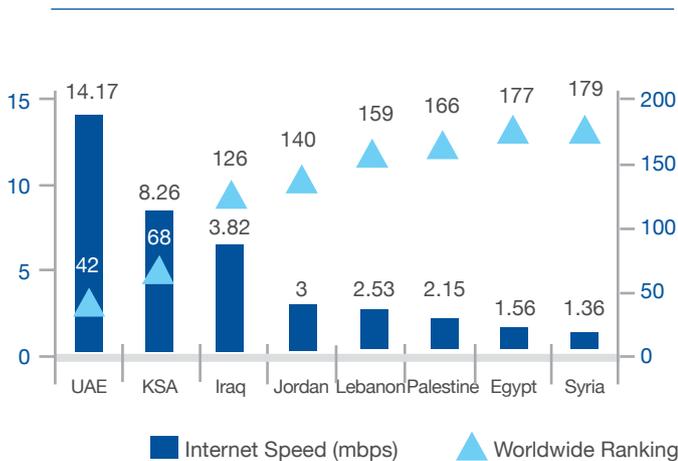
Internet evolution

Lebanon currently has an estimated download speed of 2.53 mbps and ranks 159th of 182 countries according to international speed gauge netindex.com. Nonetheless, there was a substantial improvement to previous standings, with the 1 mbps and 2 mbps hurdles being surpassed as of 2011 and 2012 respectively. However, this was not enough to improve Lebanon's ranking as it still has a long way to go in order to catch up with global standards. Having clearly missed out on first mover advantage gains, developing the local internet industry became a matter of public urgency.

Following the three day internet blackout which took place in July 2012, the Ministry of Telecommunication (MoT) intensified efforts in securing alternative internet sources. At the time, Lebanon had predominantly depended on a single fiber optic cable; the India-Middle East – Western Europe (IMEWE) which was cut for an extended period of time. Even though Lebanon benefited from two submarine fiber optic cables; IMEWE and Cadmos – Alexandros, the latter's effective capacity could not make-up for the disruption caused by IMEWE. Currently, MoT has increased the effective capacity of IMEWE and Cadmos – Alexandros from 20 gbps and 3 gbps to 30 gbps and 20 gbps respectively.

Over the last two years MoT has revived the internet sector and laid out the foundations required for its advancement. The ministry stepped up precautionary measures through entering into fresh negotiations with Cyprus for the construction of Europa, a new fiber optic cable. Not only will Europa act as an alternative internet source but will also serve as a replacement to the Cadmos – Alexandros cable, expected to expire within the next 5-7 years.

Figure 8: Internet Speed & Worldwide Ranking



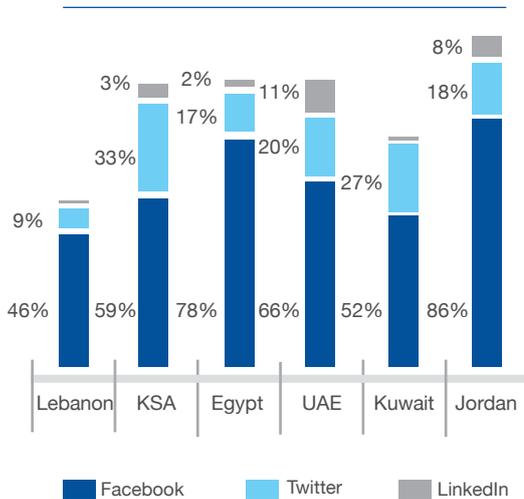
Source: Net Index by Ookla, as of June 2013



Internet providers

Internet services in Lebanon are administered by OGERO, a government owned entity which enjoys monopoly power over local fixed lines. Financially autonomous, OGERO acts as both an internet service provider (ISP) to residential consumers as well as to over 20 privately held ISP's. Together, they compete in the residential user market over DSL subscribers.

Figure 9: Consumed social media platforms among Internet Users - 2012



Source: IPSOS "MENA Internet Usage & Consumption Habits" Report

MoT estimates in its Annual Progress Report 2012 the number of DSL subscribers at 390 thousand as of May 2012, of which 240 thousand are legal and a burdensome 150 thousand are illegal. Although alternative internet services such as dial up and wireless are available, DSL represents the majority of subscribers due to its lower cost and superior performance given the available infrastructure. Of the legal subscribers it is estimated that OGERO controls just under half of the market share, with the remaining being primarily divided amongst three leading ISP's IDM/Cyberia, Terranet, and Sodetel.

Prior to the merger of IDM and Cyberia in 2012, each of the four ISP's had an

SPOTLIGHT: WEB DEVELOPMENT KICKS IN

A comprehensive report prepared by Sindibad Business on the "Investment in Internet & Technology Startups in the Arab World" demonstrates the increase in startup investment appetite. The report identifies that 134 successful business plans were launched between Jan 2010 and Nov 2012, creating around 1500 jobs in the region. The majority of funded startups took place in Jordan with 61 companies being financed; meanwhile only 12 took place in Lebanon. An estimated \$151.6 million was invested in these 134 businesses, with \$74 million being captured by UAE startups and only \$2.3 million by Lebanese. Furthermore, 82% of the total invested amount took place in 2012, 7 times higher than the amount invested in 2011 and 13 times greater than in 2010. An interesting observation is that most investors are of foreign nationalities, indicating that regional investors do not realize the value of these investments or that they lack the expertise in developing new projects.

Moreover, the amount invested in each country is not uniformly spread across the number of startups. For example out of the \$74 million allocated to startups in the UAE, \$40 million represents investments made by Reuters in Zawya and \$20 million made by JP Morgan & Blakeney in Namshi.com, an e-commerce website. Likewise, out of the \$57.8 million captured by Jordan, a majority \$40 million was provided for by South African Naspers to Souq.com.

In Lebanon, the top three investments since 2010 include Nymgo, Woopra and Anghami. Nymgo, a VOIP services company which originated in 2010 received an approximate investment amount of \$1.5M by Intel Capital. Woopra, a competitor to Google Analytics developed in September 2012 is estimated to have received \$200 thousand from Wamda Capital. Meanwhile, Anghami received near \$100 thousand from Middle East Venture Partners for its online and mobile music website.

equal market share. While IDM and Cyberia still retain separate legal entities, their combination resulted in the formation of the largest provider with an estimated client base of 60-65 thousand subscribers. Meanwhile Terranet and Sodetel follow with approximately half the number of clients.

As cited by MoT, European studies show that the majority of growth in employment has taken place within the digital economy. Lebanon, which has a highly skilled labor force and minimal employment opportunities, cannot afford to miss out on the digital revolution. During the hard times of low economic growth, perhaps it is ideal to work on the modernization and reform of the communication sector. Investing in the proper infrastructure, providing fiber optic connections, reducing cost, improving quality all go in the way of unlocking the great potential Lebanon has within the services sector.

III. External Sector

In addition to the structural trade deficit in Lebanon, the external sector sustained a new deficit that first emerged in 2011, the balance of payments. Historically a positive balance for Lebanon thanks to ample remittances and foreign inflows to the country, the balance of payments finally succumbed in 2011 to the silent drainage posting a deficit for the first time since 2006.

Despite remaining in the red in 2012, the deficit in the balance of payments managed to slightly narrow, shrinking from 5% of GDP in 2011 or around \$2 billion, to 3.6% of GDP in 2012 or around \$1.5 billion. This improvement occurred even as the current account deficit widened from 13.7% of GDP in 2011 to 16% of GDP in 2012, troubled by the trade deficit and the plunging receipts from tourism. The Central Bank benefited from the small recap of BoP in 2012 to maintain its foreign reserves. The latter stood at \$35.74 billion by the end of 2012 covering around 20 months of imports compared to 19.2 months in 2011.

A. Capital Account

The increase in the capital account through the net foreign inflows of transfers, income and capital, has largely compensated for the broadening in current account deficit. In fact, the capital account is estimated to have reached \$5.2 billion in 2012 compared to \$3.5 billion in 2011. Nevertheless, most of the capital inflows are dubbed to be short term, and attracted thanks to the appealing interest rates offered in Lebanon compared to the international averages. The banking sector has accommodated a 13.3% increase in deposits from non-residents recording \$24 billion against \$21.3 billion in 2011. Nonetheless, this situation looks more like a short term fix for Lebanon's balance of payments that might not hold in a scenario of rising international interest rates. Another consideration to be taken into account is the fact that the banking sector has had to withstand a reducing exposure in the region, especially in Syria and Egypt, due to the political unrests. Their lending portfolio has curbed and additional capital had to be mobilized to cover for the mounting provisions against doubtful or uncollectable debts. Sanctions against Syria have also banned deposits of Syrian origins in the Lebanese banking system, further losing the asset base an important contributor.

Regarding foreign direct investment (FDI) to the country, reports contradicted considerably. According to the Institute of International Finance (IIF), FDI slashed by 68% to \$1.1 billion during 2012, whereas according to

UNCTAD reports, FDI have actually increased by 18% to \$3.8 billion in 2012. The discrepancy could not be explained, however in case of a real increase in FDI, it is estimated to have been channeled into illiquid investments such as real estate, hence not contributing to a real lift of the economy, but rather to sustaining prices of the real estate. Arab investors purportedly contributed to about 50% of these inflows.

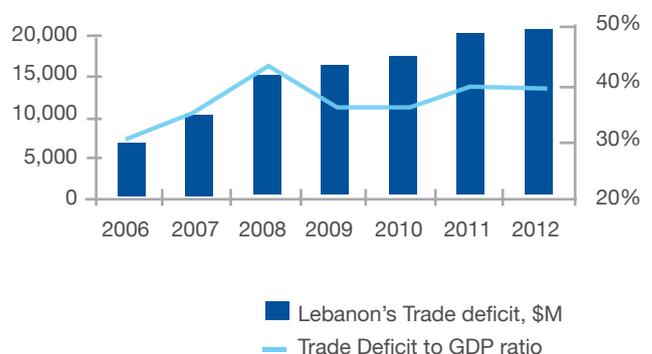
B. Current Account

The current account deficit reached \$6.7 billion in 2012, up from \$5.5 billion in 2011. Suffering from a structural trade deficit, and lower receipts from services especially tourism, the current account was supported by the remittances. The latter stabilized at \$7.6 billion during 2012, thus defending a further deterioration in the current account.

C. Trade

Regarding Lebanon's trade deficit of \$16.8 billion, the new high reached in 2012 actually said little about the real evolution of its international trade activity during that stressful year. Taken alone, and for a country which imports about half of its GDP, the increasing systematic deficit concealed the fact that demand and production actually contracted during the year. In fact, Lebanon's trade deficit recorded a much slower expansion of 5.68% during 2012 compared to higher rates of 15.91% and 7.41% in 2011 and 2010 (Figure 10), as the year's imports were hindered by the tempering local consumption, opposite to accelerating exports on the back of emergent demand from war-troubled Syria.

Figure 10: Trade Deficit & Deficit-to-GDP ratio



Source: Lebanese Customs, Blominvest Research department



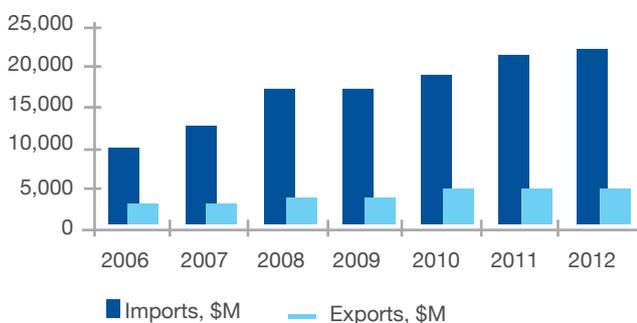
Revised imports' figures reveal a decrease

The contraction of consumption was especially pronounced during the second half of 2012, when the lagged impact of the nearly 2-year old crisis in Syria eventually reached the average Lebanese consumer accounts. Imports slowly grew by 5.68% to \$21.28 billion, compared to sharper rises of 12.21% and 10.6% in 2011 and 2010, according to official figures (Figure 8). However, 2012 imports are suspected to be inflated by a misallocation of oil imports worth \$800 million, made by EdL during 2011 but incorporated in 2012 February's totals. Accordingly, Blominvest's reallocation of the estimated amount into the last quarter of 2011 led to an actual decline of 2.28% in imports and a subsequent narrowing of Lebanon's trade deficit for 2012 by 4.2% to \$16 billion. The revised quarterly performance for imports particularly revealed severe yoy drops in Q3 and Q4.

Precious metals and re-exports to Syria save the deal

On the exports level, the attractive rise of 5.13% compared to the mere 0.28% during 2011, becomes less impressive when looking at the exports' individual growths and quantities, or compared to the 22% rise recorded in 2010, the pre-crisis period (Figure 11). In fact, the 2012 increase appears to be almost solely attributed to the overwhelmingly positive performance of the precious metals' industry, as well as to exports of first-necessity products and oil derivatives to ailing Syria, which together, compensated for the fallback of major industrial exports. Oil exports to Syria contributed to 44.6% of 2012 exports' increase, while the precious metals' contribution exceeded 100% to offset the drawback caused by the fall in industrial exports. The latter suffered from a competitiveness loss stemming from rising costs pressures and troubled exports routes.

Figure 11: Evolution of Imports & Exports



Source: Lebanese Customs

About oil imports

A closer look at the trading activity of Lebanon's largest accounts offers additional insights. The case for oil and its derivatives reflect the hampered local individual and institutional demand for energy products, while noting their heightened exports during the year. With oil imports representing almost 14.3% of GDP, Lebanon's most expensive purchases were the first in line to show a 3.48% drop to \$5.23 billion during 2012 after our revision, although they recorded a 30.52% surge based on the official figures. However, the soaring official cost of oil imports fails to hold when considering that imported quantities rose by 8% only during the year and average oil prices in 2012 remained near their 2011 averages. In the meantime, official exports of mineral products in 2012 almost tripled from \$34 million to \$132 million, with their quantities rising by 44%. The major bulk was destined to Syria which received four folds higher than usual oil exports, equivalent to \$93 million, and double the regular quantities.

Imports fall to various extents, exports to Syria boost

Direct consumption products followed suit, with the drop in their imported quantities aligning with the witnessed contraction during the year. Thus, imported tons of prepared foodstuff, beverage and tobacco diminished by 5.53%, even though their total bill rose by 8.63% to \$1.40 billion. Also imports of live animal and animal products declined both in value by 4.94% to \$824 million and in quantities by 1.86%. Regarding their exports, prepared foodstuff, beverages and tobacco rose 3.24% to \$392 million but were 17.72% lower in terms of quantities.

Industrial trade was also stalled by the rising costs of transportation, increasing wages and the need for alternative roads for exports to escape the now risky lines through Syria. As such, products used for manufacturing or transformative industries like machinery and electrical instruments, products of the chemical industries and base metals, also saw a drawback or stagnation at best, except for pearl and precious metals, which continued to shine on the exports list.

Machinery and electrical instruments were likely subject to low price levels both in raw materials and end-products. Imported quantities remained unchanged while their value dropped 2.67% to \$2.07 billion. Meanwhile, exported quantities slightly increased by 3.14% with a larger decline in value of 7.86% to \$478 million, possibly indicating the exports of lower priced or more competitive products.

3 Probably there is a portion that is being re-exported to Syria, however if this is the case, it should not appear neither in imports nor in exports but rather in the separate account of re-exports. One possible explanation could be that re-exports to Syria are being made from the readily available quantities in Lebanon.

4 Brent crude oil averaged \$111.67 per barrel in 2012 compared to \$111.26 in 2011

The performance of chemical products as well as base metals possibly reflects a maintained input to production despite the notable decline in their exports. Absent any smuggling activities, this might indicate current stock piling and/or an increase in domestic demand. In details, imports of chemicals products merely increased by 0.8% to \$1.74 billion while imported quantities increased by 5.25%. However, their exports severely declined with shipped quantities falling by 13.20% and their value dampening by 10.61% to \$343 million. As for imports of base metals, a 0.35% rise was noted to \$1.53 billion alongside a slight increase of 5.46% in their imported quantities, while their exports ended up declining by 10.4% to \$470 million with their corresponding quantities retracting by 30.50%.

On the positive front, imported quantities of pearls and precious metals rose by 5.46% but with a considerable decline in value by 26% to \$1.58 billion which might be attributed to gold price fluctuations. Their exports on the other hand rose by 15.56% to \$1.72 billion despite an 8.33% lower net exported quantity, which emphasizes the high added value of this transformative industry that singularly holds 38.45% of total Lebanese exports.

Lebanon-Syria's trade equation reverses

A special attention is also worth giving to the evolution of trading activity between Lebanon and its sole open border, Syria. In fact, balance of trade between Lebanon and its troubled neighbor switched from a negative \$95 million in 2011 to a positive \$28 million as exports to Syria in 2012 overrode imports (Figure 12). The main drivers were the surge in Syria's need for oil following the sabotage of many energy plants and the ensuing reduction of local oil production capacity by more than half. Moreover, demand on direct consumption products increased, although with a lesser impact on total trading activity. Exports to Syria thus increased by 37% to reach \$294 million while imports declined by 14.2% to \$266 million.

Figure 12: Lebanon's Trade with Syria



Aside from oil exports nearing \$93 million, the main exported items to Syria were machinery and electric instruments increasing by 42% to \$15.6 million; vehicles and transport equipment multiplying 5 times to \$12.7 million; and animals, vegetable fats and oils, which almost doubled in value to \$11 million. However, one of the considerable imports to Lebanon from Syria that maintained their edge were vegetable products which continued to increase by 19% to \$43 million whereas their exports to Syria declined by 5.25%.

However, the base of trade between the two countries was harshly hit as the larger traded accounts witnessed substantial declines both in imports and exports. The Lebanese market was not yet capable of satisfying the lost supply in Syria, and suffered the loss of a market share at the same time. For one, imported products of the chemical and allied industries from Syria lost 13.8% to \$29.91 million, along with a larger loss in exports of 19.58% to \$15.7 million. Also imports of base metals and their articles declined 25% to \$27 million, alongside a negligible rise in exports by 0.66% to \$11 million. Imports of pulp of wood, paper and paperboard rose 1% to \$16.8 million while their exports retracted 41% to \$22.5 million.

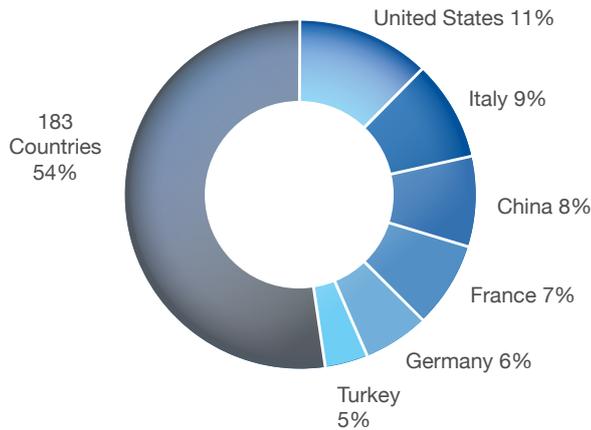
Textile, Plastics and their related items, were few of the industries that managed to partially substitute imports from Syria with exports. The latter's imports from Syria declined by 20.7% to \$15.6 million while their exports rose by 22% to \$12.4 million. Meanwhile, textile imports dropped 7.5% to \$5.8 million with their exports rising 93.58% to \$3.9 million.

Lebanon's major trading partners

Regarding the major trading partners of Lebanon during 2012, countries on both sides of the Atlantic remained favorites. USA continues to be the top preferred import destination with a stake of 11% or \$2.4 billion, followed by Italy at 9% or \$1.8 billion, China at 8% or \$1.77 billion, France at 7% or \$1.5 billion and Germany at 6% or \$1.2 billion. As for the main importing countries from Lebanon in 2012, South Africa came first with a share of 19% or \$864 million, followed by Switzerland at 12% or \$547 million. The former had replaced Switzerland as top destination for Lebanon's most precious exports. Next came KSA with a share of 8% or \$359 million, UAE at 7.9% or \$352 million, and Syria at 6.6% or \$294 million.

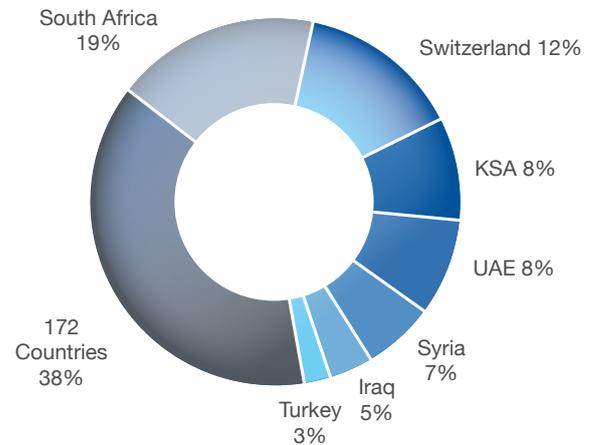


Figure 13: Major Exporters to Lebanon



Source: Lebanese Customs

Figure 14: Major Importers from Lebanon



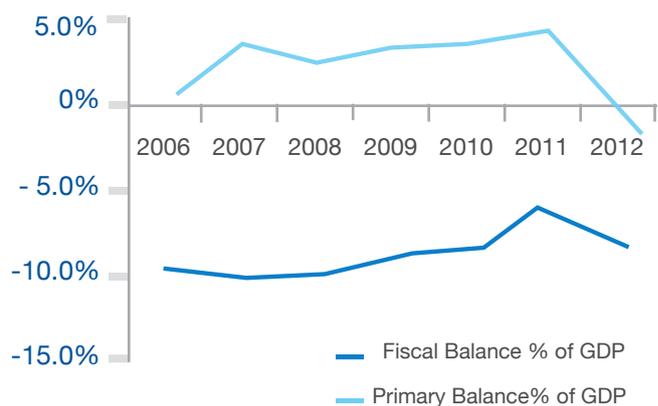
IV. Public Finance

A. Fiscal Balance

In contrast with the previous trend, 2012 witnessed an increase of fiscal deficit ratio to GDP to 9.3% and the primary surplus shifted to a small deficit for the first time since 2006, standing at \$110 million after having reached its highest surplus of 4.18% of GDP in 2011 (Figure 15). For the past five years, tight austerity measures that involved raising taxes and controlling public expenditures brought the public deficit down from 10.3% of GDP in 2007 to 5.9% of GDP by 2011. However last year made the U turn. Combined effects from the crisis in Syria and the region, as well as the general slowdown in world economy halted the natural flow of Lebanon’s public finance, freezing tourism and squeezing capital inflows while heightened expenditures amplified the shortfall.

The slowdown of economic growth to 1%, high oil prices and the adjustment of public employees’ wages to the cost of living were the main reasons behind the deterioration in public finances. The usual double digits increases in revenues slashed to a mere 0.66% in 2012 failing them to even keep up with the nominal GDP growth for the year which approached 5.7% (Figure 16). Meanwhile, unexpectedly large expenditures came forth on the back of higher transfers made to EdL to finance its expensive oil imports, prompting a general

Figure 15: Fiscal & Primary Balances as % of GDP



Source: Ministry of Finance, Blominvest Research department

increase in outlays of 14.1% to \$ 13.32 billion. Primary spending also surged 23.9% to \$9.51 billion against a 6.5% increase in 2011 to \$7.67 billion.

But it wasn’t all dark in the public finance room, deliberate capital expenditures were mobilized in an effort to stimulate the slowing economy, where noticeable spending was recorded on the level of public works and infrastructure (Telecom and Electricity).

Why the revenues departed

The sluggish growth in public revenues was mainly the result of a decline in non-tax receipts. Revenues from taxes managed to end 2012 on a positive but slight change of 3.06% to \$6.76 billion, due to mixed effects from the deteriorating situation in Syria and the slowdown witnessed in Lebanon. As for non-tax revenues which mainly consist of transfers from public institutions, they were negatively impacted by the decline of telecom transfers to the treasury. Hence they went down by 5.25% to \$2.18 billion, noting that the government decided to shift some of the telecom proceeds during the year to municipalities to boost their capacities and efficacy.

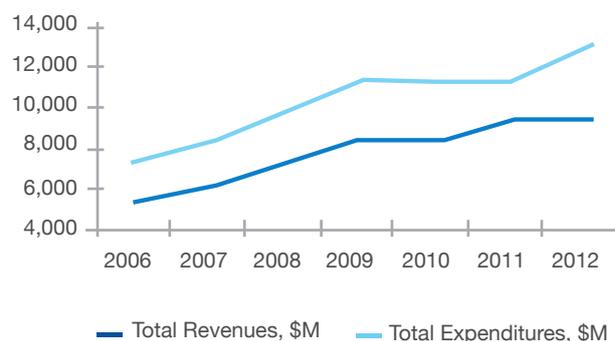
Tax receipts from domestic activity shrink

In details, the contraction of consumer spending during 2012, along with tougher operating environment for businesses reduced income from VAT taxes and taxes on profits. The former declined by 0.72% to \$2.17 billion while the latter dropped 2.55% to \$667 million. Taxes on interest income have also lowered by 0.7% to \$647 million both as result of declining interest environment as well as a slower growth in deposits.

But tax receipts from international trade expand

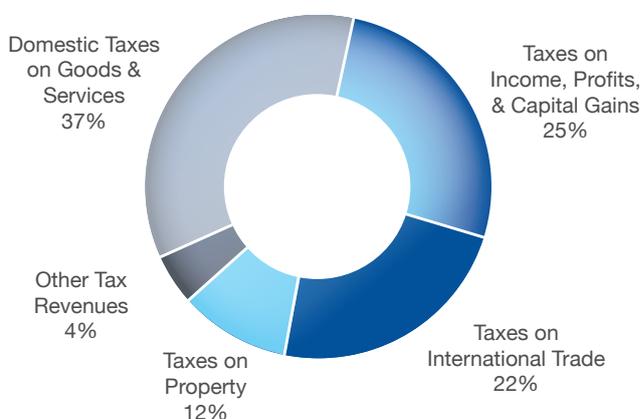
On the other hand, international trade operations, income taxes and real estate registration fees somewhat compensated for the above declines. Syria's roads blockage and threatened ports' activity led the Lebanese markets to move towards satisfying the shortage. Accordingly, proceeds from customs and excises rose 3.32% to \$528 million and \$959 million. Also the increase in salaries and wages which entered into effect towards the end of the year, led to higher revenues from taxes on income to \$347 million. Sales activity in the real estate sector and profit taking transactions led the real estate registration fees to increase by 3.18% to \$577 million and taxes on capital gains and dividends to rise to \$196 million. Interestingly, taxes on passenger departures rose by 17.4% to \$106 million and private car registrations returned \$133 million. For the record, VAT taxes contribute the most to the government's revenues with a share of 32.2% of total tax revenues, followed by excises (14.3%), tax on profits (9.9%), real estate registration fees (8.5%) and customs (7.8%).

Figure 16: Trends of Revenues & Expenditures



Source: Ministry of Finance

Figure 17: Tax Revenues Breakdown



Source: Lebanese Customs

Government spends more on energy and public salaries

Current spending rose 12% due to important upturns in its largest two components, salaries and wages and EdL transfers (Figure 18). The former rose 21.51% to \$4.46 billion following the materialization of the adjustments applied to wages during 2012 consistent with the rise of cost of living. As for transfers to EdL, they took up about \$2.26 billion of the government's outlays, thereby recording the steepest surge of 29.8% amongst all expenditures compared to 2011. And with oil and oil derivatives accounting for 27% of total imports in Lebanon and 13.4% of GDP in 2012, improving the power plants capacities would further increase the required transfers made by the government, unless a clear plan is laid to recover the ailing EdL from its operational deficits. On the other hand, transfers to NSSF were cut by 16.67% to \$660 million. On a side note, the higher council of relief received about \$130 million in 2012 up from \$7 million in 2011 following the exacerbation of the Syrian refugees' needs in Lebanon.

5 With the exception of year 2010 when both revenues and expenditures proportionally declined by 0.17% and 0.71% respectively

6 Considering Blominvest's adjusted inflation for the year, estimated at 4.7% instead of the official 10.1%



Figure 18: Government's main current expenditures



Source: Ministry of Finance

..And decides time is right to invest in infrastructure

Further increase to the budget deficit was deliberately made through the government upsizing of its capital expenditures by 12.5% to \$504 million following a decline of 3.7% in the previous year. Special attention would be given to the CDR budget which rose to \$132 million, up from \$96 million in 2011, the ministry of public work and transport which reached \$84 million from \$61 million last year, and the council of south which received \$41 million compared to \$33 million in the previous year. Under treasury expenditures, the municipalities account notably rose to \$444 million from \$244 million following the above mentioned transfers from telecom receipts to their benefit.

External debt successfully refinanced at lower cost

Another positive note concerns the substantial improvement made on the debt service level freeing up cash for the government and reducing the cost of debt. Average cost of debt for 2012 stood at 6.28% compared to 6.99% in 2011 and 7.43% in 2010. Under the umbrella of international lower interests, the debt replacing during 2012 which consisted of 2 Eurobonds rounds, brought the average cost of Foreign currency debt down to 5.78% from 6.66% and 6.86% in 2011 and 2010 respectively. As for the local currency debt, average cost in 2012 moved to 6.64% from 7.20% and 7.8% in 2011 and 2010 respectively. To note that during 2012, total public debt rose by 7.51% to \$57.69 billion, with its local currency part barely adding 1.74% against a 16.53% rise in foreign currency section to \$24.39 billion. Consequently, debt to GDP ratio re-increased to 137% of GDP in 2012 compared to 135% in 2011.

Lastly, a responsible fiscal policy is a considerable tool to stimulate the economy and maintain international confidence in Lebanon. While the impact of events in Syria remains unavoidable and some cuts in revenues seem unrecoverable in the short term, Lebanon's homework is growing urgent. The primary deficit is an additional burden to be financed by international flows which are already in a critical situation. A well thought plan is needed to secure revenues without hindering the economic growth through retuning of existing taxes and improving quality of collection, as well as preparing the infrastructure to sustain future developments and increase potential output.

B. Public Debt

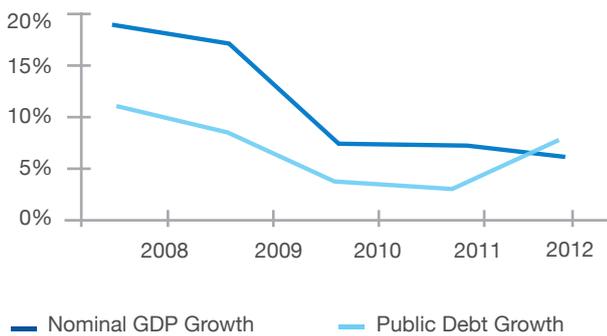
The Lebanese public debt ranks among the controversial levels of highly indebted nations, despite being labeled with a good credit quality by the international community. Economists have long debated the level of a reasonable public debt and many arguments contested the generally referenced thresholds of 60% of GDP at the start of the European Union in the 90's, and the 90% of GDP recently mentioned in a paper by Reinhart and Rogoff. Trends went more towards laying a framework, assessing debt sustainability factors and their changing dynamics instead of taking debt in absolute terms.

Lebanon's Debt/GDP: High but safe

Certainly, the need for debt-to-GDP to be on a declining or by the least steady trend remains important. For a middle income country like Lebanon, having one of highest debt-to-GDP ratios in the world still meant Lebanon was more credible than countries like Cyprus and Greece, as it brought down its debt-to-GDP ratio in the past 6 years from 180% to 137% (Figure 19).

Meanwhile the ratio went up for Cyprus and Greece from 50% and 110% in 2008, to near 90% and 160% in 2012. Gross public debt in Lebanon stood at \$57.7 billion in 2012, of which 42% are foreign denominated currency debt enjoying acceptable ratings of B1/stable outlook by Moody's, and B/negative outlook by S&P's.

Figure 19: Nominal GDP and Public Debt Growths



Sources: Ministry of Finance, Blominvest research department

The question reads: is it sustainable?

The concept of debt sustainability actually means the ability of a country to assume the burden of its debt without further accumulation. However high levels of public debt and significant budget deficits need to be reduced to ensure stability of public finances, as is the case for Lebanon. The main idea is to examine the debt's variability components, namely interest payments (a) and primary surplus (b).

Interest payments (a) are a function of (i) GDP growth which ensures the economy is generating income, (ii) interest rates which direct the cost of debt being rolled over, and (iii) the domestic currency's exchange rate against loans' currencies which render debt cheaper or more expensive. As for the primary surplus (b), it is the direct result of the government's fiscal policy, and it determines its ability to meet the short-term dues and maintain debt-to-GDP on a stable to declining path.

The case for Lebanon

Maintaining level of debt: 2012 flops

Lebanon was scoring well on the debt sustainability checklist, up until the eruption of war in Syria put them through a reality check that so far proved their buffering capacities.

The first factor in considering debt sustainability is the expansion of debt against the growth of the economy. At this level, Lebanon had done a good job during the period 2009-2011, when debt grew by 4.56% on average, less than the 6% achieved by real GDP and the 10.3% realized by the nominal GDP. This success is mainly attributed to a recovering confidence, fiscal discipline and worldwide declining interest rates. Naturally in 2012, the equivalence inverted as the spillovers from Syria to the security-sensitive country constrained output's real and nominal growths to 1% and 6% respectively, while public debt sprung 7% on the back of market issued bonds to finance the government's deficit.

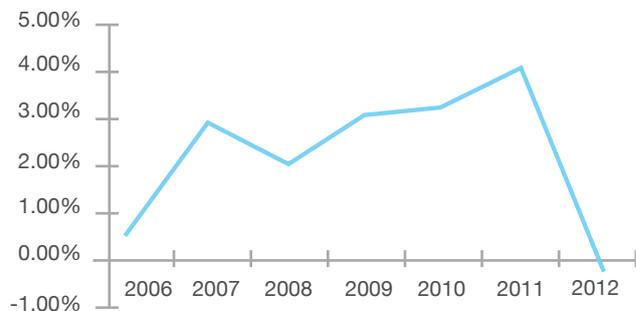
Meeting short-term dues: check, however..

Another determinant of a sustainable debt level is the country's ability to meet its immediate dues. In fact, most nations' debts are rolled over, and what matters more are the short-term obligations, consisting of the year's interest and amortized principal. In a country with a starting point of high debt-to-GDP ratio, a healthy fiscal policy would boost creditors' confidence in the country's ability to repay its debt by achieving a primary surplus that is at least enough to cover the debt service. This would ensure the stabilization of debt and reduce the ratio over time without relying solely on GDP growth.

Debt service met through issued bonds instead of primary surplus

This is one area where an adverse role is played in Lebanon's debt dynamics. Lebanon consistently managed to produce a positive primary surplus except in year 2012 (Figure 20) when the government's budget ended up with a small primary deficit for the first time in around ten years, pressured by the straining revenues and the heavy drains in expenditures. Yet, Lebanon's primary surplus per se was never sufficient to meet the country's debt service.

Figure 20: Lebanon's Primary Balance % of GDP



Source: Ministry of Finance



A look over the government's public finances for the past 5 years shows an average debt service of \$3.9 billion, with a clearly declining trend that resulted from the fall of international interest rates during that period. Meanwhile, the highest primary surplus ever reached was during 2011 scoring \$1.6 billion, far from what is needed to meet the debt service, therefore repetitively leading the government to tap the markets for financing through issuing debt securities.

The government's issued debt of domestic bonds and Eurobonds so far stand at around \$33 billion and \$19.5 billion respectively, mostly held by commercial banks with a stake of 64%, BdL 22% and public institutions 12%. It is worth noting that the average time to maturity of domestic currency TBs and bonds is 3 years while that of Eurobonds stands at 6 years. These debt issuances have resulted in short term dues that need to be met by the government, whether by rolling the debt or effectively settling it. In 2013, maturing TBs will total \$7 billion and maturing Eurobonds sum to \$824 million. This leads to an estimated total of \$7.8 billion needed in 2013 to pay for Lebanon's maturing debt.

However, the government does not use all of the proceeds from its revenues or debt issuances. In fact, the public sector's deposits at BdL and commercial banks average around \$6 billion to \$7 billion yearly, a considerable amount to be set aside without a direct usage, but quite enough to cover for any surprises especially under the current tough scenario.

... As well as through capital inflows

The above clearly shows the importance of capital flows into a country, which represent an additional financing option for the government's deficit. This is where the balance of payments have buffered Lebanon's shortfall in public finances, thanks to ample flows from expatriates and foreign investments. Historically positive with balances as high as \$7.9 billion in 2009, the BoP managed to absorb Syria's shock to Lebanon's finances for 2 years so far, ending up with a deficit of \$2 billion in 2011 and \$1.5 billion in 2012, and it may be the case that it will continue to cover for another year.

Banks' deposits guard the gap

Lebanon also enjoys a considerable cushion of assets provided by a large base of savers. The banking system sits on deposits worth 3 times Lebanon's GDP, reaching around \$125 billion in 2012, and growing by 61% since 2008. Under this view, a more meaningful ratio for the Lebanese debt would be the debt-to-deposits ratio, which stands at a very reasonable level of 46%, down from 60% in 2008. To note that about 65% of Lebanon's deposits are in foreign currencies, contributing to the Central bank's foreign reserves of \$35.7 billion, and providing a trustworthy guarantee for Lebanon's foreign debt repayment capacity.

To conclude, certain factors were not mentioned here, such as the impact of the inflation rate and the interest levels. The latter has so far worked in favor of the Lebanese debt, ensuring a lower cost of refinancing and reducing the annual costs. However, the unexpected pressure on the public finances will wipe this advantage in absence of alternative plans to avoid accumulations of debt that would reverse international confidence and at the least raise the costs of borrowing. Eventually, much is still expected from the oil discoveries in terms of bringing back the debt levels to lower stances, but it is still a necessity to control the debt variability, especially that the country needs to modernize its infrastructure which by default will call for more debt in the coming years, although one alternative would be to consider privatization and private-public partnerships that would both save debt and secure further inflows to the government.

V. MONETARY SECTOR

The central bank conserved its standard monetary policy during 2012, consisting of preserving the national currency and maintaining the soundness of the financial system. The Lebanese peg to the US dollar remained within its normal ranges for the 16th year in a row, and confidence in the domestic currency stood unshaken despite the worsening events in the region.

The main focus of BdL during the hush times of 2012 was to stimulate the economic growth and boost job creation through the issuance of circulars promoting lending to productive sectors. Moreover, the BdL reinforced the frame for compliance with international regulations regarding money laundering and terrorist financing, thus emphasizing the sector's international credibility and professional framework.

A. Exchange Rate

The central bank's intervention in the market during the year was at the normal range quoted LP/USD 1501-1515 with a middle range of 1507.5. Many of its interventions were made at the higher range during the year especially following abrupt security shocks. Nevertheless, the limited pressures on the domestic currency reflected higher confidence among market participants in the ability of the BdL to maneuver its monetary policy through difficult time periods.

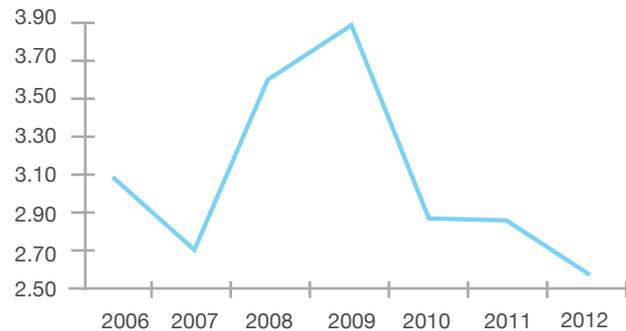
B. Interest Rates

As the exchange rate is pegged to the US dollar, the leeway in interest rate policy is limited. Hence the Central Bank followed the declining interest rates policy of the Federal Reserve throughout the financial crisis, however with a delay. In 2012, BdL kept interest rates high on deposits especially in the domestic currency, noting that the BdL succeeded in narrowing the spread between the LBP and USD deposits over the past 3 years, while preserving a good level of foreign reserves to back the domestic currency and defend the peg to the dollar (Figure 21).

Interest rates on USD deposits maintained their levels during 2012 at an average of 2.84% compared to the previous year's average of 2.83%, with a tendency to re-rise towards the end of the year. As for interests on LBP deposits, they stood at an average of 5.46%, lower than 2011's average of 5.6%. The Lebanese interbank rate preserved the same level throughout the year at 2.75%.

Despite the regional upheaval, confidence in Lebanon's monetary authority and in the banking sector remained high. The dollarization rate decreased to 64.8% in 2012 compared to 65.9% in the previous year when the distress in Syria led to flaming switches to the hard currency.

Figure 21: Spread LBP-USD Deposits



Source: BDL

On the lending side, and in conformity with the central bank's aim to encourage credit, interest rates on loans slightly declined as many incentives were offered for commercial banks to advance their credit wheels. The declining rates on loans were also due to an increased competition among the commercial banks to finance good investments, especially as they were still flushed with liquidity from the previous years' high capital inflows.

In fact, the balance of payments in Lebanon shows a cumulative expansion of net foreign assets amounting to \$19.69 billion during the period 2006-2010. This large amount enabled the absorption of the following 2 years' deficits of \$3.53 billion. Hence, ample liquidity remains available at the Lebanese banking sector. Net foreign assets (NFA) including Gold available at the Lebanese banking sector (BDL and commercial banks) dropped \$680.78 million compared to 2011 and \$1.39 billion compared to 2010 to reach \$42.7 billion by end of 2012.

As of December 2012, granted credits in LBP bore a weighted average interest rate of 7.07% compared to 7.38% in 2011, and loans in dollar average interest stood at 6.87% compared to 7.02% in December 2011. The loans' dollarization rate also improved from 78.4% in 2011 to 77.6% in 2012.

The BdL put special emphasis on micro loans and housing loans. Micro loans up to LBP 20 million targeted enterprises employing less than 4 people and offered repayment over a 5 year period. Housing loans' ceilings were also raised to reach a wider range of income and repayment period was extended, in exchange for reducing banks' required legal reserves up to 80% of the loans' value.



C. Treasury Bills

In order to cultivate demand and subscriptions from the Lebanese financial system, the Central Bank raised the coupon rates on all TB's by 49 basis points on short-term maturities and up by 56 basis points on longer term maturities. The management of the government's portfolio of TBs won some battles, extending its maturity to 1,105 days from 955 days in 2011, while slightly pushing down the weighted average yield from 6.83% in December 2011 to 6.54% in December 2012. BdL securities portfolio rose from \$13.16 billion at end 2011 to \$16.58 billion, and commercial banks' holding of government' securities rose to \$31.06 billion from \$29.15 billion in December 2011. Regarding Eurobonds, the average yield on the total portfolio retracted from 6.71% in 2011 to 6.66% in December 2012 with a maturity of 6.06 years compared to 5.7 years in 2011.

Regarding certificates of deposits, rates remained unchanged in 2012 at 3.57% for 45 days and 3.85% for 60 days.

D. Money Supply

Broad money supply M3 grew 7% in 2012 to reach \$104.01 billion following a lesser growth of 5.5% in 2011 when it stood at \$97.23 billion. Former to 2011, double digit growth rates were recorded such as 14.72%, 19.65% and 12.27% in 2008, 2009 and 2010 respectively. Year 2011 incorporated the effects of the arising distress from the Syrian crisis that led to the increase in the dollarization of deposits. Term deposits in LBP had dropped by 2.18% shrinking M2 by 1.28% in favor of a considerable 10.53% rise in foreign currencies (FC) deposits that led M3 to realize its 5.5% growth in 2011.

Meanwhile in 2012, sight and term deposits in LBP carried the higher weight in M3 growth, rising by 19% and 10% respectively, while FC deposits of the resident private sector added 4.3% only compared to 10.53% in 2011. Subsequently, the dollarization rate of M3 decreased from 59.99% in 2011 to 58.5% at the end of 2012.

Figure 22: Money Supply components

in \$B	Dec-11	Dec-12
- Currency in Circulation	1.92	2.13
- Demand Deposits in L.L.	2.15	2.58
M1	4.07	4.71
- Other Deposits in L.L.	34.83	38.46
M2	38.90	43.17
- Deposits in FX.	58.14	60.63
- Bonds	0.19	0.21
M3	97.23	104.01
TB'S held by Non-Banking Sector	5.17	5.23
M4	102.40	109.24

Source: BDL

Money supply was also affected by the increasing government expenditures, which heightened the net claims on public sector by 7.2% or \$2.44 billion. The banking sector continued to step in to finance government's expenditures through TBs subscriptions and roll over of maturities, with BDL occasionally covering for shortage in subscriptions.

E. Financial Markets

A. Stock Market

Although much of 2012 was a struggle to Lebanese equities as well as to the economy, the twilight months were aggressive enough to reflect the appetite of investors and the deep rooted faith that Lebanese stocks remain undervalued.

The international equity markets recovered in 2012, boosted by unprecedented stimulus actions and monetary policies taken by Central banks. Strategies of quantitative easing, pumping money in bonds' markets, and maintaining interest rates at near-record lows, have contributed into refreshing the markets across the world. The S&P 500 Index returned around 13% for the year, its best annual performance since 2009, and the MSCI rose about the same. Yet, performance could have been better if not for elements from both sides of the Atlantic that collided to scare investors away from the riskier assets and into the refuge of the fixed income tools. The European leaders consented over the Greek debt only towards the end of 2012 and against most speculations in the markets, earning the European equities their recovery during the second half of the year. In the United States, the biggest market moves followed official policy announcements, showing that investors remained jumpy over the mixed-colors' picture of the economy. Speculations over President's Obama's re-election chances, divergent growth prospects and persistent bonds' purchases by the FED have led investors to stick to bonds despite their record-low yields and inflation-eroded returns.

In this international context, the Lebanese equity market fought its own battles. Pressures stemmed from the internal afflictions as well as from the complicating situation in neighboring countries. Syria's war did not end in 2012. Egypt's new ruler failed to sustain the welcome woos. Lebanon tumbled between warnings from repercussions of the Syrian fighting on the Lebanese scene and the many security skirmishes and political bickering between its fractions.

Stock market thwarts as the Syrian crisis is priced

The Lebanese equities priced in the Syrian crisis along the year and incorporated the government's reactions at each milestone. As such, the trending was down over the course of the year with limited breakthroughs on easing political climates. The BLOM Stock index (BSI) which tracks the market, lost 0.65% during 2012, however dipping by as much as 4%-5% in the 3rd and 4th quarter, and bottoming in October at 1,104 points.

Figure 23: BLOM Stock Index Trend



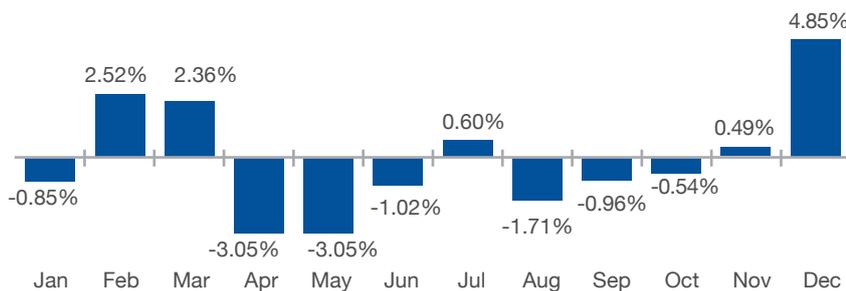
Source: Blominvest Research department, BSE



The first half starts negative

In a closer look to the year's progress, the first half of the year was generally negative with the BSI recording a drop of 3.2%. In fact, the stock market started 2012 slow, only to record a strong come back in February and March following the good performance results posted by major Lebanese banks, and despite the disagreements over the minimum wages and the resignation of minister Charbel Nahhas. During April, the distribution of banks' dividends led the stock prices to decrease, while the complicating situation in the North posed additional downward pressure on the stocks' prices.

Figure 24: BLOM Stock Index monthly performance



Source: Blominvest Research department, BSE

The second half comes brighter

The second half of the year was brighter as the BSI picked up 2.64%, led by the strong performance of December that saw the recovery from a period of successive shocks.

In detail, and after a slight improvement in July, the markets had plunged again in August on news of the arrest of minister Samaha and the fears of its repercussions on the local political scene as well as further entanglement of Lebanese fractions in the Syrian events. The following months remained in the red as the loosening security hindered the market activity, despite the strong favorable signals sent by the successful Pope's visit to the country. Lebanese equities hit their bottom in October shocked by the assassination of a top security official, Brig. General Wissam El Hassan, which brought to the Lebanese minds ghosts of the period 2005-2007. However the subsequent status quo restored faith in the possibility of containing the security skirmishes, allowing equities to breathe and ignore the recurring events north of the country.

Equities surged again in December although from a low base, as investors took advantage of the low price levels of listed companies to adjust their portfolio holdings, just before they closed down their books for a rough year. In fact, since the lowest level of 1,1104 points hit by the BSI on October 23rd, the market rallied by 5.85% throughout the last 2 months of the year.

Best and Worst performers

On the overall scale of the market, the best performer was Ciment Blancs (nominal) adding 36.9% to end the year at \$3.3 compared to \$2.41 in 2011, however with a small traded value of \$73k along the year. Following were Audi GDR shares which added 11.52% closing at \$ 6.29 up from \$5.64, and BLOM GDR adding 6.71% closing at \$7.95 with a maximum recorded during the year at \$8.

The worst performers on an annual basis were BEMO bank which fell 19.57% to close at \$1.89, with a total traded value of \$1.5 million, followed by Solidere shares down 10.83% and 9.6% respectively for classes A and B to close the year at \$13 and \$12.93 after bottoming at \$12.13 and \$12.15 during the last quarter of 2012. Out of the 27 listed stocks, 15 ended the year on a gain, 9 lost in value and 3 remained unchanged.

On the sectors level, banks' shares accounted for 60.32% of total traded value during the year, recording a volume of 32.81 million shares worth \$ 218.5 Million. BLOM listed shares gained 5.8% to \$7.85 and Audi common shares added 4.82% to \$6.09. Meanwhile, BoB shares lost 2.06% to \$19, Byblos Bank common shares fell 2.45% to \$1.59.

BLOM Preferred shares index rises

The BLOM Preferred shares index increased by 2.76% during 2012. BLOM Preferred 11 added 0.39%

to \$10.17, Audi Preferred shares D added 0.49% to \$ 10.35 while Audi preferred F maintained their price at \$100 and Preferred E dropped 0.5% to \$100. BoB preferred H and Preferred D gained 4% and 4.23% respectively to end the year at \$26 and \$27.1, while its E shares dropped 1.15% to \$25.7. BLC Preferred shares A and B rose 2% each to \$102. As for Byblos Preferred 08 and 09 shares, respective gains were 0.69% and 1.09% to \$101.7 and \$102.1. Beirut Preferred Fund lost 0.29% to \$103.5.

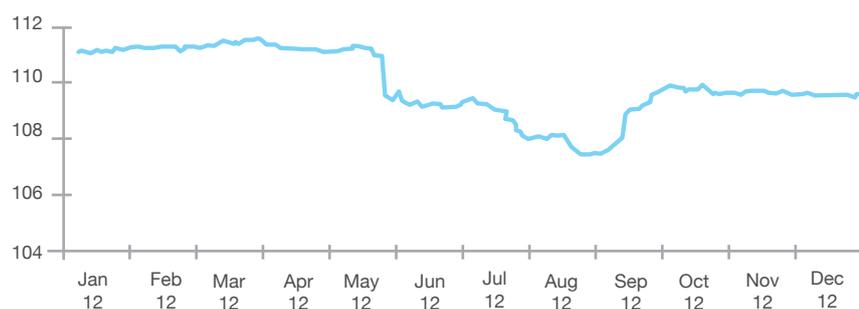
In the industrial sector, Holcim Liban lost 7.24% to \$15.75 while Ciment Blancs (nominal) leaped 36.93% to \$3.3 and Ciment Blanc (bearer) added 0.31% to close at \$3.26. As for the retail sector, RYMCO shares gained 5.6% to \$2.64.

Solidere A accounted for the largest traded value during the year with 7.35 million shares worth \$97.54 million dealt on the market, followed by Audi common shares with 8.22 million shares worth \$47 million exchanging hands.

Between Arab bourses and Levant

Regionally, the Arab markets have had a good year, while the Levant bourses posted mixed results. The market cap of Levant bourses totaled \$37.87 billion while the market cap for Mena bourses totaled \$925.62 billion. Star performers were Egypt jumping by as much as 48.44%, with its market capitalization soaring to \$60.2 billion towards the end of 2012 from \$48.6 billion at the end of 2011, while in the GCC, UAE beat all other bourses with Dubai jumping 20.94% and Abu Dhabi climbing 9.76%. Saudi Arabia wasn't far behind increasing by 7.42%. Kuwait also returned 2.46% and Muscat was up 1.05%. Only Qatar and Bahrain in the GCC backed, with Qatar dropping 4.86%, and Bahrain going down 6.4%. Outside the Gulf markets, Amman edged down 2.24% with its market cap shrinking to around \$26.1 billion from \$26.9 billion in 2011. Damascus plunged 13.31%, Tunis lost 3.75% and Casablanca, the second largest market outside the Gulf, was down 14.67%.

Figure 25: BLOM Bond Index (BBI) Performance



Source: Blominvest Research department

B. Eurobond Market

Internationally, 2012 was a positive year for bond markets

The safe assets geared up on tough drivers, namely the central banks of the largest economies which pursued systematic strategies consisting of aggressive bond buying and maintaining ultra-low interest rates, therefore boosting demand for government bonds and depressing their yields. Meanwhile a sluggish economy in the US, along with the onset of a recession in Europe and a slower growth in China, translated the traditional rule: bad news for the economy, good news for the treasuries. High demand was seen across the fixed income markets ranging from modest gains in the US treasuries to aggressive advances especially in the emerging markets' bonds. The difference in the US was that 2012 witnessed better economic growth than Europe, which translated into a good performance of the stock market and a modest demand in the bonds markets as investors preferred to invest in equities rather than the low yielding bonds.

In Lebanon, investors profited from the spread between the yields of the government Eurobonds and the US treasuries during the first half of the year, but the market failed to sustain international demand later as the country felt the repercussions of the war in Syria and went through domestic political and security skirmishes.

LISTINGS AND DE-LISTINGS

By the end of 2012, the Beirut Stock Exchange accounted for 27 stocks, with a higher market cap of \$9.24 billion compared to \$9.05 billion last year, being the result of new listings on the BSE. During the year, Audi Bank listed additional 309,260 of common shares, issued 1,500,000 new preferred F shares, and converted 1,936,221 of its common shares to GDRs over 2 rounds. BLC Bank also issued 2 new preferred classes A and B amounting to 400,000 shares and 550,000 shares respectively. On the other hand, BoB redeemed and cancelled its 4,000,000 Preferred D shares by the end of the year. Total volume traded on the BSE during 2012 reached 47.22 million shares valued at \$362 million.



New debt issued worth \$5.475 billion

During 2012, the Lebanese government issued Eurobonds for a total of \$5.475 billion, of which \$2.475 billion were tapped on the primary market over 2 rounds, in April and November. The remaining \$3 billion were issued in March and December as part of the debt replacement agreements between the BdL and the ministry of finance, according to which the MoF is allowed to redeem Treasury Bills from BdL's portfolio against Eurobonds for the same amounts but at lower interest rates and longer maturities.

First round of Eurobonds met with success

The attractiveness of the Lebanese yields proved high during the first round conducted in April as the \$950 million issuance was 3 times oversubscribed with a considerable international participation accounting for 33% of the issuance. The transaction encompassed new 5-year bonds (coupon 5%) and the reopening of the 14-year bonds (coupon 6.375%).

Second round faced with mixed sentiments

However, the second round executed during November was received with mixed sentiments especially that it came at a critical period that followed the assassination of a top official in Lebanon. The Lebanese government offered a voluntary debt exchange on bonds maturing in 2013 in return for the newly issued longer maturity/lower coupons bonds, resulting in \$701 million of exchanged bonds, whereas an additional \$ 823.6 million were raised in cash. Only 46% of the 2013 bonds holders found the exchange offer appealing, a rate that was judged modest but sufficient, especially that the 2013 bonds were trading at a premium to par and offered high coupon rates of 9.125% and 8.625%. As for the international participation, it was limited to an estimated 12% compared to an average of 20% during previous issues.

BLOM Bond Index (BBI) ends 2012 on a down note

Summing up the year, the BLOM Bond Index which tracks the Eurobonds denominated in dollars, finished 2012 at 109.07 points down by 1.7% since year start, mainly skewed by the slowing demand during the second half of the year, leading the weighted average yield on holding the Eurobonds to rise 14 basis points to 5.02%. The performance of the medium and long term bonds reflected the demand fluctuations during the year, peaking during March-April when the 5Y bond and the 10Y bond reached their lowest yields of 4.65% and 5.8% respectively, and fading in August when yields rose to 5.65% and 6.49% respectively. The two benchmark notes ended the year on a slight change, with the 5Y Lebanese Eurobond returning 4.83%, down by 2 basis points since year start and the 10Y bond maturing in 2022 yielding 5.95%, up by one basis point since end 2011.

Yields' spreads against US benchmarks remain lower than CDS quotes

In comparison and as the US bond markets had a good year, the US 5y and 10y treasuries yields had each dropped by 11 bps to end at 0.72% and 1.78% respectively. This led the spread between the Lebanese 5Y and 10Y bonds yields and their US comparables to widen from 402 bps and 405 bps, to 411 bps and 417 bps respectively.

On the other hand, the Lebanese Credit default swaps which reflect the perceived default risk of the government, stood at 450 bps by end December 2012, narrowing from 472 bps in December 2011, after peaking during August at 558 bps and re-hitting highs following October's best achieved low of 396 bps.

As seen above, the Lebanese Eurobonds yield spreads against their US benchmarks remain lower than what is suggested by Credit default swaps, potentially hinting that offered yields on the Lebanese Eurobonds are not fully reflective of the assessed risk premiums seen by international investors. This is mainly due to the stable and dedicated local investors with domestic banks constituting the core base of Eurobonds holders. Consequently, Eurobonds prices and their spread against the US treasuries reveal much less volatile than CDS spreads. However by the end of 2012, the difference was narrowing, as on one hand the stabilization of the political situation in the country was accommodated by the markets, and on the other, the US yields dropped.

Figure 26: Yield Spreads between Lebanon and US 5Y & 10Y Bonds (in basis points)



Source: Blominvest Research department, US treasury

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