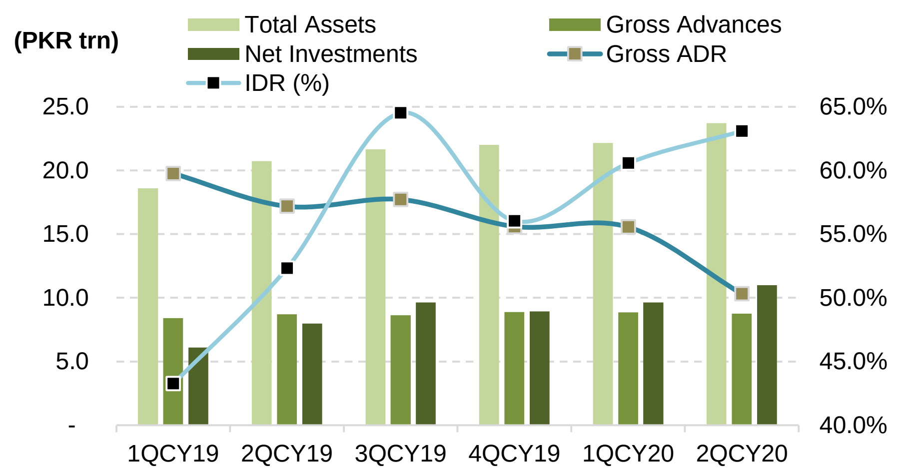
Sector Loan Growth under Pressure, IDR Supporting Assets Growth

Balance Sheets of banks have been growing at astonishing rates over the last few quarters. During Jun'20 Asset base of the banking sector sharply increased by 14.4% YoY (Mar'20: 19.2% YoY) compared to a mere 7.9% in Jun'19. Investment books of banks have been the primary contributor to the expansion in balance sheets of banks with investments rising a whopping 38% YoY during Jun'20 (Mar'20: 59% YoY). However, banks' loan growth has seen a severe meltdown since the outbreak of the pandemic. Aggregate demand in the country has nosedived, outlook for economic activity in the near term remains bleak hence curtailing loan growth of banks. However recent months have seen a stark turnaround in economic activity across the country attributable to a miraculous improvement in the COVID-19 situation across the country (6,762 active cases against a high of 108,642 and average infection close to 2-3% compared to a high of ~25%). Gross ADR ratio of the industry has dwindled to 50.3% as at Jun'20 compared to 57% SPLY while IDR during the same period has accelerated to 63% as at Jun'20 vis-à-vis 52% SPLY. Banks shifted their assets in favour of investments and had diverted funds towards high yielding government bonds in CY19 as interest rates climbed to a peak of 13.25%. Yields had reached highs of 14.2%, 14% and 13.9% on the 3-Yr, 5-Yr and 10-Yr PIB respectively over the last year. We expect IDR to hover around the same levels in the near-to-medium term while ADR is also expected to revive now that outlook for economic activity has significantly improved. The budget FY21 has also focused on reviving consumer spending and economic activity by curtailing duties and tariffs for various sectors which may help spurring activity. With interest rates having come down 625 bps, banks will be looking to move towards the shorter end of the yield curve while starting to realise significant capital gains on their bond portfolios as rates seem to have bottomed out.

Figure: 01 Balance Sheet Growth of the Sector



Source (s): SBP, AHL Research

Pakistan Banking Sector

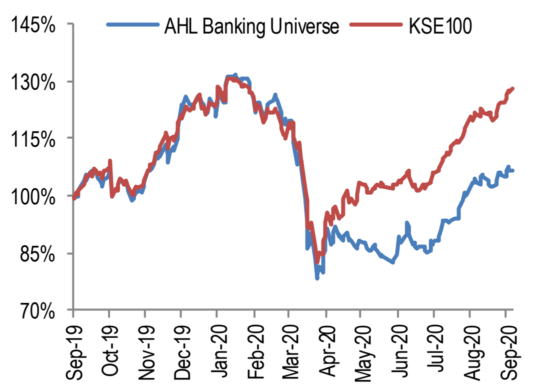
Market Weight

Sector Market Cap (PKR bn)	1,297
Sector Market Cap (USD mn)	7,776
No. Listed of Companies	20
Weight in KSE100 Index	22.1%

Pakistan Banking Sector

PKR bn	Jun-20	Jun-19	YoY
Total Assets	23,705	20,718	14%
Investments	10,979	7,968	38%
Advances	8,065	8,104	0%
Non-Performing Loans	847	768	10%
Borrowings	2,971	2,620	13%
Deposits	17,404	15,227	14%
Liabilities	21,891	19,230	14%
Paid up Capital	556	547	2%
Equity	1,814	1,488	22%

Relative Performance



Source: Bloomberg

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Credit Slowdown Has Dented Asset Quality

Credit quality of the banking system has faced a severe dent following the outbreak of the pandemic. Infection ratio as at Jun'20 for the banking sector stands at 9.7% against 9.1% as at Mar'20 and 8.8% SPLY. NPLs are up 10% YoY / 5% QoQ while slowdown in loan growth has exacerbated the deterioration in infection, with gross advances growth clocking in at a nominal 0.6% YoY whilst declining 1% QoQ. The spike in NPLs is in spite of the moratorium given by the SBP (principal repayment deferment scheme whereby companies can have their principal repayments deferred for one year with no impact on credit history). As per latest data, PKR 644bn worth of loans have been deferred by banks (~7% of gross advances). Banks have built up their coverage ratios and booked heavy provisioning expenses during the outgoing quarter, in order to build buffer against further NPL accretion and cushion the adverse impact on the banks' balance sheets. Total coverage ratio for the sector has climbed up to 82% against 78% SPLY. Most banks have booked a general provision to cushion any stress on books from future NPL build up.

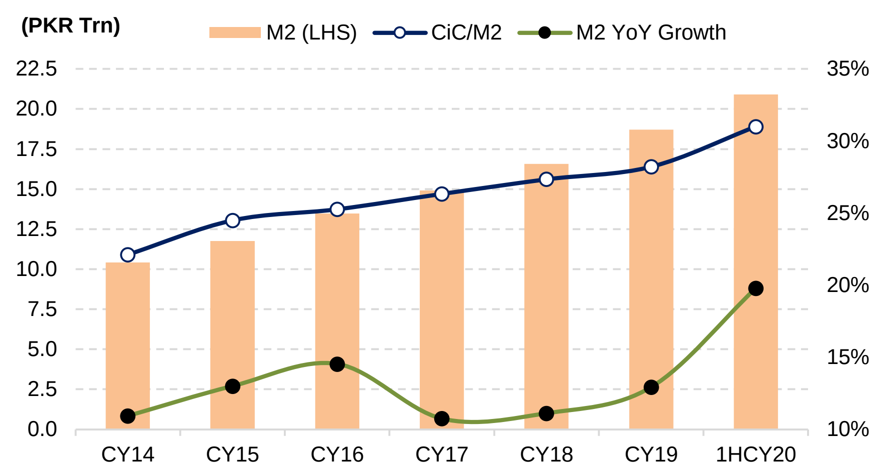
Consolidated Capital Base Places Banks On a Firm Footing

Unlike the 2008 crisis banks in Pakistan have entered the current crisis posed by the COVID-19 pandemic with strong balance sheets. In CY08 and CY09, CAR for the banking sector stood at 12.2% and 14% respectively. CAR for the industry is currently at a mighty 18.7% against 16.1% SPLY (against requirement of 11.5%), while CET1 ratio stands at 14.7% against a requirement of 9%. Currently only 3 banks have reported a CAR below the regulatory requirements against 6 banks SPLY, while 25 banks' CAR is above 15% against 19 banks SPLY. Owing to banks' strong balance sheets the SBP has encouraged banks to lend more and fuel the economic revival in the country. For instance, the SBP had reduced the Capital Conservation Buffer (CCB) from 2.5% to 1.5% in order to free up liquidity for banks to fuel credit growth in the economy. Slowdown in credit growth and higher investments in risk-free debt instruments has contributed to slowing down the growth in risk weighted assets which increased by 3.7% YoY during Jun'20 against 5.5% YoY during Jun'19.

Broad Money Growth Fueling Deposits

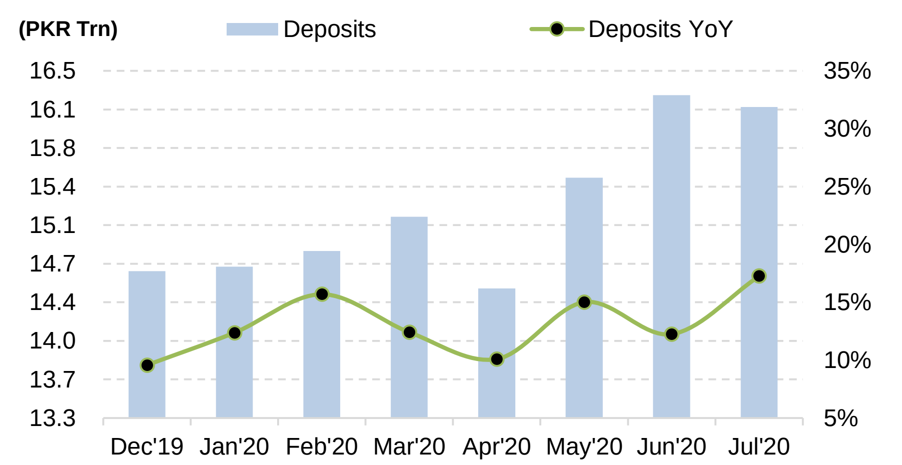
Deposit growth in the banking system has picked up pace in recent months, especially since the outbreak of the novel coronavirus. Deposit growth during Jun'20 clocked in at 14.3% which is the highest YoY surge since Mar'17 when deposits registered a 14.4% YoY increase. The sudden surge in deposits can be attributed to the recent surge in money supply which has been accentuated by growth in currency in circulation, which has contributed 31% to the M2 stock as per latest SBP data, vis-à-vis 28% at the end of CY19. Increased borrowings by the government for fiscal support since the outbreak of the pandemic has spurred this growth. Government borrowings for budgetary support have registered a sharp 15% rise CYTD, with the borrowings from scheduled banks increasing 27% CYTD.

Figure: 02 M2 Growth



Source (s): SBP, AHL Research

Figure: 03 Staggering Growth in Deposits



Source (s): Company Financials, AHL Research

MCB: Weathering the Storm

Our top pick from banks is MCB (Jun'21 TP: PKR 232/share, upside of 36%) primarily owing to sound fundamentals amid an environment which is seen as not too conducive for the banking sector. Lack of international exposure (~5% of loan book compared to ~19% for UBL and ~18% for HBL) protects the bank from overseas NPL accretion (threat faced by UBL particularly) as well as regulatory risks. Despite a one-time hit of PKR 1.6/share due to revision in corridor (discount rate is now 100 bps above policy rate), a high saving deposit proportion has helped fuel a higher downward revision in deposit costs, cushioning pressure on NIMs. Furthermore, MCB traditionally boasts impressive asset quality owing to prudent lending practices and coupled with a low Gross ADR of 42% compared to sector ADR of 50%, places the bank on a relatively firmer footing in an environment where asset quality deterioration is a major threat for banks. PIB accumulation (+193% YoY, contributing 43% to investments vis-à-vis 17.5% SPLY) should help keep NIMs afloat as well. A lucrative CY21F dividend yield of ~12% adds to the appeal of the stock. The stock trades at an attractive CY21 P/B of 1.1x – a 26% to last 5-Yr average P/B of 1.51x, while offering a forward 5-Yr average ROE of 17.7% against last 5-Yr average ROE of 15.2%.

Exhibit: 01 Valuation Snapshot

		CY19A	CY20E	CY21F	CY22F
EPS	PKR	19.85	23.09	25.28	25.85
DPS	PKR	17.00	20.00	20.00	21.00
P/E	x	10.32	7.40	6.76	6.61
DY	%	8.30	11.70	11.70	12.28
P/B	x	1.42	1.12	1.10	1.08

Source: Company Financials, AHL Research

Investment Yields, Deposit Portfolio to Support NIMs

Maturity profiling of investments is a primary source of support to the bank's NII going forward. A shift from the lower end of the yield curve to the higher end when interest rates had peaked should help arrest pressure on the bank's NIMs, following monetary easing of 625bps. As per the management, the average yield on the bank's fixed rate bond portfolio stands at 11.3% while average yields on the floater bonds stand at 13.7%. As at 1HCY20, PIBs contribute 44% to investments. Going forward we model the bank's investment yields to settle at 10.2% by Dec'20, while IDR is assumed at an average of ~69% over the next 5 years. The bank is likely to shift towards shorter tenor securities given that the interest rates have most likely bottomed out.

	MCBPA
Recommendation	**BUY**
Target Price (Jun'21)	231.7
Current Price	171.0
Upside (%)	35.5
Shares (mn)	1,185
Market Cap. (PKR mn)	202,598
Market Cap. (USD mn)	1,220

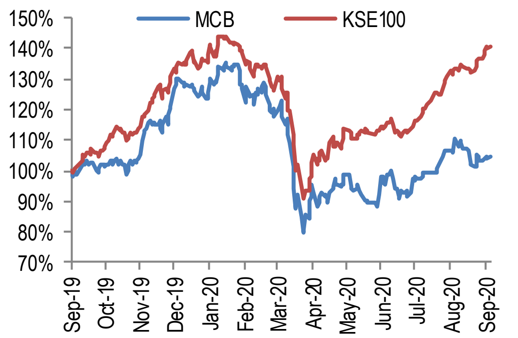
Major Shareholders

- Maybank, D.G Khan Cement, Nishat Mills Ltd

Price Performance

	3M	6M	12M
Return (%)	2.7	-8.1	4.3
Avg. Volume (000)	443	549	636
High Price - PKR	183.3	186.0	224.4
Low Price - PKR	150.9	132.9	132.9

Relative Performance



Source: Bloomberg

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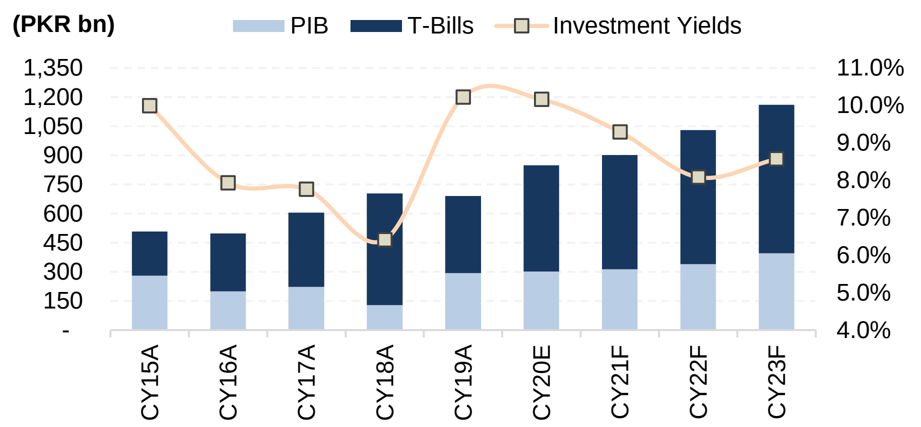
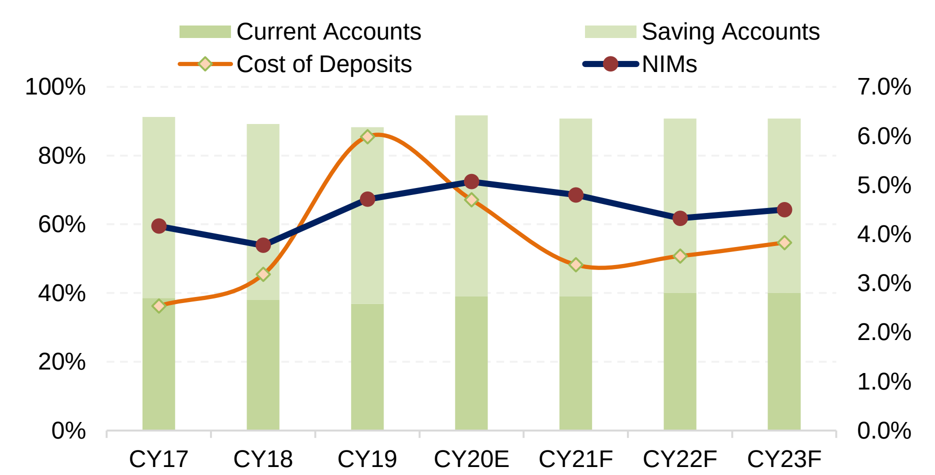
Figure: 04 Investment Book to Shift towards Shorter End of the Yield Curve



Source (s): Company Financials, AHL Research

MCB's stellar deposit franchise will help the bank weather the storm of monetary easing. A 54% saving deposit proportion resulted in a one-time hit to earnings of PKR 1.6/share due to revision in the SBP corridor. However the heavy concentration of saving deposits in its portfolio has helped the bank to enjoy a drastic reduction in its interest expense as a result of the aggressive rate cuts. Cost of funds for the bank has come down to 6.3% as at Jun'20 (against 7.2% last quarter) vis-à-vis sector cost of funds of 6.8%. With the impact of the June rate cut of 100 bps yet to reflect, NIMs should sustain pressure in 3Q before taking a significant hit in 4Q. The management expects NIMs to start deteriorating from 4Q onwards. We expect the bank's cost of deposits to recede to 4.7% by Dec'20 against 6% as at Dec'19, while NIMs are modelled at 5% as at CY20 (CY19: 4.7%) and at 4.8% in CY21.

Figure: 05 CASA King



Source (s): Company Financials, AHL Research

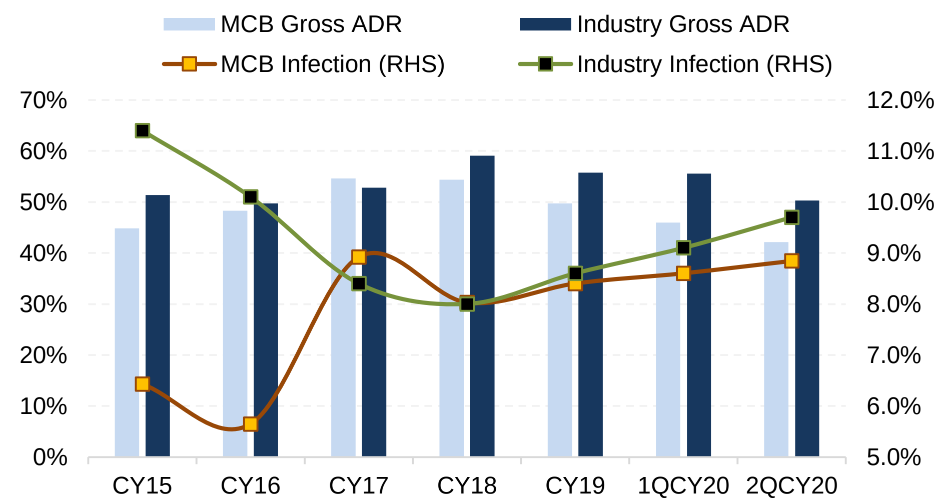
Capital Gains to Support NFI

Unlike most banks that decided to protect their earnings, MCB restrained from booking any capital gains during 1HCY20 as its NII momentum coupled with an impressive control on OPEX has kept the bank on a firm footing. While NIMs are to face suppression, monetary easing has inflated banks' revaluation surplus on the investment book, particularly on PIBs. Moreover, the strong rebound in the equity market has helped further. As of Jun'20, MCB's surplus on its AFS investments portfolio stands at a massive PKR 30.4bn against PKR 6.7bn as at Dec'19. The federal government securities portfolio holds a surplus of PKR 30.5bn while the equity portfolio bears a deficit of PKR 163mn (PKR 2.5bn deficit as at Mar'20) as a result of the hammering of the stock market following the COVID-19 outbreak. During the low interest rates era of CY15-CY17, MCB's capital gains constituted an average of 0.85% of its Investments book. We have assumed this ratio at 0.7% for CY20 and 0.5% for CY21. Capital gains are estimated at PKR ~6bn in CY20 and PKR 4.8bn in CY21, translating to a per share impact of PKR 3.06 and PKR 2.49 respectively.

Well Shielded from Asset Quality Deterioration

MCB has traditionally been known for conservative lending practices over the last 10 years. The last time the bank's Gross ADR ratio exceeded 60% was in CY10. It may be noted that the same is true for the industry as a whole. However, the bank's average gross ADR has been starkly lower over the last 10 years as opposed to that of the whole industry – 50% against 56% respectively. As at 2QCY20 the bank's gross ADR stands at 44% against an industry ADR of 50% for all banks while the bank's IDR stands at 69% against sector IDR of 63% for all other banks. Conservative lending, coupled with an accumulation of high yielding bonds places is likely to be a strong shield for the bank in the low rates era. Moreover, a low ADR should help shield the bank from major asset quality deterioration as well. The COVID-19 pandemic is a looming sword over banks' infection ratios with cash cycles of companies facing severe suppression. A one-year moratorium has been given by the SBP for principal repayments. However, the management is of the view that NPLs will start emerging once the moratorium expires. In the last 2 years, overall NPLs in the banking system have registered a whopping 34% rise in NPLs, since the SBP initiated its monetary tightening regime. MCB during the said period has seen a minimal 4% jump in its NPLs. This has in part been supported by recoveries flowing in from NIB in addition to its prudent lending and strict credit risk management. As at 2QCY20, MCB has recovered ~PKR 5.3bn from the NIB book out of a total of PKR 29.6bn, as per the management. Management expects delay in achieving the earlier target of 40% recovery in 3 years since acquisition. That said, certain clients have significant exposure and progress on recovery against those accounts would speed up the total recovery. Going forward, we have remained conservative in our modelling and have assumed NPLs to increase 12% by Dec'22 from CY19.

Figure: 06 **Asset Quality**



Source (s): Company Financials, AHL Research

1HCY20: NII Downturn, Absent Capital Gains Suppress Earnings

MCB announced earnings for 1HCY20 below expectations, at PKR 13.4bn (EPS: PKR 11.33), depicting a YoY uptick of 29% / 3% QoQ (2QCY20 EPS: PKR 5.74). NII momentum for the bank continued with monetary easing providing drastic fuel on a sequential basis. NFI for the bank was down 9% YoY / 17% QoQ and the bank booked hefty provisioning charges during 2Q. Net Interest Income of the bank settled at PKR 38.3bn, portraying an impressive 29% YoY increase while on a sequential basis, witnessed a 21% acceleration owing to suppressed interest expense due to the aggressive rate cuts by the Central Bank. Surprisingly a loss on sale of securities was booked by the bank worth PKR 51mn during 2Q. The loss during 1HCY20 on sale of securities was down 68% YoY. As per management the capital loss was booked on previously impaired securities. The bank saw a contraction of 7%, 37% and 14% YoY during 1HCY20 in its fee, dividend and FX operations income, respectively. Fee income took a 19% QoQ hit following various SBP relief measures for customers in the wake of the COVID-19 outbreak. The bank booked hefty provisioning charges this quarter worth PKR 3.3bn, up 143% YoY / 323% QoQ. Significant expenses were booked in spite of reversals against equity impairments and as per management, the bank has taken a prudent stance to build up coverage in order to cushion any stress on its portfolio. Total provisioning settled at PKR 4.1bn during 1HCY20 with a general charge being booked worth PKR 4bn. Impressive control on costs continued with OPEX staying stagnant YoY during 1HCY20 whilst declining 3% QoQ. CIR stands at 42% during 1HCY20 against 51% SPLY. Effective tax rate was 41% during 1HCY20.

Exhibit: 02 Financial Highlights

PKR mn	1HCY20A	1HCY19A	YoY	2QCY20A	2QCY19A	YoY	QoQ
Interest Earned	80,409	63,418	27%	38,752	34,082	14%	-7%
Interest Expense	42,156	33,839	25%	17,785	18,841	-6%	-27%
NII	38,253	29,580	29%	20,967	15,241	38%	21%
NFI	7,627	8,385	-9%	3,459	4,595	-25%	-17%
Total Income	45,879	37,965	21%	24,426	19,835	23%	14%
OPEX	19,369	19,282	0%	9,551	9,592	0%	-3%
Provisions	4,076	907	349%	3,296	1,356	143%	323%
PBT	22,847	17,975	27%	11,731	8,931	31%	6%
Taxation	9,373	7,554	24%	4,867	3,519	38%	8%
PAT	13,425	10,422	29%	6,801	5,435	25%	3%
EPS (PKR)	11.33	8.79		5.74	4.59		
DPS (PKR)	5.00	8.00		-	4.00		

Source (s): Company Financials, AHL Research

Financial Highlights

MCB Bank Ltd. (MCB)

PKR bn	CY18A	CY19A	CY20E	CY21F	CY22F
Income Statement Items					
Mark-up Earned	87.5	148.1	143.4	131.8	138.9
Mark-up Income	48.0	63.7	73.0	76.0	75.6
Admin Expense	35.7	37.7	40.5	44.3	48.9
Provisions	-0.8	2.7	7.2	3.2	2.1
Pre-Tax Profit	30.8	39.8	45.0	49.3	47.3
Profit After Tax	20.4	23.5	27.4	30.0	30.6
Balance Sheet Items					
Advances	567	548	575	604	684
Deposits	1,122	1,227	1,352	1,435	1,613
Investments	754	757	944	990	1,115
Borrowings	223	93	162	158	177
Total Equity	151	171	182	185	188
Total Assets	1,585	1,612	1,827	1,913	2,122

Current Price			171.0	**Upside**		36%
Target Price			231.7	**Stance**		BUY
	Unit	**CY18A**	**CY19A**	**CY20E**	**CY21F**	**CY22F**
Per Share						
Earnings*	PKR	17.2	19.9	23.1	25.3	25.8
Earning Growth	%	(7.3)	15.6	16.3	9.5	2.2
Dividend	PKR	16.0	17.0	20.0	20.0	21.0
Book Value	PKR	127.1	144.0	153.3	155.9	158.3
Valuation						
P/E	x	11.3	10.3	7.4	6.8	6.6
DY	%	8.3	8.3	11.7	11.7	12.3
P/B	x	1.5	1.4	1.1	1.1	1.1
RoE	%	13.3	14.6	15.5	16.4	16.5
RoA	%	1.4	1.5	1.6	1.6	1.5
ADR	%	54.6	54.4	49.7	46.2	45.7
IDR	%	67.2	61.8	69.8	69.0	69.1
NIMs	%	3.8	4.7	5.1	4.8	4.4

Source: Company Financials, AHL Research

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Arif Habib Limited (AHL) uses three rating categories, depending upon return form current market price, with Target period as June 2021 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 +10% from last closing of market price(s)
HOLD	Upside* of subject security(ies) is between -10% and +10% from last closing of market price(s)
SELL	Upside* of subject security(ies) is less than -10% from last closing of market price(s)

* Upside for Power Generation Companies (Ex. KEL) is upside plus dividend yield.

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)**
- **Reserve 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**

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Disclosure required under Research Analyst Regulations, 2015:

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

- Analyst and Close relative of analyst have shareholding in MCB.