ARIF HABIB LIMITED

REP-300

Commercial Banks
Bumper profits YTD, more in the offing

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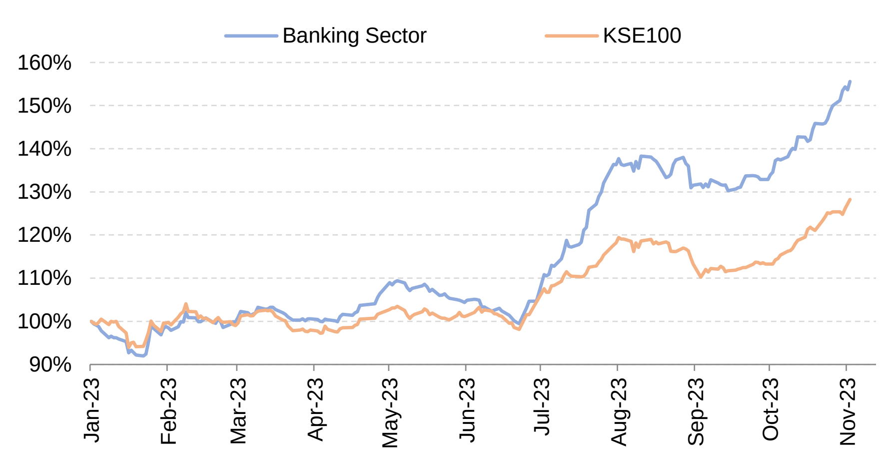
Continued profit momentum near term, growth to taper off in 2HCY24

During 9MCY23, the banking sector reaped substantial profits, courtesy of strategic rate hikes of 500bp following up with 625bp hike in CY22. However, the scenario is poised for change in CY24F in our view, as rates have peaked and we expect the monetary easing cycle to start in 1QCY24 pushing rates down to 15% by Dec'24 (22% currently). The reversal of the monetary policy stance is likely to put some pressure on sector NIMs, however we see mitigating factors in the form of i) lagged repricing of assets versus funding costs, ii) potential for higher balance sheet expansion and iii) opportunity to recognize capital gains on the Fixed PIB portfolio. In this backdrop, we expect near term earnings of the sector to remain robust with full year CY24F earnings growth expected around c12%. However, the implementation of IFRS-9 and the potential for NPL accretion surpassing projections may suppress the overall financial performance of the sector.

Exceptional profits and dividends in CY23TD

In CY23TD, the banking sector has unveiled a truly remarkable performance, achieving record-breaking milestones with a remarkable 84% YoY surge in dividends and a substantial 97% YoY growth in profitability within the initial nine months of the year. This achievement marks an unprecedented high in dividend payouts and profitability for the banking sector during this period. Consequently, this trend has resulted in a significant boost in the performance of banks (35.5%) compared to the KSE-100 index (14.5%) during 9MCY23. Moreover, the surge in profitability experienced by KSE-100 banks can be predominantly attributed to the remarkable earnings growth reported by MCB (+134%), ABL (+130%), and UBL (+126%). Additionally, the upswing in the banking sector's profitability was primarily fueled by a substantial increase in net interest income, which posted an impressive 67% YoY surge during 9MCY23.

Exhibit: KSE100 vs banking sector

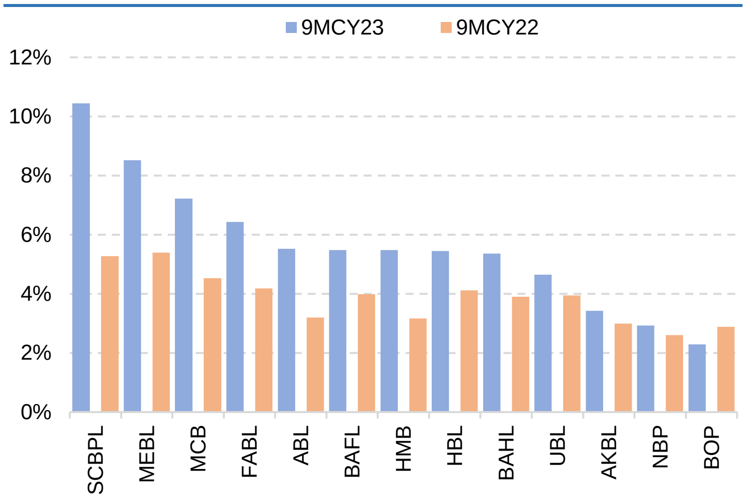


Source (s): SBP, AHL Research

Main drivers of profitability in CY23E

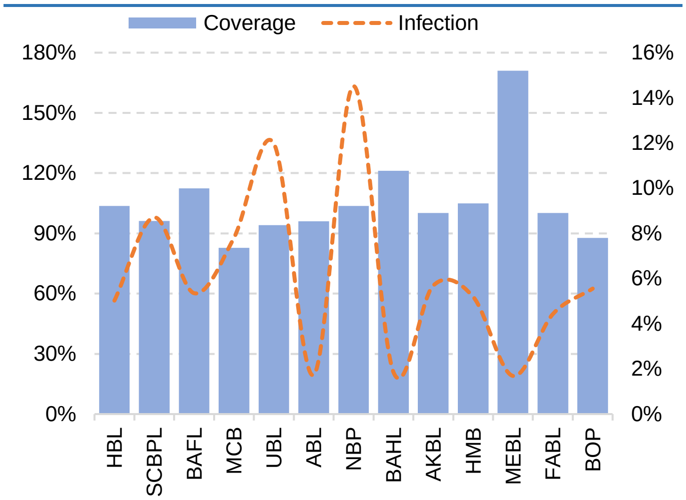
- **NII- The profitability catalyst:** The significant growth in net interest income was primarily influenced by a 500bp rate hike implemented since the beginning of the CY23. Net Interest Income for the sector exhibited a 67% YoY increase over the 9MCY23, with same increase on a QoQ basis. Although there were no additional rate hikes following the June rate hike, which brought the policy rate to a substantial 22%, earnings continued to gather momentum sequentially during the 3QCY23 mainly due to lagged impact of asset repricing. In 9MCY23, interest earned experienced a notable 91% increase on a YoY basis, while interest expenses also rose 105% YoY. Going forward, NIMs of the banks are expected to average at 5.5-5.7% in CY23E. Conversely, non-funded income posted a YoY decline of 2% during 9MCY23 which was mainly due to a significant 37% YoY decrease in FX income.
- **Infection remains stagnant**: NPLs of the banking system jumped YoY by a 9% during 9MCY23, clocking-in at PKR 722bn (9MCY22: PKR 661bn). The infection ratio of the industry slightly increased to 6.5% in 9MCY23 from 6.3% in 9MCY22. Moreover, the provisioning saw an uptick in 9MCY23, arriving at PKR 731bn, posting a 12% YoY increase (9MCY22: PKR 653bn). This significant increase was primarily due to an increase in general provisioning which was documented as banks endeavored to strengthen their coverage ratios in anticipation of potential economic challenges and potential loan defaults by their customers. Banks also exercised prudence in their lending practices to avoid specific provisioning requirements. Coverage ratio of the sector showed an uptick, average clocking in at 101% in 9MCY23, compared to 99% SPLY.

Exhibit: Net Interest Margins (NIMs)



Source (s): SBP, AHL Research

Exhibit: Asset Quality (Infection vs. Coverage)

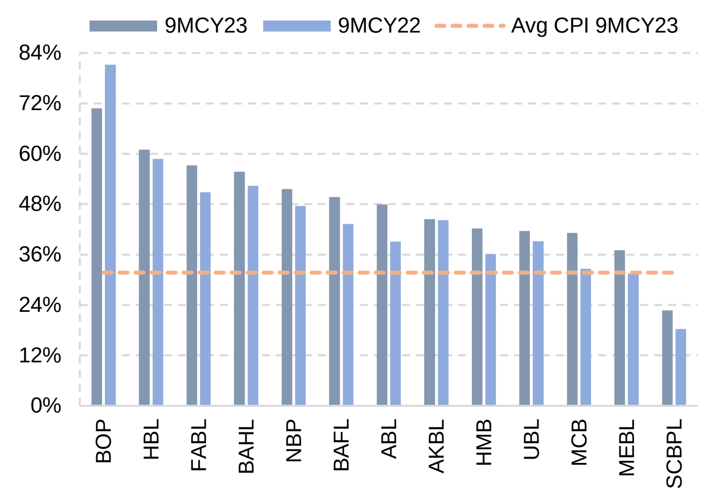


Source (s): SBP, AHL Research

- **OPEX surges**: Operating expenses in the sector increased by 31% on a YoY basis during 9MCY23. However, a significant 50% increase in total income during 9MCY23 helped dampen the impact on the cost-to-income ratio, resulting in a reduction to 43% during that period, down from the 48% recorded in the corresponding period of the previous year. This increase in the operating cost is attributed to branches expansion, the impact of high inflation which averages at 31.7%, and the devaluation of the PKR (30.8% average) in 9MCY23.
- **Attractive dividend yields**: CAR for the industry is currently at a concrete 17.8% against 16.7% SPLY (vs. minimum requirement of 11.5%). The sufficient capital buffer and high profitability allowed the banking sector to pay out hefty dividends this

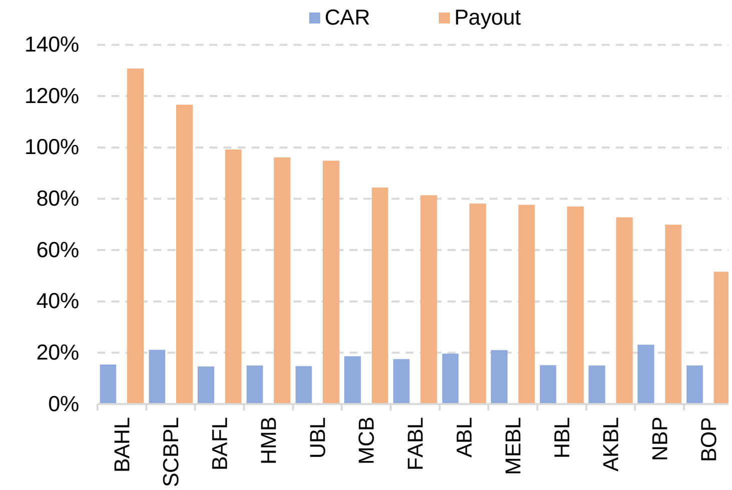
year. This served as a catalyst for the banking sector's price action. The payout of the banking sector experienced a substantial 84% increase in 9MCY23, taking the average dividend yield to 19%. Leading the charge, UBL achieved a remarkable 97% payout during the 9MCY23, paying out PKR 33/share, making it the highest dividend payout in the KSE-100 index.

Exhibit: Cost to Income Ratio



Source (s): SBP, AHL Research

Exhibit: Capital adequacy vs. Payout Ratio



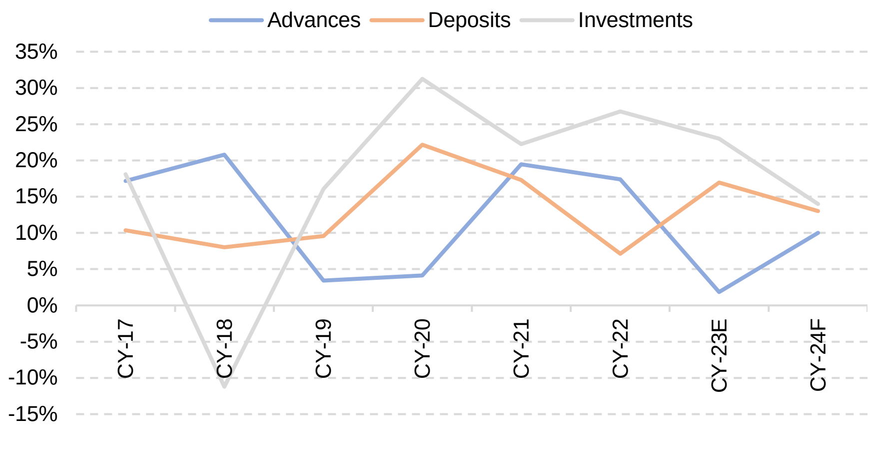
Source (s): SBP, AHL Research

Factors impacting profitability going forward

- **NII to continue supporting in near-term:** Interest rate cuts expected during CY24F are likely to be a catalyst initially for the profitability of banks in 1H due to immediate downwards adjustment of deposit rates (lagged impact of asset re-pricing). Moreover, banks have started building up their investment portfolios towards the longer end of the curve – another stimulus for NIMs going forward. We project AHL banking universe earnings to portray a jump of 12% YoY during CY24F, while NIMs for our coverage universe are expected to contract by ~130bps. NIMs will initially remain high before contracting by the end of CY24F which would compress earnings in the latter half of the year.

- **Balance-sheet growth to offset 2HCY24's NIM compression:** With inflation to begin its downhill journey more prominently next year, we expect monetary easing to start which should allow NPL build-up to slow down. Moreover, deposit growth is likely to slow down as well after a growth of 17% CYTD – a repercussion of the banks shedding off fixed deposits. In the year ahead, we project deposit growth to continue, albeit at a slightly moderated rate, ~13% in CY24F. we believe, banks will seek to offset the compression of their NIMs by persistently focusing on current account balances and striving to achieve increased volumetric-based growth. Deposit base expansion of banks is likely to continue to be mobilized towards investments as banks would continue to lend to the government. Re-profiling of investment book following maturity of legacy bonds coupled with investments in attractive shorter-term securities (inverted yield curve) would help fuel investment yields initially next year. Moreover, loan growth should accelerate to 10% vs. 2% in CY23E as the economy shifts into growth.

Exhibit: Balance sheet growth

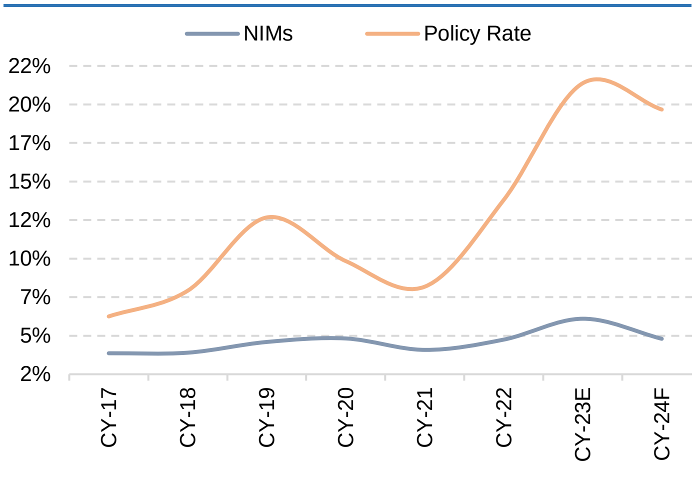


Source (s): SBP, AHL Research

- **Adequate capital position to support payouts:** We believe Pakistan banks under coverage possess sufficient capital adequacy to withstand any credit quality disruptions, with a Tier 1 Ratio ranging from 12% to 20%, led by MEBL, in compliance with Basel III standards. Additionally, the central bank has taken proactive measures by increasing capital requirements for systemically important banks, namely NBP, HBL and UBL, by 250 bps, 150bps and 50bps, for 2023. Looking ahead, due to the robust state of the banks' balance sheets, we anticipate that the capital positions of overall banking sector will remain strong, allowing them to continue their payout policies. We expect our coverage bank's average CY23E's dividend yield to clock-in at 15.2%.

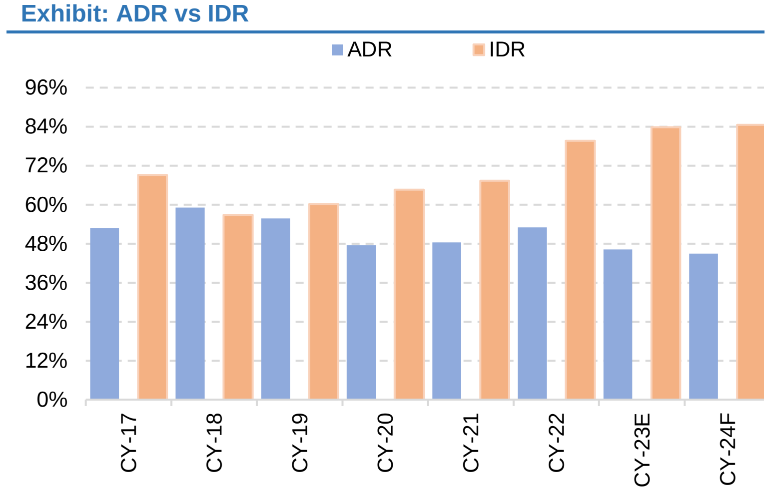
- **Provisioning buffers to deflect any asset quality:** Banks have taken a proactive approach to fortify their provisioning buffer, raising it to ~ 0.32% of the domestic loan book in 9MCY23 (9MCY22: 0.21%). This robust provisioning strategy is anticipated to be maintained through Dec'23. Furthermore, with the adoption of IFRS 9 scheduled to begin in CY24F, even though banks are well-prepared to handle potential fluctuations in asset quality, there is a possibility of witnessing an increase in provisioning charges.

Exhibit: Net Interest Margins



Source (s): SBP, AHL Research

Exhibit: ADR vs IDR



Source (s): SBP, AHL Research

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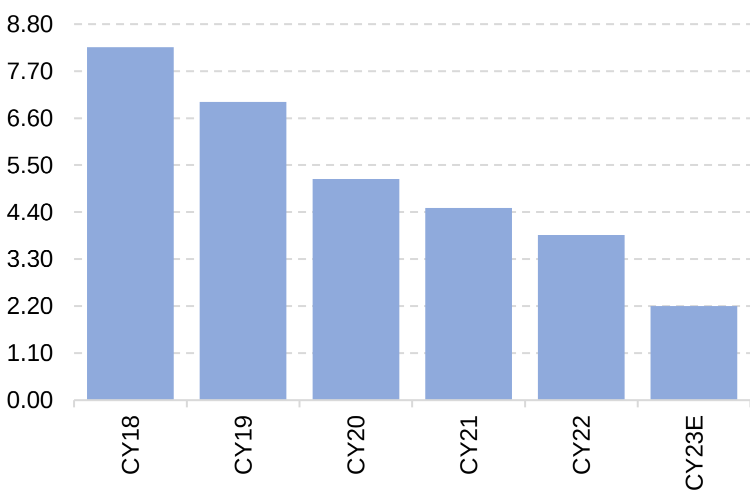
Key risks

- Further stretch in global economic slowdown and geo-political instability to adversely affect international operations & loan book quality.
- A Non-Performing Loan (NPL) accretion that surpasses initial expectations, leading to a more pronounced asset quality deterioration.
- Regulatory risks, such as those associated with the Treasury Single Account, as well as the likelihood of resumption of taxation on income generated from government securities.
- A rise in administrative expenses or provisioning charge (with IFRS-9 implementation), which could exert additional pressure on the sector.

Valuation and Top picks

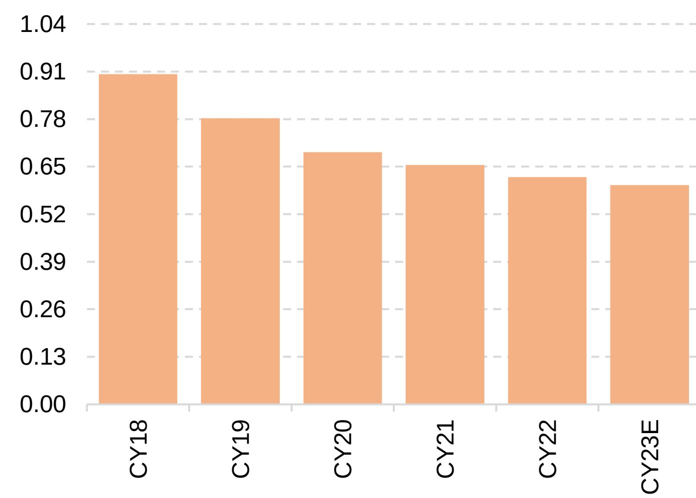
Within our banking sector, the valuation metrics for our banking universe are currently positioned at the lower end of their historical ranges in terms of both P/E and P/B multiples. Their current P/E ratio stands at 2.4x, while their P/B ratio is at 0.6x. This represents a significant discount compared to the 5-year average of 5.8x for P/E and 0.7x for P/B multiples. Furthermore, banks under our coverage are offering an impressive dividend yield of 15.2% in CY23E. Our top picks are: MEBL, UBL, MCB, and BAFL.

Exhibit: Price to Earnings Ratio



Source (s): SBP, AHL Research

Exhibit: Price to Book Ratio



Source (s): SBP, AHL Research

Disclaimer

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Equity Research Ratings

Arif Habib Limited (AHL) uses three rating categories, depending upon return form current market price, with Target period as Jun'24 for Target Price. In addition, return excludes all type of taxes. For more details kindly refer the following table;

Rating	Description
BUY	Upside* of subject security(ies) is more than +15% from last closing of market price(s)
HOLD	Upside* of subject security(ies) is between -15% and +15% from last closing of market price(s)
SELL	Upside* of subject security(ies) is less than -15% from last closing of market price(s)

Equity Valuation Methodology

AHL Research uses the following valuation technique(s) to arrive at the period end target prices;

- **Discounted Cash Flow (DCF)**
- **Dividend Discounted Model (DDM)**
- **Sum of the Parts (SoTP)**
- **Justified Price to Book (JPTB)**
- **Reserved Base Valuation (RBV)**

Risks

The following risks may potentially impact our valuations of subject security (ies);

- **Market risk**
- **Interest Rate Risk**
- **Exchange Rate (Currency) Risk**

Disclosure required under Research Analyst Regulations, 2015:

In order to avoid any conflict of interest, we hereby disclosed that;

Arif Habib Limited (AHL) has a shareholding in NBP, BOP and FABL.