ABBASI SECURITIES

1st November 2017

Banking Sector Earnings to Face Headwinds in CY18

REP-091

ABBASI SECURITIES

Research Department
111-555-ASL (275)
research@abbasisecurities.com

Jama Punji

Glossary

ADR	Advances to Deposit Ratio
BMR	Balancing, Modernization and Replacement
CAGR	Compounded Annual Growth Rate
CYXX	Calendar Year End December 20XX
Coverage Ratio	Provision for NPLs/Non performing Loans
CPEC	China Pakistan Economic Corridor
IDR	Investments to Deposit Ratio
Infection Ratio	Non Performing loans/Advances
NII	Net Interest Income
NIMs	Net Interest Margin
NPLs	Non Performing Loans
PIBs	Pakistan Investment Bond – Issued in maturity of 3 Years, 5 Years & 10 Years
T-Bills	Treasury Bills - Issued in maturity of 3 months, 6 months & 12 months

Summary

- The objective of this report is to identify key drivers of profitability in the banking sector in the six year period from CY11 to CY16. The report is based on 9 listed banks out of 20 representing 85% of the sector's market capitalization

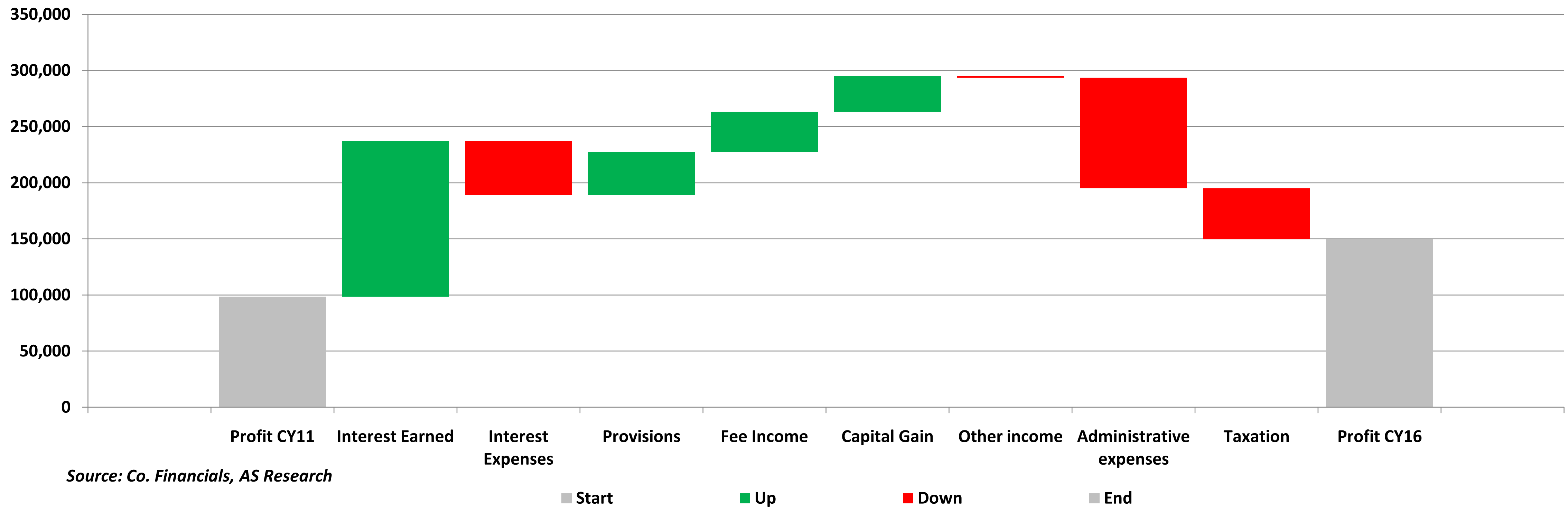
- In the 5 year to 31 December 2016, total assets of our sample increased by Rs5.35tr (CAGR of 14.06%). Assets increased because of increase in deposit base & retained earnings. Of the total increase Rs3.9tr was due to increase in deposits, while retained earning accounted for 2.7% of growth in total assets

- On the liabilities side, deposits grew at a CAGR 13.28%. Deposit growth was partly driven by an average M2 growth of 14.16% per annum

- Net earnings of the sector grew at a 5year CGAR of 8.75%. Whilst increase in investment in PIBs protected NII from lower interest rates, net earnings were also supported by higher capital gains, increase in fee income and decline in provision for NPLs

- We estimate that post maturity of high yield PIBs, banks earnings could decline by 15% in CY18 (assuming no change in interest rates)

Earnings drivers between CY11 to CY16



Source: Co. Financials, AS Research

•Net earnings increased from Rs98.5bn to Rs149.5bn representing a CAGR of 8.75%

•We observe that increase in interest income (+Rs138.5bn) was more than offset by higher interest expense (+Rs48bn) and increase in admin expenses (+Rs98.3bn)

•Key drivers of earnings therefore were : (i) decline in provision charge on NPL (down Rs38.3bn), (ii) higher fee income (+Rs35.8bn) and higher capital gains (+Rs32bn)

•Higher effective tax rate partly offset the positive earnings effect of the aforementioned factor. We note that in the above period, effective tax rate has increased from 34.5% to 39.5%. This is partly due to imposition of super tax at the rate of 4%

Overview of Banking Assets

ABBASI SECURITIES

Rs in Mn	CY11	CY12	CY13	CY14	CY15	CY16
Investments	**2,224,902**	**2,939,261**	**3,266,841**	**4,046,888**	**5,229,004**	**5,631,058**
T Bills	*1,462,477*	*1,916,216*	*2,131,509*	*1,318,978*	*1,907,504*	*2,098,660*
PIBs	*345,916*	*480,559*	*569,521*	*2,050,609*	*2,534,657*	*2,588,978*
Others	*433,608*	*519,396*	*538,338*	*561,408*	*662,014*	*809,566*
Gross Investment	***2,242,001***	***2,916,170***	***3,239,368***	***3,930,994***	***5,104,175***	***5,497,204***
T Bills % of Total Investment	*65.2%*	*65.7%*	*65.8%*	*33.6%*	*37.4%*	*38.2%*
PIBs % of Total Investment	*15.4%*	*16.5%*	*17.6%*	*52.2%*	*49.7%*	*47.1%*
IDR	*48.7%*	*54.5%*	*53.3%*	*59.3%*	*68.6%*	*66.1%*
Advances (Net)	**2,369,552**	**2,687,642**	**2,836,502**	**3,079,580**	**3,203,454**	**3,668,014**
Gross Loans	*2,608,879*	*2,946,305*	*3,118,522*	*3,398,022*	*3,537,747*	*4,000,190*
Non Performing Loans	*304,509*	*324,609*	*346,881*	*378,280*	*369,715*	*357,316*
Provisions	*196,293*	*210,026*	*213,575*	*252,888*	*265,355*	*315,541*
Infection Ratio	*11.7%*	*11.0%*	*11.1%*	*11.1%*	*10.5%*	*8.9%*
ADR	*51.9%*	*49.9%*	*46.3%*	*45.1%*	*42.0%*	*43.1%*
Coverage Ratio	*64.5%*	*64.7%*	*61.6%*	*66.9%*	*71.8%*	*88.3%*
Other Assets	**1,162,910**	**1,305,467**	**1,402,261**	**1,425,077**	**1,566,451**	**1,814,396**
Total Assets	**5,757,364**	**6,932,369**	**7,505,604**	**8,551,545**	**9,998,909**	**11,113,468**

Source: Co. Financials, AS Research

• Between CY11 and CY16 total assets increased by Rs5.36tr (CAGR of 14.06%). Much of this increase is attributable to increase in deposit (+Rs3.9tr) whilst borrowing from financial institutions attributed Rs0.83tr to total assets growth

•Asset mix of banks changed considerably. Share of investment in total assets increased from 38.9% in CY11 to 49.4% in CY16. Share of advances in total assets decline by 8 percentage points to 33% in CY16

•Within investments, banks increased their allocation to higher yielding PIBs. The shift towards PIBs was more profound in CY14 when interest rate started to decline

•SBP's policy rate decline from 10% in Nov-14 to 5.75% in May-16 a decline of 42%. To protect their NIMs banks invested in higher yielding PIBs. A review of data suggests that much of this investment was made in 3-year PIBs between Apr-14 and Dec-14 at yields ranging from 10.59% to 12.59%

• Advances have grown at a CGAR of 9.13%. The growth in advances is primarily driven by i) CEPC related financing (mainly power projects), ii) expansion and BMR by major industries such as cement, steel and textile. Moreover positive growth in consumer financing (credit cards, auto finance and personal loans) also added to growth in advances

Overview of Liabilities

Rs in Mn	CY11	CY12	CY13	CY14	CY15	CY16
Deposits	**4,565,767**	**5,389,073**	**6,127,622**	**6,826,737**	**7,619,944**	**8,518,020**
Remunerative	*3,189,164*	*3,795,872*	*4,245,992*	*4,618,233*	*5,108,089*	*5,562,217*
Non-Remunerative	*1,376,603*	*1,593,201*	*1,881,630*	*2,208,234*	*2,511,855*	*2,955,804*
Remunerative% of Deposits	*69.8%*	*70.4%*	*69.3%*	*67.6%*	*67.0%*	*65.3%*
Non Rem.% of Deposits	*30.2%*	*29.6%*	*30.7%*	*32.3%*	*33.0%*	*34.7%*
Borrowings from FIs	**351,312**	**574,730**	**343,767**	**493,055**	**1,081,282**	**1,185,855**
Other Liabilities	**285,583**	**331,210**	**333,256**	**387,077**	**400,026**	**446,069**
Total Liabilities	**5,202,662**	**6,295,013**	**6,804,645**	**7,706,870**	**9,101,252**	**10,149,944**

Source: Co. Financials, AS Research

•Deposit base of banks increased at a 5year CGAR of 13.28% and reached Rs8.5tr at the end of CY16

•Non-Remunerative deposit grew at 16.5% per annum, post CY13. During this time, banks' focus was more towards low cost deposits, as they sought to improve NIMs by lowering their cost of deposits

• Borrowing form financial institution increased from Rs0.35tr to Rs1.19tr between CY11 and CY16. Higher borrowing indicates banks need to maintain liquidity as Government of Pakistan has continue to borrow from commercial banks to meet budgetary expenditure

Profitability Highlights

ABBASI SECURITIES

Rs in Mn	CY11	CY12	CY13	CY14	CY15	CY16
Interest Revenue	526,418	558,347	549,735	649,564	694,261	665,277
Interest Expense	(262,663)	(305,387)	(307,076)	(352,532)	(335,352)	(310,756)
Net Interest Income	**263,754**	**252,961**	**242,659**	**297,033**	**358,909**	**354,521**
Provisions & other charges	(40,774)	(32,265)	(34,945)	(16,485)	(27,703)	(2,382)
Non- Interest Income	**79,340**	**99,909**	**106,752**	**127,602**	**152,104**	**145,438**
Fees, comm. & Brokerage	*38,287*	*44,077*	*52,615*	*58,675*	*69,348*	*74,119*
Capital gain	*5,853*	*11,796*	*16,915*	*23,932*	*40,893*	*37,971*
Other income	*35,201*	*44,036*	*37,222*	*44,995*	*41,862*	*33,347*
Admin & Other Expense	(152,027)	(163,980)	(183,322)	(209,373)	(231,067)	(250,354)
Pre-Tax Profit	**150,293**	**156,625**	**131,144**	**198,776**	**252,243**	**247,223**
Taxation	(51,947)	(51,458)	(38,323)	(65,770)	(102,233)	(97,653)
Profit After Tax	**98,345**	**105,167**	**92,822**	**133,005**	**150,009**	**149,570**

Source: Co. Financials, AS Research

•Net earnings of the sector increased at a 5 year CGR of 8.75%, from Rs98bn to Rs149.5bn (+Rs51.2bn). Key drivers of earnings were:
(i) NII increased by Rs90.8bn. Despite a decline in interest rates between CY14 and CY15, banks were able to grow NII by: (a) growing their balance sheet (deposit growth of 13.28% per annum) (b) investing in higher yielding PIBs (as mention in earlier slides); and (c) growing their non-remunerative deposits (as a portion of total deposits)

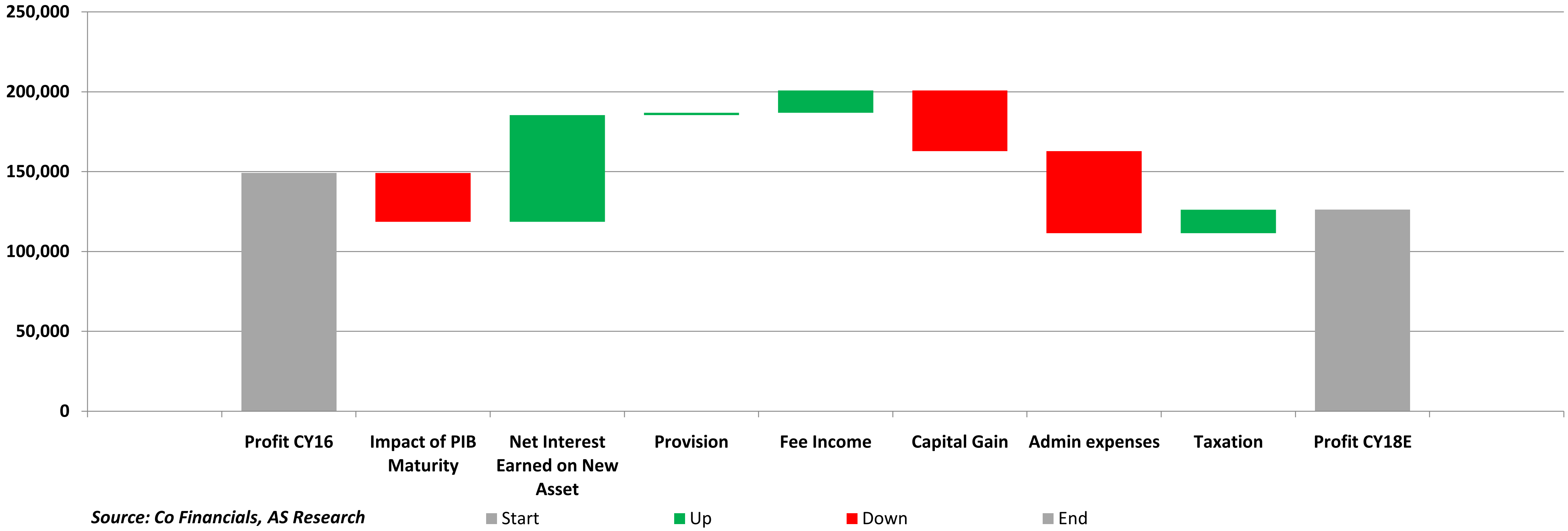
(ii) Admin expenses increased by Rs98bn (CAGR of 10.5%) due to: (a) increase in number of branches from 6,991 in CY11 to 8,706 in CY16 and (b) inflationary cost increases

(iii) Reduction in provision charges from Rs40.8bn in CY11 to Rs2.4bn in CY16 added Rs38.4bn to net earnings growth. In this regard we note that asset quality of advances showed considerable improvement. Infection ratio declined from 11.7% to 8.9% (CY11-CY16) and coverage ratio improved from 64.5% to 88.3% in CY16

(iv) Fee income growth contributed Rs35.8bn to earnings growth during the period as banks were able to grow fee income at a CAGR of 14.2%. We note that banks have continued to concentrate on fee income to eliminate inefficiencies and leakages in this revenue line

(v) Capital gains contributed an additional Rs38bn to earnings growth. Capital gains largely emanate from gain booked on sale of higher yielding PIBs. Our working suggests that by Q2CY17 banks had recognized gains on around 20% of their PIB portfolio

Projected Earning Bridge from CY16 to CY18E



Source: Co Financials, AS Research

•We expect net earnings to decline by 15% over 2 years to 31 December 2018 (down Rs22.3bn)

•We expect that NII to grow as the negative impact of maturity of higher yielding PIBs is likely to be more than offset by the effect of anticipated growth in the balance sheet

•Decline in net earnings is expected to come from higher administration expenses and elimination of capital gains

•Current environment of low interest rates, maturity of high yielding PIBs and re-investment of PIBs at lower yields could drag profitability of the banking sector. As already witnessed in CY16, we expect profitability of the banking sector to come under pressure in the coming period

•We further note that maintaining NIMs will be a fine balancing act in the coming period. Re-investment into PIBs could expose banks to mark-to-market risk as interest rates goes up. Whilst re-investment in T-bills could result in a significant decline in NII (this is not factored into our estimates)

•Estimated PIBs maturity in 2HCY17 & CY18 is ~Rs1.5trn having weighted average yield of ~10.8%. This may result in decline in interest income by Rs27.8bn (net of re-investment at lower rate). This decline in interest income could partially offset the positive impact of growth in net interest income resulting from balance sheet growth

•We expect income from capital gains to dry up as higher yielding PIBs mature. Furthermore, equity market is also showing bearish trend which could further limit the possibility of recognizing capital gains

•We anticipate admin costs to maintain upward trajectory. If admin costs continue to grow in the region of ~8%-10% per annum, banking profits could be affected by ~R51bn

•As mention in above projected earning bridge, ex-capital gains and provisions, net earnings of our sample banks is expected to decline by 15% to Rs126.7bn in CY18 (CY16 Rs149.1bn)

•We expect interest rates to remain flat until at least 2HCY18 as current inflation number and exchange rate movement do not warrant any uptick in interest rates. Moreover current political situation also suggests that government may be unlikely to take any unpopular decisions

Estimated Earnings	**HBL**	**UBL**	**MCB***	**ABL**	**NBP**	**BAHL**	**HMB**	**BAFL**	**AKBL**
EPS 2016	**23.23**	**22.69**	**19.82**	**12.84**	**10.85**	**7.33**	**5.85**	**4.95**	**4.15**
Less: Downside	(3.14)	(2.13)	(0.44)	(2.04)	(2.54)	(2.00)	(2.46)	(0.53)	(1.72)
EPS CY18E	**20.09**	**20.56**	**19.38**	**10.80**	**8.31**	**5.33**	**3.39**	**4.42**	**2.43**
Current pries 31-Oct-2017	160.49	179.09	198.78	79.49	44.14	55.07	32.51	39.92	19.24
P/E - CY18E	7.99	8.71	10.26	7.36	5.31	10.33	9.59	9.03	7.92
P/B - CY18E	1.33	1.21	1.46	0.83	0.67	1.35	0.84	0.92	0.70

***** excluding NIB book*

Source: Company Financials, ASL Research

6 Years Snapshot of Banking Sector (Sample)

ABBASI SECURITIES

Rs in Mn	CY11	CY12	CY13	CY14	CY15	CY16
Interest Revenue	526,418	558,347	549,735	649,564	694,261	665,277
Interest Expense	(262,663)	(305,387)	(307,076)	(352,532)	(335,352)	(310,756)
Net Interest Income	263,754	252,961	242,659	297,033	358,909	354,521
Provisions & other charges	(40,774)	(32,265)	(34,945)	(16,485)	(27,703)	(2,382)
Non- Interest Income	79,340	99,909	106,752	127,602	152,104	145,438
Admin & Other Expense	(152,027)	(163,980)	(183,322)	(209,373)	(231,067)	(250,354)
Pre-Tax Profit	150,293	156,625	131,144	198,776	252,243	247,223
Taxation	(51,947)	(51,458)	(38,323)	(65,770)	(102,233)	(97,653)
Profit After Tax	**98,345**	**105,167**	**92,822**	**133,005**	**150,009**	**149,570**
Assets						
Investments	2,224,902	2,939,261	3,266,841	4,046,888	5,229,004	5,631,058
Advances	2,369,552	2,687,642	2,836,502	3,079,580	3,203,454	3,668,014
Total Assets	**5,757,364**	**6,932,369**	**7,505,604**	**8,551,545**	**9,998,909**	**11,113,468**
Liabilities						
Deposits	4,565,767	5,389,073	6,127,622	6,826,737	7,619,944	8,518,020
Borrowings from FIs	351,312	574,730	343,767	493,055	1,081,282	1,185,855
Total Liabilities	**5,202,662**	**6,295,013**	**6,804,645**	**7,706,870**	**9,101,252**	**10,149,944**

Source: Co. Financials, AS Research

- **Disclaimer** **REP-091**

Disclaimer: This document is prepared for information purposes only. The information and data on which this report is based are obtained from sources which we believe to be reliable but we do not guarantee that it is accurate or complete. This document does not take account of the investment and trading objectives, financial situation and particular needs of clients, who should seek further professional advice or rely upon their own judgment and acumen before making any investment / trading decision.

- **Analyst Certification**

The author(s) of this report hereby certifies(y) that this report accurately reflects his/their own independent opinions and views as of the time this report went into publication and that no part of his/their compensation was, is or will be affected by the recommendation(s) in this report. The research analyst or any of his/their close relatives do not have a financial interest in the securities of the subject company aggregating more than 1% of the value of the company and the research analyst or their close relatives have neither served as a director/officer in the past 3 years nor received any compensation from the subject company in the past 12 months. The Research analyst or his/their close relatives have not traded in the subject security in the past 7 days and will not trade for 5 days post publication of the report.

- **Valuation Methodology**

To arrive at period end target price, Abbasi Securities uses different valuation methodologies:

· Comparable Method (P/E, P/B etc.)

· Discounted Cash flow Method

·Equity and Asset based valuation

- **Rating**
  - BUY Total return more than 20% from last closing of market price
  - HOLD Total return is in between 10% and 20% from last closing of market price
  - REDUCE Total return is less than 10% from last closing market price

ABBASI SECURITIES

Contact us:
Email: research@abbasisecurities.com
Website: www.abbasisecurities.com
Telephone: 111-555-275