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Abstract

This study summarizes and highlights the main findings of FitchSolution "Lebanon Trade and Investment Risk Report Q3 2019" report adding some information and data by BLOMInvest Bank.

Despite the fact that Lebanon is highly open both to trade and foreign direct investment "*Lebanon is becoming an increasingly high-risk location for FDI*", according to FitchSolutions Report "Lebanon Trade and Investment Risk Report Q3 2019". This can be mainly linked to the international financial and economic crises, political instability in the region especially that the country depends highly on risk sensitive sectors such as banking, tourism and real estate and most importantly the Syrian Crisis and the influx of refugees. Moreover, corruption has become a vital issue in Lebanon preventing its development and prosperity and affecting several business-related areas. Accordingly, the report gives Lebanon a score of 51.9 out of 100 on the "Trade and Investment Risk Index". The index scores each country on a scale of 0-100, with 100 being the lowest risk. The index is computed using the average of the 3 categories Economic Openness, Government Intervention and Legal which are further broken down into sub-categories. The individual categories and sub-categories are also scored out of 100, with 100 the best.

	Economic Openness	Government Intervention	Legal	Trade and Investment Risk Index
Lebanon score	68.5	63.4	23.5	51.9
MENA average	48.2	53.3	42.6	48
MENA position (out of 18)	3	6	14	9
Global average	49.3	50.4	50.1	49.9
Global position (out of 201)	35	42	172	94

1. Economic Openness Analysis

Economic Openness analyses a country's openness to foreign investment and international trade. Lebanon receives a score of 68.5 out of 100 for Economic Openness, ranking in a competitive third position of the 18 states in the MENA region, only behind the UAE and Bahrain.

Lebanon operates under a free trade system and a competitive market with a practical commercial approach. The country benefits from favorable access of its export activities to international markets. However, since 2011 the overall trade in Lebanon has been experiencing a worsening deficit due mainly to the Syrian war as major exports' trade routes have been closed. Moreover, the government's main expenditures and political issues are preventing it from implementing long term sustainability reforms. In details, public spending is directed towards non-productive activities such as debt servicing, electricity subsidies and employees' salaries payments. In addition, political affairs stand at the center of government with the

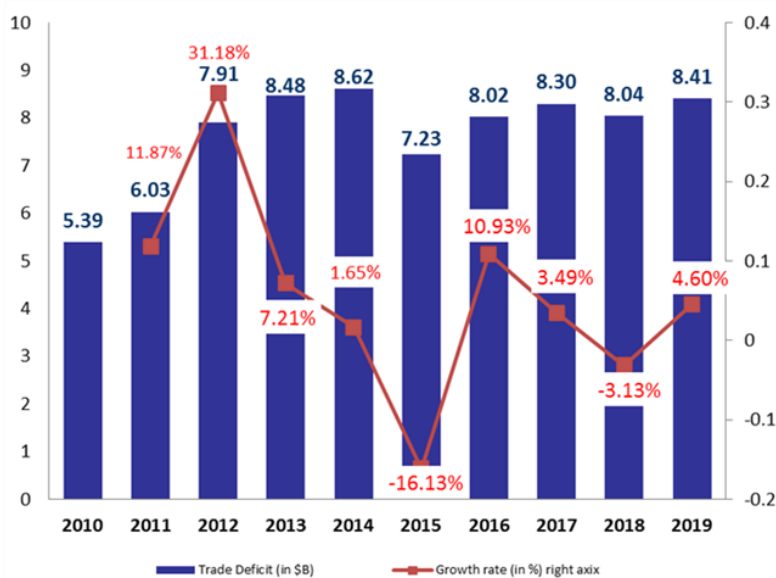
country having experienced many political deadlocks and conflict with regional neighbors such as Israel and Syria causing investors to be more cautious when it comes to committing large sums in capital investments.

Trade Openness

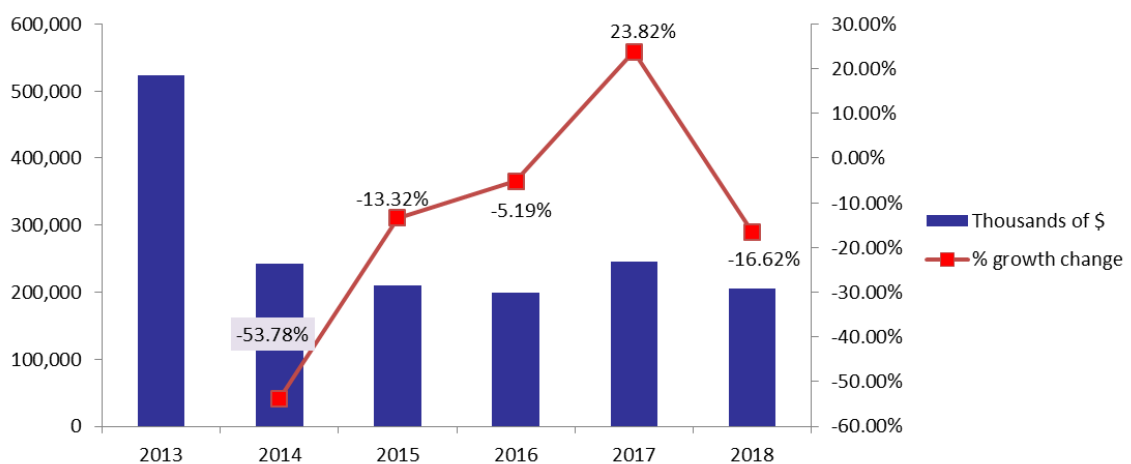
Lebanon’s economy is heavily based on consumption and since the main supply-side sectors of the economy such as real estate, trade, and public administration do not produce the consumption goods in demand, the goods needed are therefore imported which lead to the important current account deficit.

Although Lebanese products have taken advantage in substituting for the loss of Syrian production, the Lebanese export performance will continue to suffer from the weakness of the Syrian economy since the start of the war in Syria in 2011. Moreover, the southern border with Israel is also effectively closed which increase the pressure on the port and Airport infrastructure, raising the risk of congestion and delays to supply chains and higher costs associated with international trade.

Yearly Evolution of the Trade Deficit



Yearly Evolution of Lebanese Exports to Syria

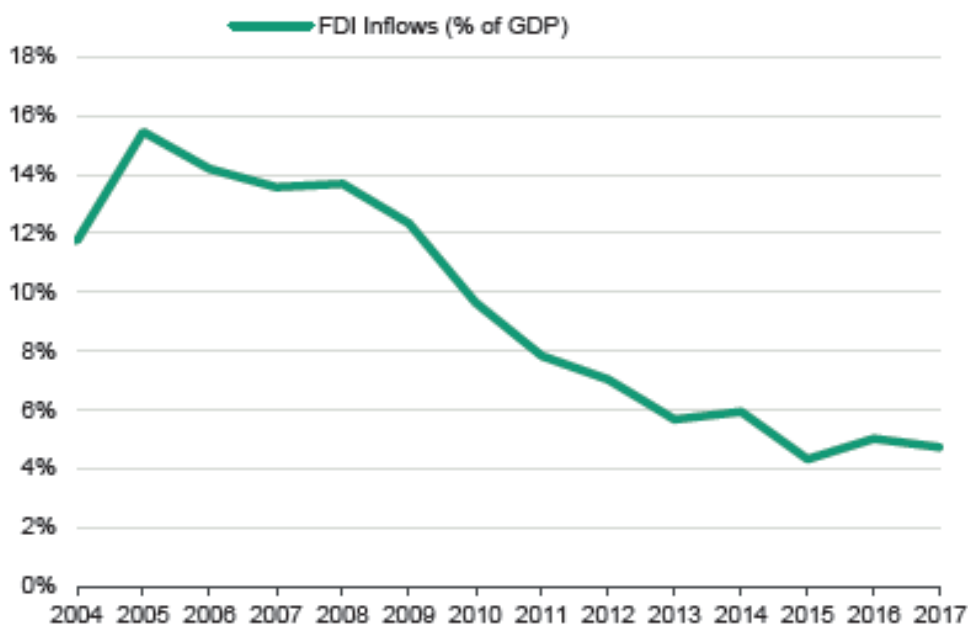


Source: Lebanese Customs

Lebanon has signed multiple free trade agreements (FTAs) and investment treaties over the last few years which can further improve trade flows and accelerate its integration into regional and global economies. First, Lebanon is member of the Greater Arab Free Trade Area (GAFTA) along with 16 other MENA states which aims to facilitate and develop Trade among Arab countries through a gradual lowering of tariffs and removal of trade barriers between member states. Moreover, Lebanon is working on agreements with the EU and the US noting that most of the Lebanese industrial and agricultural goods already benefit from tariff-free access to EU markets. However, Lebanon is still not a member of the World Trade Organization (WTO) which continues to act as a barrier to free trade and creates uncertainty for trading relationships.

Investment Openness

Since the civil war, Lebanon has been trying to attract foreign investments especially after year 2000 when new laws for privatization arose. The government has been seeking foreign investors to privatize the state-owned enterprises starting by telecommunications, electricity and water. Foreign investments in tourism, industry, and other sectors were also highly welcomed in Lebanon especially since 2001, when a new investment and real-estate laws were implemented. In details, Investment Law No.36 was enacted to reinforce the organization's mission (IDAL) and to provide a framework for regulating investment activities in priority sectors in Lebanon. The Investment Development Authority of Lebanon (IDAL) is the national investment promotion agency that was established in 1994 with the aim of promoting Lebanon as a key investment destination, attracting and facilitating investments in the country. Moreover, the stock of FDI increased during the financial crisis in 2008 since Lebanon was considered a stable destination for investment. The growth in FDI during the pre-crisis period (2002-2010) helped Lebanon to finance its current account deficit and boosted BDL's reserves asset. However, the crisis period (2011-2017) witnessed a sharp decline in net FDI and other investments. In fact, as a percentage of GDP, FDI has retreated amid the unstable domestic and regional environments mainly the civil war in neighboring Syria. As such, despite the government offering incentives to encourage investors to overlook potential risks, Fitch expects this slow rate of growth to continue over the medium term. As for FDI barriers in Lebanon, it remains relatively few. The only remaining barriers exist in terms of some localization and job creation requirements, particularly if businesses wish to benefit from incentive programs, the dominant presence of (State-owned enterprises) SOEs in a few sectors and limited foreign ownership restrictions.



Sources: National Statistics, Moody's Investors Service

2. Government Intervention Analysis

Government Intervention analyses a country's taxation system and the availability of financing. The scoring system favors countries which offer lower taxation and open sophisticated financial markets with easy access to loans. The main issue in Lebanon remains in its political fragmentation and uncertainties and the non ability to implement structural reforms resulting in weak business confidence. In January 2019, Lebanon announced the formation of a new government after 8 months of deadlock. Moreover, political issues have negative impacts on Lebanese Commercial Banks. First, investors will take a wait and see approach before committing large sums in capital investments and foreign deposits growth will therefore be affected. In addition, the political instability and environment of high interest rate will lead to a decrease in new loans in the short term. Moreover, FitchReports considers the imposition of sanctions on Hezbollah as one major risk to the banking sector. Hezbollah which is considered a "terrorist" group by the US is involved in the banking, construction and trade segments especially in South Beirut, Baalbek and southern Lebanon. Lebanon is placed sixth regionally out of 18 states receiving a score of 63.4 out of 100 for Government Intervention.

Taxation

Lebanon has an advantage for foreign investors when it comes to taxation system. In fact, the country has a regionally moderate corporate tax rate and limited "excess bureaucracy and regulation that serves as cost on business" known as red tape. However, Tax reforms passed in 2017 will increase the tax burden on businesses (particularly financial firms) although most companies will still experience moderate tax rates on a global comparison.

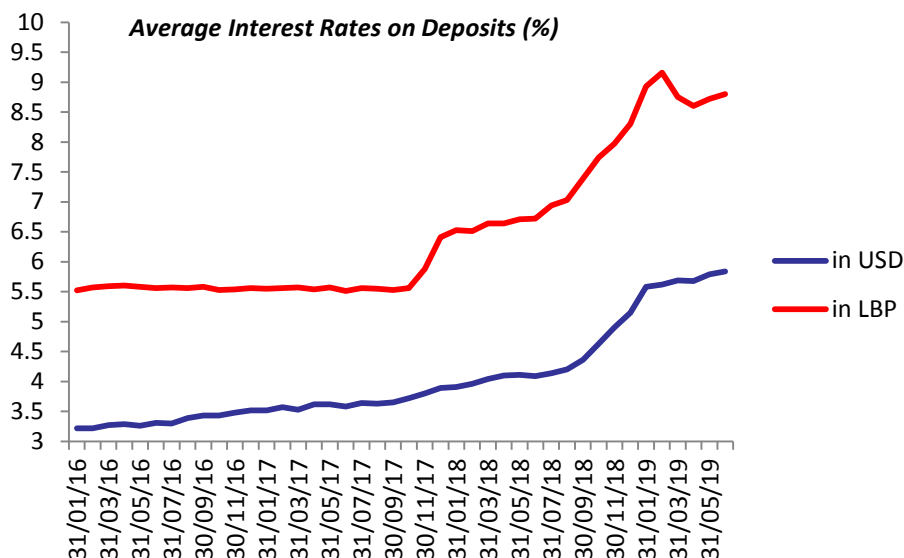
Financial Barriers

The Lebanese banking sector has expanded in recent years and branches number has increased domestically and in foreign markets providing important range of debt instruments and financial services such as overdrafts, housing and consumer loans, as well as loans to small- and medium-sized enterprises (SMEs). Moreover, the banking system has proven resilient to domestic shocks and regional turmoil which boost investors' confidence. In addition, investors' flows and transactions are eased by the presence of international banks such as Standard Chartered Bank and Citibank.

The Lebanese retail banking sector performance is good compared to the majority of its MENA peers. According to the World Bank's 2017 Financial Inclusion Indicators:

- ✓ About 44.8% of the total adult population had an account at a formal banking institution in 2017 compared to an average of 43% for the MENA region.
- ✓ 23% of the adult population borrowed from a formal financial institution (compared to regional averages of 11% and 15% owned credit versus the MENA average of 10%.

Deposit inflows are the key source of funding for the economy and banks have become the main trigger for capital inflow. However, Political developments affected the risk premiums Lebanese banks pay on deposits. As such, in order to counter some of these pressures and to allow banks to attract customer deposits the BdL intervened since May 2016 through a series of financial operations. Although the environment of high interest rates persisted through 2019, total customer deposits (resident and nonresidents) lost a 2.06% YTD to stand at \$169.6B by May 2019 noting that this policy led to a sharp decline in lending to the economy. Against this backdrop, Fitch Country Risk team highlights that "even in the face of a more stable political and fiscal situation, private sector activity is unlikely to pick up at a rapid pace in 2019."



Source: BDL

The domestic financial market is still underdeveloped on a global comparison with a limited number of listed companies on the country's stock exchange. The economic slowdown, higher public debt and continuous political turmoil continued to exacerbate investors' loss of confidence and weighted on the Beirut Stock Market's performance making it one of the top losers for H1 2019 in the Arab countries. In fact, Blom Stock Index (BSI) slumped by 11.37% since the start of the year to settle at 865.66 points by the end of June 2019. Activity on the BSE has been sluggish in H1 2019. The market capitalization declined from \$9.52B by the end of 2018 to \$8.20B end of H1 2019. Moreover, the total traded volume and value slumped from 23.25M shares worth \$168.67M in H1 2018 to 18.63M shares worth \$103.05M in H1 2019.

3. Legal Environment Analysis

Lebanon receives a low score for the Legal Risk pillar of the Trade and Investment Risk Index, with 23.5 out of 100 placing the country 14th out of 18 states in the MENA region. In fact, corruption is a major obstacle for economic progress in the country. Deep-rooted patronage networks impose monopolies and undermine competition and while the Lebanese Penal Code criminalizes most forms of corruption; enforcement of these laws is poor. Moreover, Bribery has huge impact on any organization leading most of the time to ineffectiveness and even to systemic failure especially in the absence of controls. In 2018, Lebanon ranked in 138th position out of 180 countries in the global Corruption Perception Index.

Bureaucratic Environment

Lebanon faces important problem in the area of "Business Establishment". According to the 2018 "Doing Business report", Lebanon ranks 143 out of 190 in the Starting a Business indicator due mainly to the following reasons:

- Establishing a company takes time and is costly. For example, it takes, on average, over 15 days involving eight procedures and costing 42% of (the economy's) income per capita to establish an LLC with 15 employees or more in Beirut. This is double the number of procedures in comparator countries, where no fees are charged. Moreover, offshore companies should have a Lebanese lawyer and must have annual services fee at a minimum of \$6K per year.
- Online Company establishment is very difficult since the required documents and fees are not available online.
- Even if the company is formed the difficulties remain in its liquidation. In fact, it needs three years to resolve insolvency at a cost of 15 % of the estate, with a recovery rate of 31.4 cents on the dollar.

Legal Environment

Corruption is mainly present in the performance of the Lebanese judiciary. Judicial corruption is tied to external influences on the judiciary; most significantly, the long reach of political forces that control judges' career paths. In fact, members of supervisory judicial bodies are largely appointed by the executive branch of government. Furthermore, the judiciary system faces important issues in the delays and inefficiency, as well as a shortage of qualified and independent personnel which cause difficult process for enforcing contracts. As a result, investors become more concerned since they rely on the court system to interpret the rules of the market and protect economic rights.

A major concern for investors is Lebanon's weak intellectual property rights (IPR) regime. In fact, this creates an important issue for investors in advanced high technology and pharmaceutical sectors where intellectual property rights play an important role. The problem is that intellectual property rights acquired in other countries are not automatically guaranteed in Lebanon, requiring companies to file new applications. Lebanon is still on the US Trade Representative's Special 301 Watch List as of 2017, indicating insufficient improvements to the IPR regime.

Mobilizing investment and ensuring that it contributes to sustainable development is a priority for all countries. The inflow of hard currency in Lebanon is essential for the stability of the monetary system and more specifically the maintenance of the Lebanese Pound's peg to the dollar. Although Lebanon has been a main hub of FDIs in the region during 2002-2010, FDI (as a percentage of GDP) has witnessed a decrease in the past years due to the difficult economic and political situations. As such, structural reforms in different areas and political stability remain inevitable in order to restore investors' confidence and attract much needed capital inflows.

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