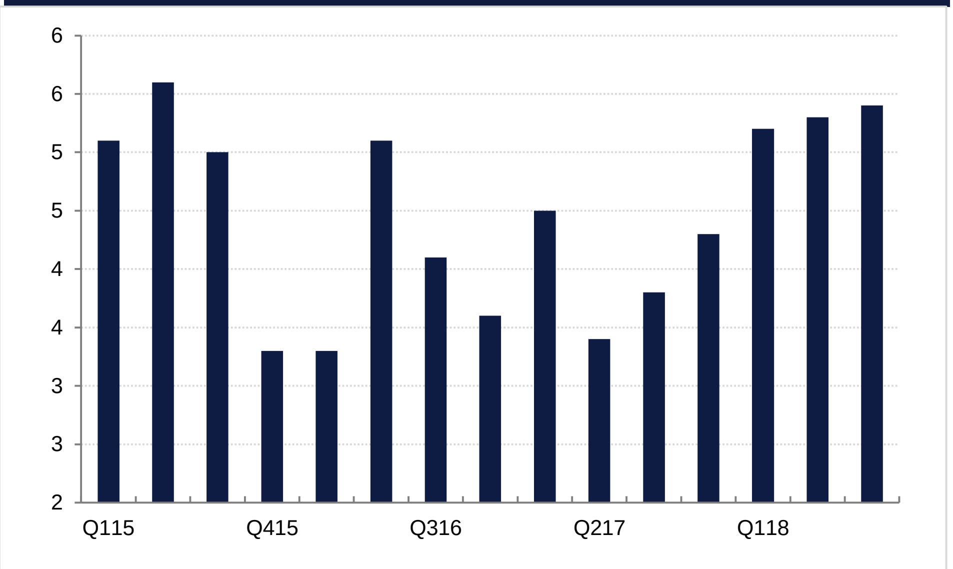
بنك الإمارات دبي الوطني
Emirates NBD

Egypt Quarterly

- **Growth outlook:** Egypt's pick-up in growth has slowed a little in recent quarters, as the authorities have pursued macroeconomic stability at the cost of a more rapid expansion in the economy. According to the communique from the Central Bank of Egypt's latest MPC meeting on June 28, real GDP growth in the third quarter of fiscal 2017/18 was 5.4%, compared to 5.3% the previous quarter and 3.8% in Q3 FY2016/17.
- **Fiscal policy:** Egypt achieved a primary budget surplus equivalent to 0.2% of GDP in the 2017/18 fiscal year ended in June, the first time this has been achieved in over a decade. In 2018/19 we anticipate that this surplus will expand to 1.9% of GDP as further progress is made on fiscal reforms. However, the overall budget deficit will remain wide at 8.5% as the cost of servicing the country's considerable debt load will weigh on public finances.
- **Balance of payments:** Egypt ran a balance of payments surplus of USD 11.0bn over the first three quarters of 2017/18, matching the surplus recorded over the same period a year earlier. This has seen the Central Bank of Egypt's FX reserves climb to a record USD 44.6bn in June, compared to USD 31.3bn in June 2017 and just USD 17.6bn in June 2016. The robust balance of payments surplus has contributed to greater macroeconomic stability, a steadier currency, and improved investor confidence. However, the pace of reserves accumulation has slowed markedly over the three months not yet covered in the recent balance of payments data release.
- **Monetary policy:** As was widely expected, the Central Bank of Egypt kept its benchmark interest rates unchanged at its meeting on June 28, namely 16.75% for the overnight deposit rate and 17.75% for the overnight lending rate. The CBE's cutting process has been put on hold as a number of key factors have led the bank to adopt a more cautious approach to monetary loosening.
- **Egyptian pound:** We hold a slightly more bearish view on the Egyptian pound as compared to last quarter, now forecasting a year-end exchange rate of EGP 18.00/USD, from current levels of EGP 17.89/USD.

Real GDP growth, % y/y



Source: CBE, Emirates NBD Research

Egypt
Quarterly
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Daniel Richards
MENA Economist
+971 4 609 3032
danielricha@emiratesnbd.com

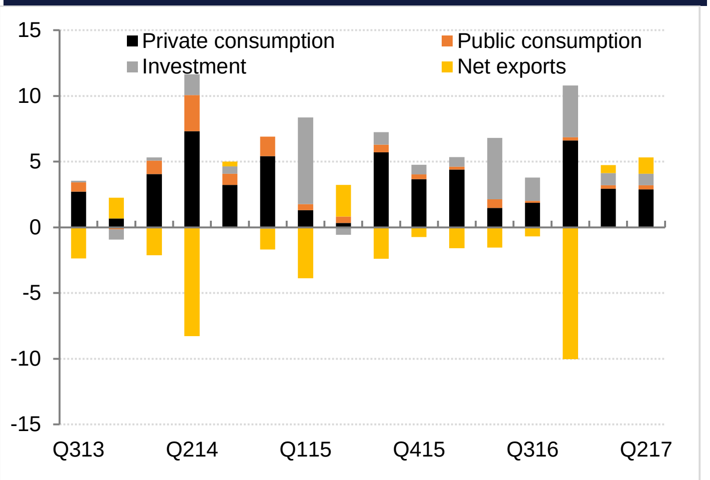
Content

Growth Outlook

Egypt's pick-up in growth has slowed in recent quarters as the authorities have pursued macroeconomic stability at the cost of a more rapid expansion in the economy. According to the communique from the Central Bank of Egypt's latest MPC meeting on June 28, real GDP growth in the third quarter of fiscal 2017/18 was 5.4%, compared to 5.3% the previous quarter and 3.8% in Q3 FY2016/17. We estimate growth of 5.3% in 2017/18, strengthening to 5.5% in 2018/19 and 6.1% in 2019/20.

Although the breakdown of Q3 GDP was not yet available at the time of writing, we imagine that the trend identified in our last Egypt Quarterly continues to play out – namely that the drivers of growth have been external rebalancing and government investment, and that private sector activity has remained relatively weak. Leading indicators suggest that this will remain the case in Q4, and we expect that the private sector will remain under considerable pressure owing to Egypt's reform programme.

Real GDP growth by component, pp



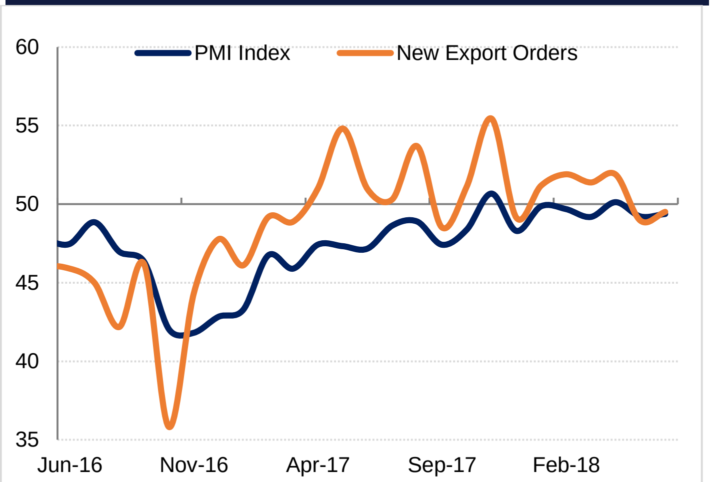
Source: Haver Analytics, Emirates NBD Research

Nevertheless, these pressures will begin to ease later in the year, and the improved macroeconomic fundamentals should provide a solid base from which Egypt can pursue stronger, more durable, growth in the years ahead. Prime Minister Mostafa Madbouly's recently touted target of up to 8.0% by 2021/22 is ambitious, but in excess of 6.5% is certainly feasible, comparing favourably to an average of 3.8% over the five years to 2016/17. The IMF passed Egypt on the third review of its support programme in June, praising the 'strong programme implementation and generally positive performance.'

PMI remains contractionary

The Emirates NBD Purchasing Managers' Index for Egypt, which measures activity in the non-oil private sector, has struggled to rise above the neutral 50.0 level which delineates contraction and expansion. The index stood at 49.4 in June, and has breached 50.0 only twice in the past 33 months, implying that its contribution to GDP growth will remain minimal in the coming quarter. With new orders remaining contractionary in June, and inflationary pressures set to increase in the next several months, firms will remain under pressure through the rest of the year. The ongoing subsidy reform programme, which has seen electricity prices for factories rise by 42% with the start of the new fiscal year, will curb firms' spending power, and this is especially the case as the CBE opted to maintain its overnight lending rate at the high level of 16.75% at its latest meeting. This will continue to constrain credit demand and private investment.

PMI



Source: IHS Markit, Emirates NBD Research

These inflationary pressures will also curb growth in consumer spending activity, as households will see their electricity tariffs rise 21%, petrol by as much as 50%, and cooking gas by 60%. Price growth has fallen dramatically from the 33.0% peak hit in mid-2017, but climbed from 11.4% in May to 13.4% in June and will remain elevated over the coming months. Unemployment has fallen steadily but remains high at 11.3% in December.

Conditions set to improve

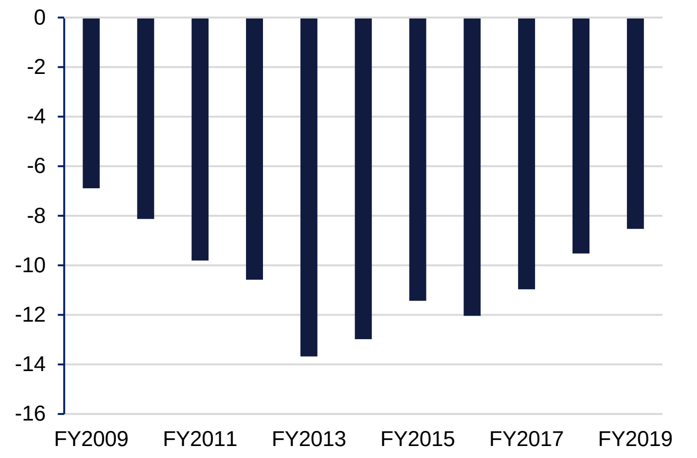
However, looking further ahead, there remain grounds for optimism; interest rate normalisation began with two 100bps cuts earlier in 2018, and after a pause as these new subsidy cuts bed in, we expect that rate-cutting will resume later in the year. While inflation will pick up, it has already more than halved, and greater political stability following the peaceful elections earlier in 2018 will boost confidence.

Ongoing reform to the business environment will also encourage greater private sector investment, and the positive effect of the improved macroeconomic stability on sentiment towards Egypt should not be discounted. Keeping rates high and pushing ahead with severe subsidy cuts will bring considerable short-term pain for consumers and businesses, but these policies will also ensure narrowing twin deficits, a curb on public debt accumulation, a stable currency and robust FX reserves. In what can be seen as a vindication of its policies, Egypt was comparatively little affected by the rout in EM over the past several months. The most high-profile victims of this were Argentina and Turkey, but developing economies all over the world were negatively impacted.

Fiscal Policy

Egypt achieved a primary budget surplus equivalent to 0.2% of GDP in the 2017/18 fiscal year ended in June, the first time this has been achieved in over a decade. In 2018/19 we anticipate that this surplus will expand to 1.9% of GDP as further progress is made on fiscal reforms. However, the overall budget deficit will remain wide at 8.5% as the cost of servicing the country's considerable debt load will weigh on public finances. The continued commitment to fiscal reform indicated in the latest budget will see this narrow in the coming years, and this is an improvement on the 9.5% recorded last year, but the process will be gradual, and higher oil prices and tightening global monetary policy pose a challenge.

Fiscal balance, % GDP

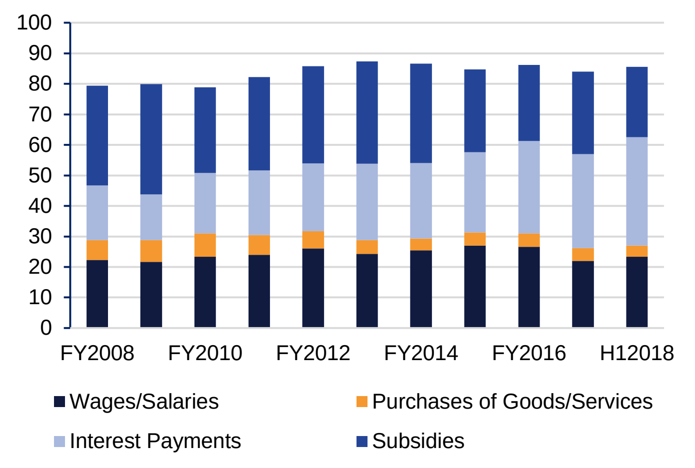


Source: Haver Analytics, Emirates NBD Research

Since entering into its IMF-sponsored reform programme in late 2016, Egypt has implemented a series of wide-ranging reforms, among them policies directly aimed at narrowing its formidable budget deficit, which averaged 12.1% of GDP over the preceding five years. VAT was raised and there has been significant reform to government subsidy payments, a trend furthered in the current budget which cuts fuel subsidies by 26.3% to EGP 89bn and electricity subsidies by 46.7% to EGP 16bn. Prices have already spiked as this is implemented – petrol prices have increased by as much as 50%, cooking gas by 60%, and electricity by 21% for households and 42% for factories. These latest cuts will see subsidy payments continue to fall as a proportion of GDP, having stood at just 23% in H1 2017/18, compared to as much as 34% in recent years. However, higher oil prices, which have averaged USD 71.6/b over the year-to-date, compared to an average USD 54.8/b in 2017, will slow this process.

The subsidy cuts are not being implemented purely to draw down the deficit, but rather they will also enable spending to be allocated elsewhere into potentially more productive avenues. The 2018/19 budget entails a spending increase of EGP 200bn, and while a fair proportion of this will go into government wages and social security programmes, there is also an allocation for investment which will help support future growth and higher revenue streams. Education and health have been allocated an increase of 16.0% in the current budget.

Expenditure, % of total



Source: Haver Analytics, Emirates NBD Research

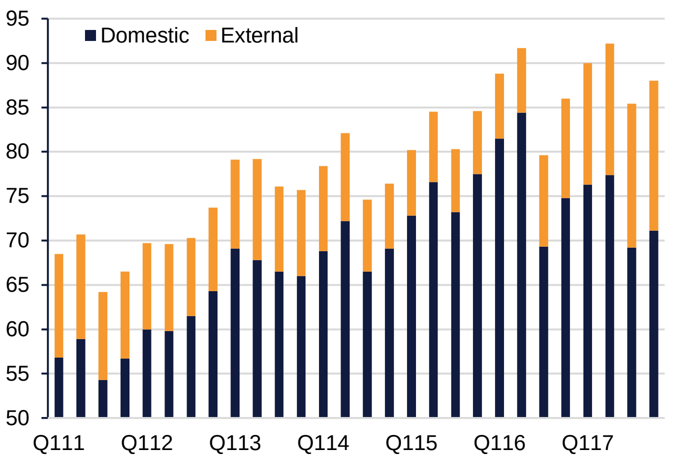
On the revenue side of the fiscal equation, the government is optimistic that stronger real GDP growth will help in narrowing the budget deficit. This will work through both generating higher tax revenues, and through making the economy larger, thereby making the nominal debt level smaller as a percentage of GDP. There have also been some tax adjustments, notably raising the price of cigarettes.

Finance Minister Mohamed Maait said in July: 'We plan to increase the contribution of non-sovereign sectors to tax revenues by further tightening control over these sectors, working to integrate more informal sector enterprises, countering tax evasion attempts and expanding mechanisms of mechanization.' While improving tax collection from the informal economy and clamping down on tax evasion is an effective way of boosting revenues, the government will need to walk a fine line in its plans to 'tighten control' of 'non-sovereign sectors' if it is to achieve its aim of boosting private sector activity – an aim repeatedly endorsed by the IMF in its programme reviews.

	Amt (USDmn equivalent)	% of Total debt
EGP	119,289	61.52
USD	55,364	28.55
EUR	9,809	5.06
Other	9,451	4.87

With the primary budget expected to remain in surplus over the coming years, lowering its debt servicing costs will be crucial if Egypt is to effectively draw down its budget deficit and public debt burden – 88.0% of GDP in Q4 2017. The government's interest bill accounts for over 45% of revenues, and with 61.5% of that denominated in local currency debt with an interest cost of over 15%, this proves costly. As a result, we anticipate that Egypt will continue in its aims to increase the share of external, dollar-denominated debt in its portfolio; Egypt has issued Eurobonds of USD 6bn so far this year and plans to continue issuing around USD 4-6bn in Eurobonds over the next couple of years. On July 18, Egypt's Eurobond maturing in 2028 was trading with a yield of 7.2%, making it an increasingly attractive option as compared to local debt.

Government debt, % GDP



Source: Haver Analytics, Emirates NBD Research

The outlook in this regard is increasingly positive given the more stable macroeconomic position Egypt is in, with narrowing twin deficits, substantial FX reserves, and increased political security as compared to two years ago. S&P recently upgraded Egypt's credit rating from B- to B with a stable outlook citing these factors in its decision-making process. Further, Egypt's five-year CDS has fallen from a peak of 882bps in mid-2013 to circa 390bps now, another indication of the more favourable investor outlook, all of which should keep its external borrowing costs contained.

2028 eurobond, % yield

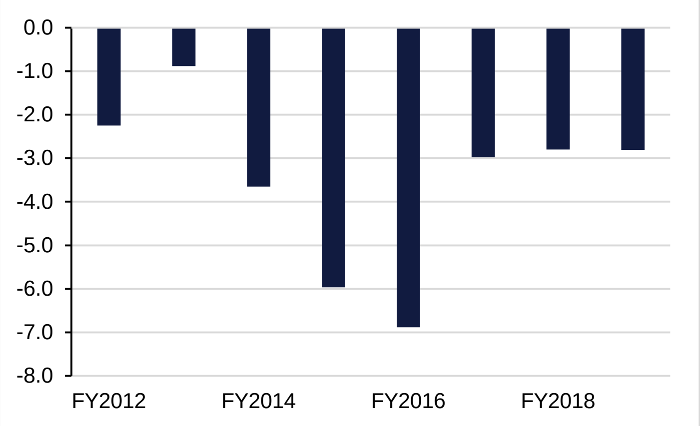
Source: Bloomberg, Emirates NBD Research

That being said, the issuance of external debt is not without risks, and while we expect that the pound will remain fairly stable over the coming years, minimising the currency risk of such securities, a sell-off can never be entirely discounted. This is especially the case given the pressure EM came under earlier this year. While Egypt was largely unaffected as compared to outliers such as Argentina and Turkey, yields on its 2028 eurobond did spike to 8.1% in June, before coming back over the intervening weeks. With developed markets, led by the US, slowly starting to tighten monetary policy as compared to the extraordinarily loose stance of the past decade, the hunt for yield will not be quite so acute, likely pushing up borrowing costs for EM issuers.

Balance of Payments

Egypt ran a balance of payments surplus of USD 11.0bn over the first three quarters of 2017/18, matching the surplus recorded over the same period a year earlier. This has seen the Central Bank of Egypt's FX reserves climb to a record USD 44.6bn in June, compared to USD 31.3bn in June 2017 and just USD 17.6bnin June 2016. The robust balance of payments surplus has contributed to greater macroeconomic stability, a steadier currency, and improved investor confidence. However, the pace of reserves accumulation has slowed markedly over the three months not yet covered in the recent balance of payments data release. Reserves rose only USD 1.7bn q/q in the three months to June, indicating that the balance of payments surplus has grown only marginally in the intervening period.

Current account balance, % GDP



Source: Haver Analytics, Emirates NBD Research

Evidence suggests that this is a result of portfolio outflows impacting the financial account in recent months, as the emerging markets sell-off which affected countries around the globe made itself felt in Egypt too, if to a lesser degree than seen in some. Yields on Egypt's local debt climbed over the period from April, with Reuters reporting that bankers were attributing this to as much as USD 5bn in foreign portfolio investment leaving the country. The decline in the EGX 30 equity index since the end of April, back to levels last seen at the start of March, suggests that foreign inflows into equity markets may also have reversed modestly.

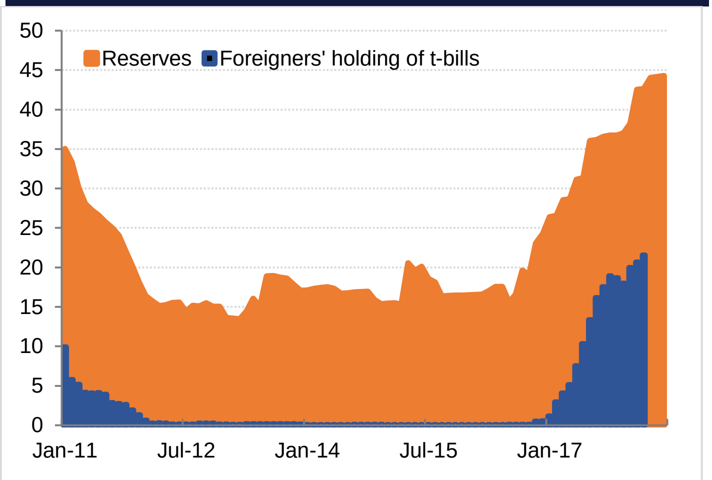
The sharp rise in foreign ownership of t-bills from less than USD 1bn in 2016 to USD23.1bn in March – last available data – has been one of the major successes from Egypt's reform programme and has been the primary driver of the rapid accumulation of FX reserves, given a persistent current account deficit and FDI inflows that have not yet expanded as much as was perhaps hoped. Given this, stimulating real GDP growth while remaining attractive to foreign portfolio investors is a major challenge for the CBE in setting its monetary policy, especially in light of recent global developments. Over the three-quarter period just reported, Egypt's net portfolio inflows expanded 91.0% y/y to USD 14.9bn. If global conditions see this begin to reverse, then Egypt would be more prone to higher borrowing costs and a potentially weaker currency as reserves are drawn down.

EGX 30

Source: Bloomberg, Emirates NBD Research

That being said, there have also been substantial improvements in the current account balance, and we believe that even should Egypt see a slowdown or reversal in its portfolio inflows, this will be offset somewhat by a stable trade deficit and a growing services surplus. We forecast a current account deficit equivalent to 2.8% of GDP in FY 2018/19, compared to an estimated 3.0% last year, and 6.9% the year prior to that. The pound's depreciation has been the key driver of the adjustment, constraining imports and leading to an uptick in exports. In the three quarter period just reported, the trade deficit declined by 1.3% y/y, driven by a 17.6% boost in exports and only a 5.5% increase in imports. Higher oil prices compared to recent years have already increased oil imports by 10.2%, and they will continue to weigh on the rebalancing, but Egypt's exporters are showing signs of strength as they start to take advantage of the more competitive currency.

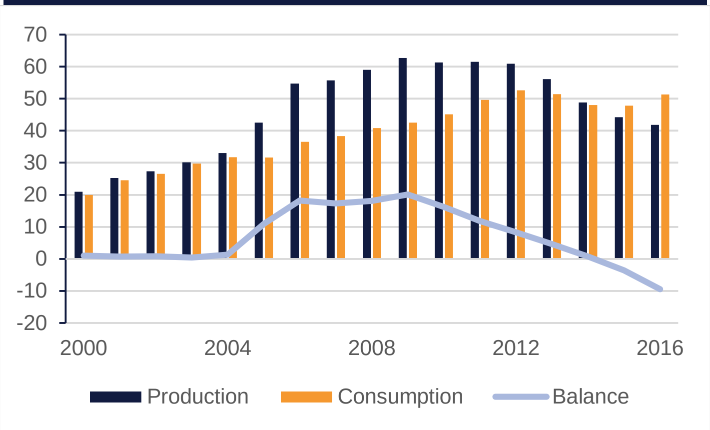
Reserves, USDbn



Source: Haver Analytics, Emirates NBD Research

A notable boost to Egypt's efforts to narrow its current account deficit will be provided by the ongoing development of its offshore gas sector. The launch of the Zohr gas field, with others in the pipeline, has seen Egypt issue what could prove to be its last tender for LNG imports for the time being at least. According to petroleum and mineral resources minister Tarek el-Molla, Egypt's current total output is 6.0mn cubic feet a day, but this could rise to 6.5mn, making the fourth quarter of the calendar year 'imports-free'.

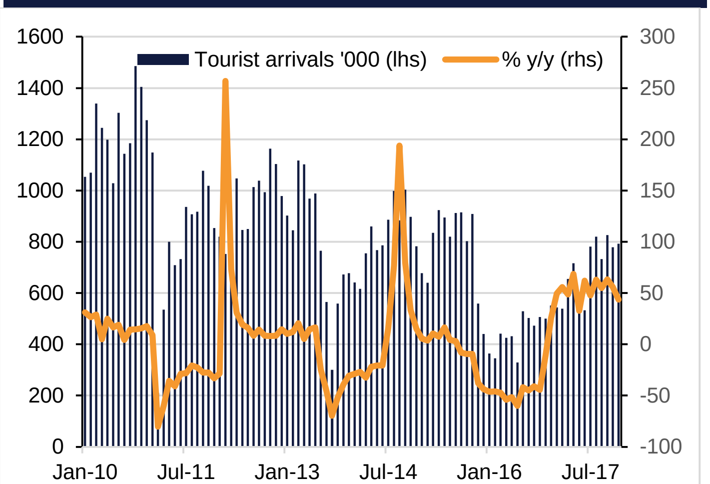
Gas sector



Source: BP Statistical Review, Emirates NBD Research

Still more positive has been the services account, which has seen its surplus expand by 138.2% y/y, a major factor behind which has been travel. Exports grew 155.2% y/y over the three quarters as visitors have begun to return to Egypt – tourist arrivals were up 53.4% in 2017. Equally, travel payments have fallen 22.2% y/y, following a 33.0% decline the previous year, as Egyptian spending abroad has been curbed by the weaker pound. With the resumption of direct flights between Egypt and Russia and a more stable political environment, continued robust growth in the tourism sector is likely.

Tourism

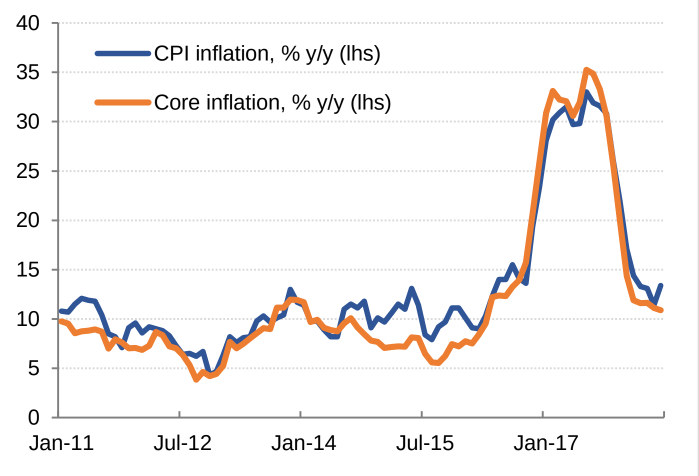


Source: Haver Analytics, Emirates NBD Research

Monetary Policy

As was widely expected, the Central Bank of Egypt kept its benchmark interest rates unchanged at its meeting on June 28, namely 16.75% for the overnight deposit rate and 17.75% for the overnight lending rate. This was the second consecutive meeting at which the bank held rates static after two 100 bps cuts earlier in the year. The CBE had been forced to hike by a cumulative 700 points after it devalued its currency at the end of November 2016, which led to a peak of 33.0% inflation mid-2017. With the devaluation in the base, and inflation falling, the bank had room to begin normalising policy earlier in 2018. However, the cutting process has been put on hold as a number of key factors have led the bank to adopt a more cautious approach to monetary loosening.

Inflation & EGP

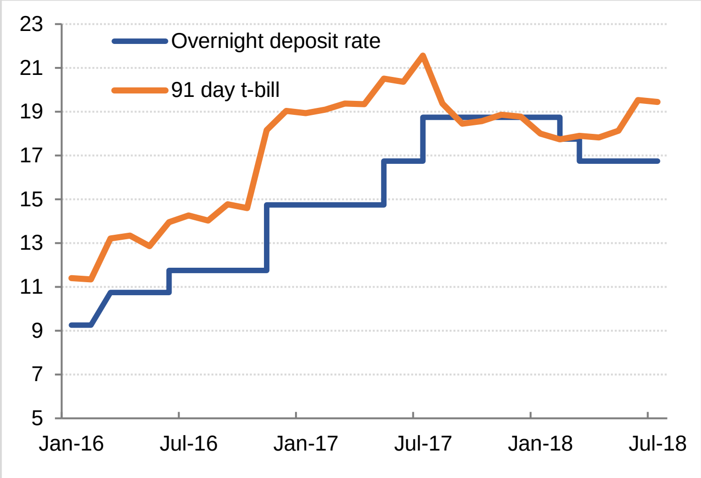


Source: Haver Analytics, Emirates NBD Research

First, inflationary pressures are set to pick up over the next several months as a raft of subsidy cuts have come into effect with the start of the new fiscal year. Petrol prices have increased by as much as 50%, cooking gas by 60%, and electricity by 21% for households and 42% for factories. While inflation fell to just 11.4% in May, the lowest level since April 2016, it increased by three percentage points to 13.4% in June. The CBE's target range of 13.0% ± 3 in Q4 2018 remains realistic, but we expect that inflation will remain fairly elevated, making a hold at the next meetings in August and September a likelihood. That being said, given that the higher price growth is being driven primarily by supply side issues, and will not be to the levels seen last year, we do not see a risk that the bank will look to hike rates.

Maintaining the backing of the IMF will also likely be a consideration for the MPC, given its strong support for high rates – the Fund once again in July commended Egypt and urged it to maintain its tight monetary policy in order to curb inflation. In a positive sign, on June 29 the fund approved the latest USD 2bn tranche of Egypt's USD 12bn support programme, which will take the total funding dispersed to USD 8bn. The IMF said that 'Egypt has begun to reap the benefits of its ambitious and politically difficult economic reform programme.' Other factors which will contribute to the MPC's decision to hold rates include the need to maintain the portfolio inflows the country has enjoyed since the removal of the pound's peg to the dollar, especially in light of tightening global monetary conditions, which the bank highlighted in its communiqué.

Rates, %



Source: Haver Analytics, Emirates NBD Research

We maintain the view that the rate-cutting cycle will be resumed later in 2018, but on the back of the reported departure of USD 5bn in foreign portfolio investment, the slowing in reserves accumulation, the more challenging global environment, and support of the IMF for high rates, we have modified this view.

We do not expect that the cutting cycle will be abandoned altogether, only that where earlier we anticipated two rate cuts of 100bps each we now expect just one. Macroeconomic stability has been the primary focus of the CBE, but as Egypt proved comparatively resilient to the EM rout seen in recent months, we expect that with the economy in a more stable position, efforts will turn to normalising policy and boosting growth. This will be a gradual process, and the central bank will pay close attention to inflation, and the guidance of the IMF, but there will most likely be room for a further rate cut before year-end.

Egyptian Pound

We hold a slightly more bearish view on the Egyptian pound as compared to last quarter, now forecasting a year-end exchange rate of EGP 18.00/USD, from current levels of EGP 17.89/USD. We had previously anticipated a modest strengthening given that the currency was likely oversold when its peg to the pound was removed in late 2016, but higher oil prices, combined with tightening monetary policy in the US and greater risk-off sentiment towards EM by international investors, will see the currency remain under modest pressure. Alongside an apparent preference by the CBE for a more competitive currency, the likelihood of a stronger pound has diminished, even despite the fact that the pound remains very weak on a REER basis as compared to its long-run averages.

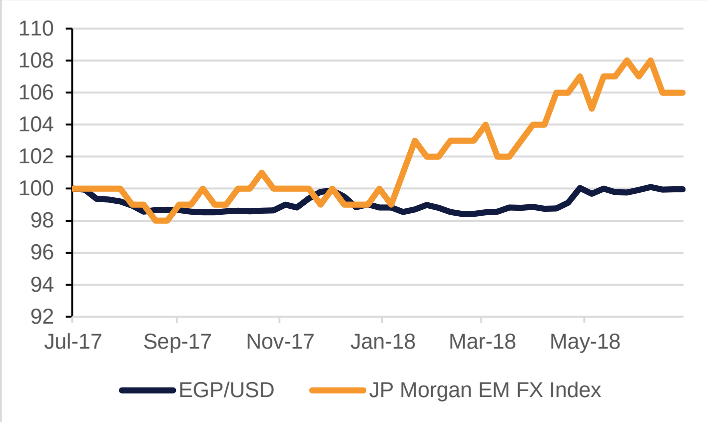
EGP/USD

Source: Bloomberg, Emirates NBD Research

When compared to the rest of the EM currency universe, the Egyptian pound emerged relatively unscathed over the past several months, but that is not to see it was entirely unaffected. The currency has been trading around the EGP 17.90/USD level since the rout began, as compared to an average EGP 17.67/USD over January to April. With tightening monetary policy in the US prompting continued dollar strength, and the CBE likely to restart its rate cutting cycle later in the year, there are mounting pressures on the pound.

That being said, the CBE remains in a position of considerable strength given that reserves have continued to climb this year, albeit at a slower pace over the past several months. Additionally, further to the USD 44.3bn of official reserves as of June, the CBE also holds USD 13.0bn of other foreign currency assets which will cover those funds invested into Egypt via its repatriation mechanism. Much of the considerable inflow into Egyptian local debt has entered the market via this system, which guarantees dollar availability.

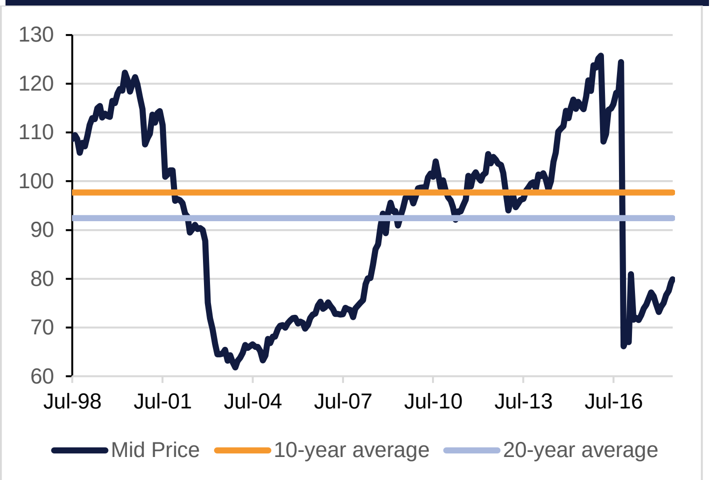
EGP, EM FX, rebased 12 months



Source: Bloomberg, JP Morgan, Emirates NBD Research

While the currency will remain fairly steady, a modicum of higher volatility is likely as greater availability of dollars has seen international investors increasingly turn away from the repatriation mechanism. The CBE has looked to accelerate this process through introducing a 1.0% entrance fee for using the mechanism in December 2017. Bloomberg reported in March that as much as 30% of debt-related foreign currency trades had begun going through the open market.

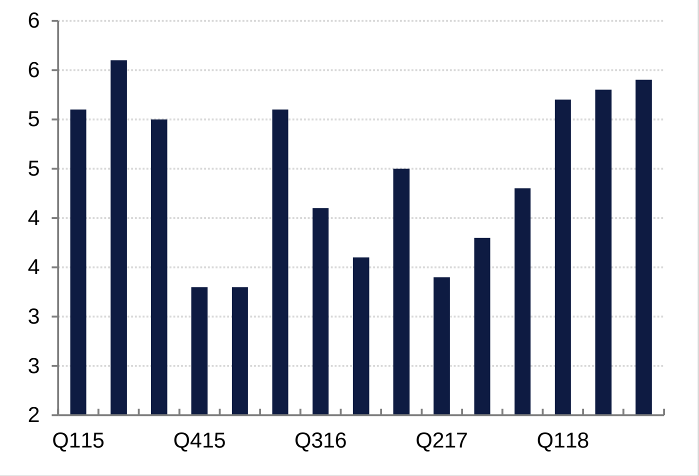
EGP REER



Source: Bloomberg, JP Morgan, Emirates NBD Research

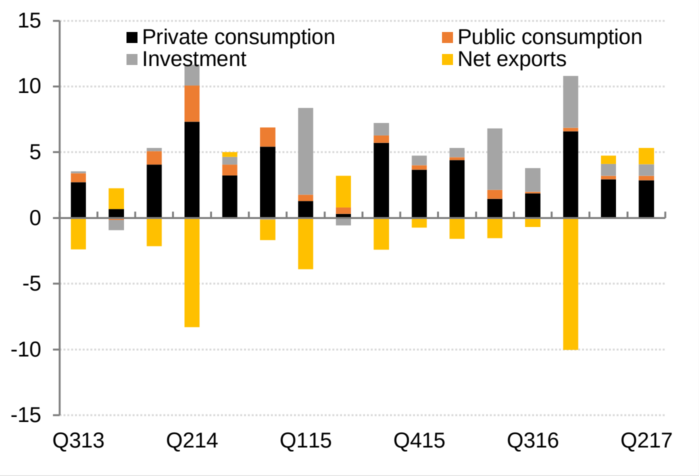
Although the hot money issue will remain at the fore, it will become less important to the pound as the rest of Egypt's economy strengthens. Higher oil prices are a challenge, but exports are steadily increasing and the development of the gas sector is a major positive. FDI is also starting to improve, with net inflows in Q3 2017/18 up 3.6% y/y and 107.1% q/q,

Real GDP growth, % y/y



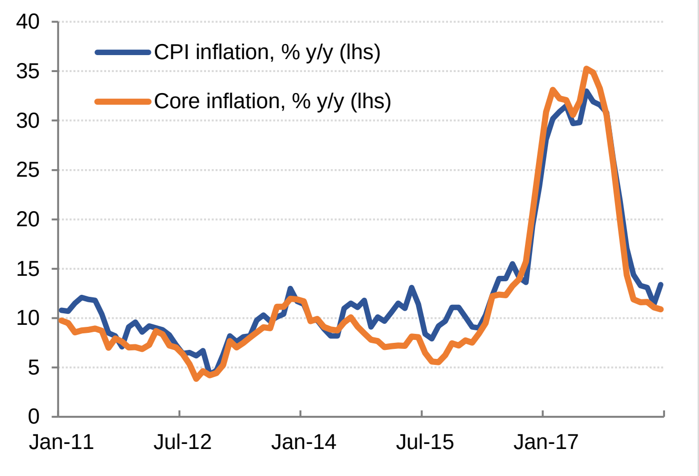
Source: Haver Analytics, Emirates NBD Research

Real GDP growth by expenditure



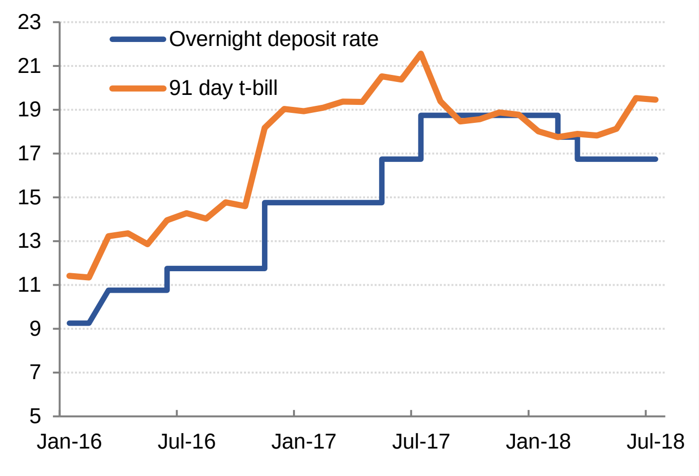
Source: Haver Analytics, Emirates NBD Research

Inflation



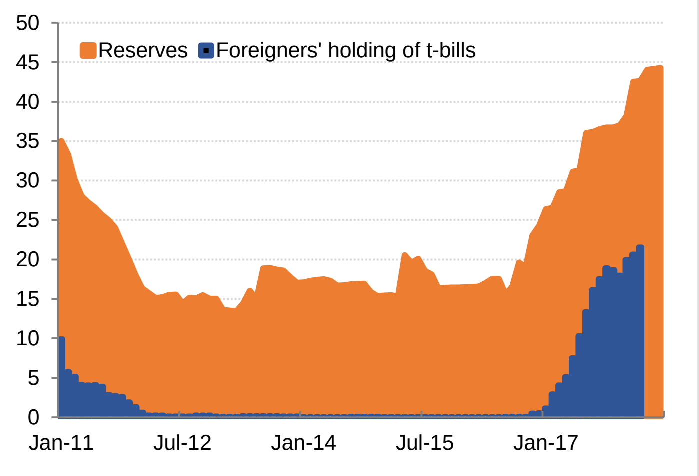
Source: Haver Analytics, Emirates NBD Research

Rates, %



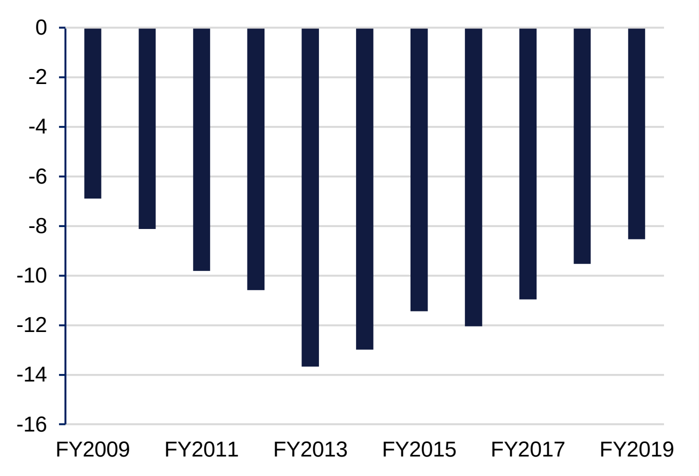
Source: Haver Analytics, Emirates NBD Research

Reserves, USDbn



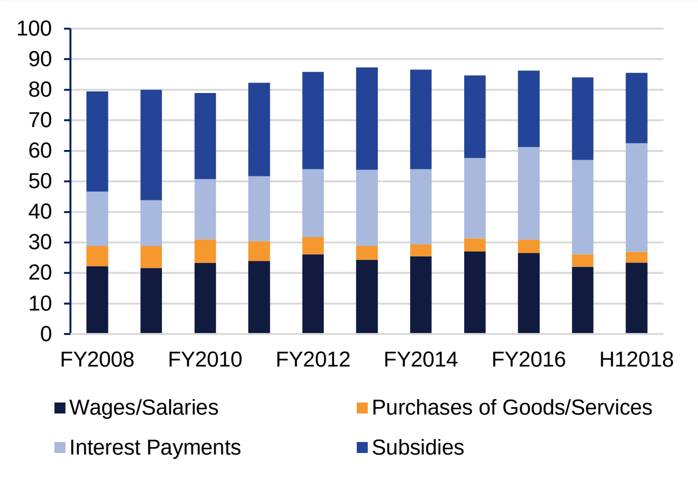
Source: Haver Analytics, Emirates NBD Research

Fiscal balance, % GDP



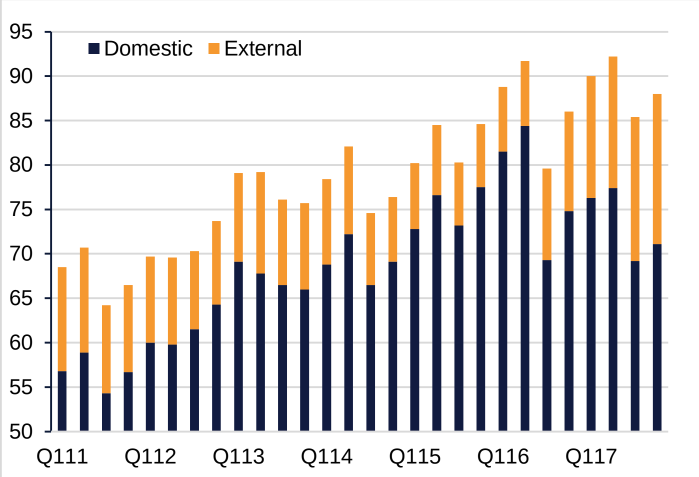
Source: Haver Analytics, Emirates NBD Research

Expenditure, % of total



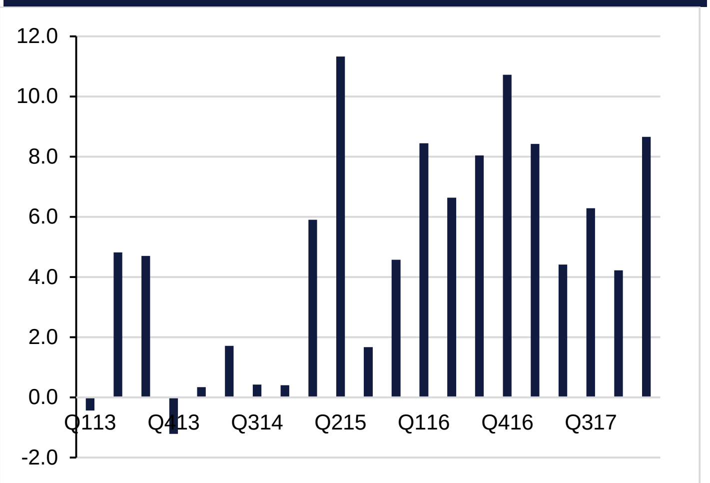
Source: Haver Analytics, Emirates NBD Research

Government debt, % GDP



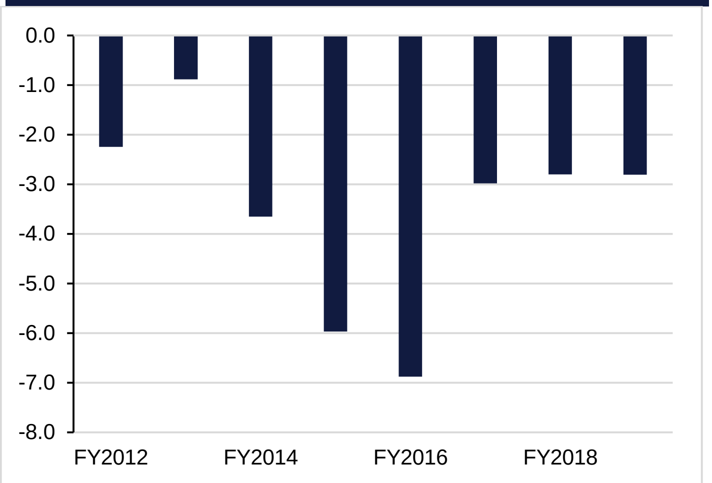
Source: Haver Analytics, Emirates NBD Research

Net FDI, USDbn



Source: Haver Analytics, Emirates NBD Research

Current account, % GDP

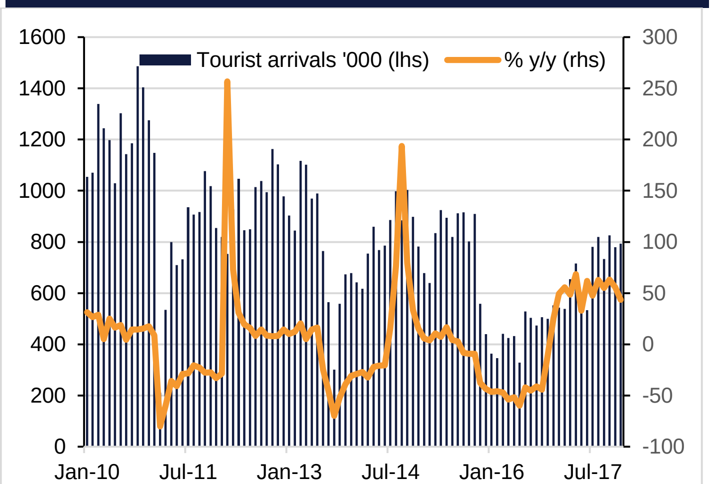


Source: Haver Analytics, Emirates NBD Research

EGP/USD

Source: Bloomberg, Emirates NBD Research

Tourist arrivals



Source: Haver Analytics, Emirates NBD Research

Key Economic Forecasts: Egypt

National Income*	2015	2016	2017	2018f	2019f
Nominal GDP (EGP bn)	2443.9	2709.4	3399.6	4227.6	5016.2
Nominal GDP (USD bn)	332.6	332.4	189.9	236.5	276.8
GDP per capita (USD)	3635	3554	1987	2421	2773
Real GDP Growth (% y/y)*	4.4	4.3	4.2	5.3	5.5
Monetary Indicators (% y/y)					
M2	16.4	18.6	39.3	20.3	17.5
CPI (average)	10.4	13.7	29.6	15.0	12.0
External Accounts (USD bn)*					
Exports	-39.1	-38.7	-36.8	-37.5	-43.9
Imports	13.4	13.0	15.1	17.0	18.7
Trade Balance	-52.4	-51.7	-51.9	-54.5	-62.5
% of GDP	-15.8	-15.6	-27.3	-23.0	-22.6
Current Account Balance	-12.1	-19.8	-14.9	-6.7	-8.1
% of GDP	-3.7	-6.0	-6.7	-2.8	-2.7
Reserves	20.0	17.6	31.3	44.0	42.0
Public Finances*					
Revenue (EGP bn)	-38029	-40035	-24451	-22369	-25163
Expenditure (EGP bn)	733350	804704	1025109	1167135	1246473
Balance	-279430	-326355	-372758	-402647	-427763
% of GDP	-11.43	-12.05	-10.96	-9.52	-8.53
Central Government Debt (EGP mn)	1871332	2285644	2685898	3500000	4000000
% of GDP	76.6	84.4	79.0	82.8	79.7

*Source: Haver Analytics, Emirates NBD Research. *Fiscal*

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Emirates NBD Research & Treasury Contact List

Emirates NBD Head Office
12thFloor
Baniyas Road, Deira
P.OBox777
Dubai

Jonathan Morris
General Manager Wholesale Banking
JonathanM@emiratesnbd.com

Aazar Ali Khwaja
Senior Executive Vice President
Global Markets & Treasury
+971 4 609 3000
aazark@emiratersnbd.com

Tim Fox
Head of Research &
Chief Economist
+9714 230 7800
timothyf@emiratesnbd.com

Research

Khatija Haque
Head of MENA Research
+9714 230 7803
khatijah@emiratesnbd.com

Anita Yadav
Head of Fixed Income Research
+9714 230 7630
anitay@emiratesnbd.com

Daniel Richards
MENA Economist
+9714 609 3032
danielricha@emiratesnbd.com

Athanasios Tsetsonis
Sector Economist
+9714 230 7629
athanasiost@emiratesnbd.com

Edward Bell
Commodity Analyst
+9714 230 7701
edwardpb@emiratesnbd.com

Mohammed Altajir
FX Analytics and Product Development
+9714 609 3005
mohammedtaj@emiratesnbd.com

Aditya Pugalia
Director, Financial Markets Research
+9714 609 3027
adityap@emiratesnbd.com

Sales & Structuring

Group Head – Treasury Sales
Tariq Chaudhary
+971 4 230 7777
tariqmc@emiratesnbd.com

Saudi Arabia Sales
Numair Attiyah
+966 11 282 5656
numaira@emiratesnbd.com

Singapore Sales
Supriyakumar Sakhalkar
+65 65785 627
supriyakumars@emiratesnbd.com

London Sales
+44 (0) 20 7838 2241
vallancel@emiratesnbd.com

Egypt
Gary Boon
+20 22 726 5040
garyboon@emiratesnbd.com

Emirates NBD Capital

Ahmed Al Qassim
CEO- Emirates NBD Capital
AhmedAQ@emiratesnbd.com

Hitesh Asarpota
Head of Debt Capital Markets.
+971 50 4529515
asarpotah@EmiratesNBD.com

Investor Relations

Patrick Clerkin
+9714 230 7805
patricke@emiratesnbd.com

Group Corporate Affairs

Ibrahim Sowaidan
+9714 609 4113
ibrahims@emiratesnbd.com

Claire Andrea
+9714 609 4143
clairea@emiratesnbd.com