Banking Sector Update

3Q CY09 trends support positive outlook for 2010

Pakistan banks reported in-line or above consensus 3Q CY09 earnings. For our coverage banks, the overall profitability rebounded sharply by 26% QoQ underpinned by i) sharp drop in credit provisions 2) positive surprise in NIMs in the quarter under review 3) trading gains from strong capital markets and 4) controlled opex growth +2% YoY. Consequently, the average ROE and ROA improved 181bps and 27bps to 17.6% and 1.8% respectively. Within our coverage banks, ABL led the pack with the highest ROE at 29% followed by MCB at 25%.

Asset Quality – Stress seems to be easing off
Recent quarterly data reveals sequential easing in fresh NPL accumulation as growth receded to 4.8% or PKR 9.3bn for our coverage banks compared to average quarterly buildup of 8% QoQ growth or PKR 13bn in the 1Q and 2Q CY09. However, despite slowdown in NPL buildup the NPL/Gross Advances ratio increased on account of seasonal contraction in loans during the 3rd quarter. Total provisions for our coverage banks declined by 38% QoQ while Provisions/Gross Advances ratio eased considerably by 26bps to 0.48%.

NIM surprise on the upside in 3Q CY09
Last quarter banks saw net interest margins reverse course, expanding by 5bps on average to 6.1%. NIM expansion was mainly a result of funding costs declining faster than asset yields. The drop in funding costs was mainly due to i) downward repricing of term deposits as a result of previous rate cuts and ii) shifting mix towards CASA deposits. Within our coverage banks, ABL and UBL posted the highest improvement in CASA mix at 5.2% and 6.0% respectively while NBP registered a decline of -5.8% in CASA deposits.

Loan growth to pick-up in coming quarters
With current focus on economic stabilization rather than growth, fundamental factors are not indicative of a rapid expansion in loan books to historical levels of 20% range. However, a sequential recovery in loan growth is on the cards given i) 4-5% growth in 4Q CY09 inline with seasonal patterns ii) easing interest rates iii) demand from energy sector iv) revival in working capital loans given higher commodity prices and v) higher trade related loans amid global recovery and vi) lower NPLs increasing banks lending appetite. Going forward we expect 10-12% growth in loans during CY10-CY11E.

Post 3Q CY09 earnings forecast adjustment
We have fine-tuned CY10-CY11 forecasts for our coverage banks in view of third quarter results. Key changes include i) lower credit cost forecasts given NPL slowdown and further relaxation by the regulator ii) increased NIM forecasts given higher KIBOR and decline in funding costs iii) lowered admin expense forecasts given lower than expected opex growth.We expect earnings for our cluster to decline by 10% in CY09 and register strong earnings growth in CY10 at 24%.

Sector Stance Neutral – Stock selective approach
The banking sector has more than doubled in YTD CY09 and IGI Universe has rallied 17-118% in absolute terms and has outperformed the benchmark KSE100 index by 47% on average. Our Gordon Growth valuations cost of equity is 18% while sustainable ROE ranges from 13-23%. The implied PB multiples range from 0.4-2.1x. Concerns over asset quality and slowing credit growth that were a major overhang on bank stocks are now receding as macro/NPL outlook continues to improve. At current levels, our universe trades at average forward PE and PB of 8.3x and 1.2x respectively and we maintain a neutral stance on the sector. We maintain a neutral stance on MCB, ABL and HBL while a Buy stance on NBP, UBL and BAFL.

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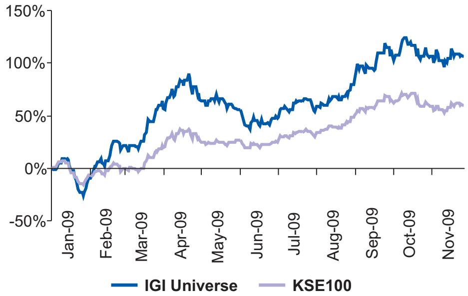
IGI Universe Banks

	CY07A	CY08A	CY09E	CY10E
Div Yield	4.9%	3.7%	4.6%	6.4%
P/E (x)	7.9	9.0	8.3	6.7
P/B (x)	1.6	1.5	1.2	1.1
ROE	23%	18%	16%	17%
ROA	2.1%	1.8%	1.6%	1.8%
NIM	5.5%	5.6%	5.9%	5.3%

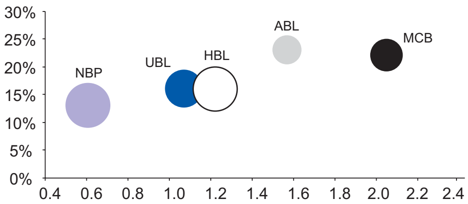
Source: Company Reports & IGI Research

Sector Price Performance



Source: Bloomberg

ROE-PB Comparison



Source: IGI Research

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IGI Securities

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3Q CY09 Earnings rebound sharply – Signs of a Turnaround

IGI Universe Earnings - 9M CY09

	9M CY09	9M CY08	Change
NII	132,839	112,445	18%
Provisions	34,779	16,805	107%
Non-Interest Income	39,870	42,331	-6%
Operating Expense	69,551	61,664	13%
PBT	68,837	76,306	-10%
PAT	45,353	50,419	-10%

Source: Company Reports & IGI Research

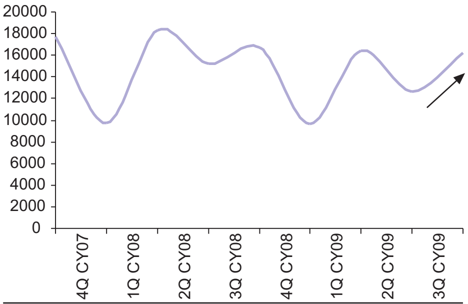
IGI Universe Earnings - 3Q CY09

	3Q CY09	2Q CY09	Change
NII	44,584	43,861	2%
Provisions	9,772	15,888	-38%
Non-Interest Income	12,550	15,050	-17%
Operating Expense	23,568	23,030	2%
PBT	24,252	19,993	21%
PAT	16,296	12,891	26%

Source: Company Reports & IGI Research

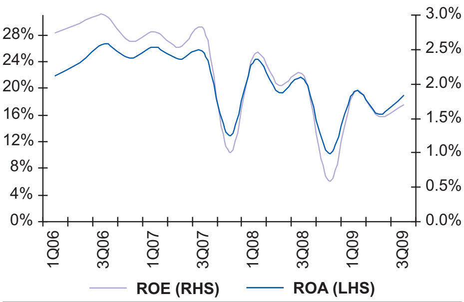
Pakistan banks solid third quarter earning season predict that macro/NPL headwinds may now be leveling off. For our coverage banks, in 3Q CY09 the overall profitability rebounded sharply by 26% QoQ. The recent earnings improvement resulted mainly from i) sharp drop in credit provisions 2) positive surprise in NIMs in the quarter under review 3) trading gains from strong capital markets and 4) containment of cost/income ratios. Consequently, the quarter witnessed positive ROE and ROA momentum up by 181bps and 27bps to 17.6% and 1.8% respectively. Within our coverage cluster, ABL led the pack with the highest ROE at 29% followed by MCB at 25%. Line by line analysis reveals that key variables driving valuation outperformance e.g. macro conditions, NIMs, and asset quality are showing material sequential improvement. For analysis purpose, we have used our coverage banks (NBP, HBL, UBL, MCB, ABL and BAFL) as the proxy for the sector.

Quarterly Earnings Trend



Source: Company Reports & IGI Research

IGI Universe - ROE and ROA

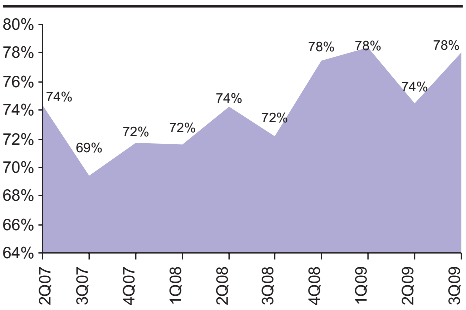


Source: Company Reports & IGI Research

NII registers double digit growth; but run rate slows

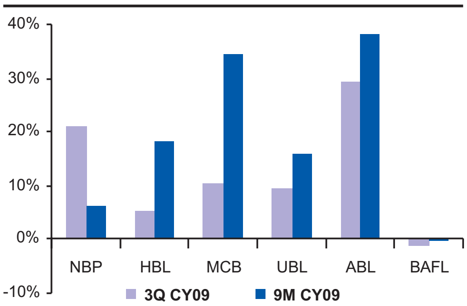
On a year-on-year basis, net interest income (NII) for IGI Universe banks increased by 12% YoY to PKR 44.6bn as against 39.8bn last year underpinned by 11% growth in interest earning assets and stable NIMs (6.1%). However, as illustrated in the graph below, on a sequential basis, YoY growth in NII is slowing on the back of strong base effect, declining yields and slow loan growth. Meanwhile, on a QoQ basis, 2% growth in NII resulted from funding costs declining faster than asset yields. During the quarter, rate of asset yield contraction slowed as KIBOR inched up and stabilized at 12.5% level while funding costs came down on downward re-pricing of term deposits and shifting of deposit mix in favor of low cost CASA deposits.

IGI Universe - NII/Total Income



Source: Company Reports & IGI Research

Net Interest Income Growth



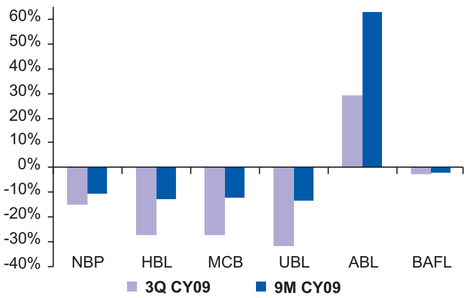
Source: Company Reports & IGI Research

IGI Securities

Non-Interest Income – a drag on operating earnings

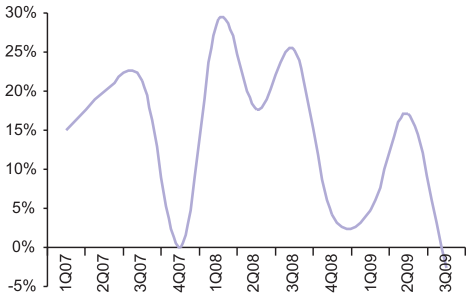
Total non-interest income declined 18% YoY to PKR 12.5bn in 3Q CY09 as compared to 15bn last year. Sluggish non-fund income resulted in its share in gross income decline to 22% in Sep09 as against 26% and 28% in Jun09 & Dec08 respectively. The key swing factor which has led to sharp fall in non-fund income is the lower FX dealing gains in 3Q CY09. Last year, during 2H CY08 banks booked strong exchange gains on the back of unusual currency/interest rates volatility. However, on the back of relatively stable PKR, forex gains declined 53% YoY. Secondly, fee income also remained under pressure on account of slowdown in loan growth and lower trade volumes. For our coverage banks, total fee income declined 3% YoY and 19% QoQ to PKR 6.5bn.

Non Interest Income Growth



Source: Company Reports & IGI Research

Fee Income Growth

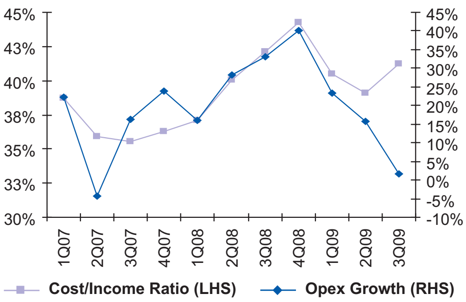


Source: Company Reports & IGI Research

Stable if not improving cost ratios

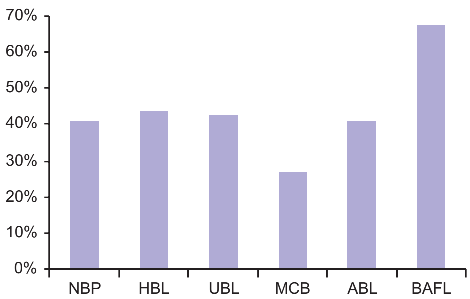
In the past 12 months banks have faced increased macro and P&L headwinds alongside slowing core business activity. Key challenges included passive credit growth, high NPL formation and credit costs and inflation driven operating costs. Hence, amid limited avenues for growth banks are being forced to implement strong opex controls by limiting increase in number of branches and staff costs. On a consolidated footing, banks in our coverage fared well in controlling admin expenses both on YoY and QoQ basis, which has led to stable cost/income ratio at 40% for our coverage banks. Within our cluster, cost/income ratio containment is clearly visible though HBL and BAFL relatively lagged behind in this front.

IGI Universe - Cost Trends



Source: Company Reports & IGI Research

Cost/Income Ratio - 3Q CY09

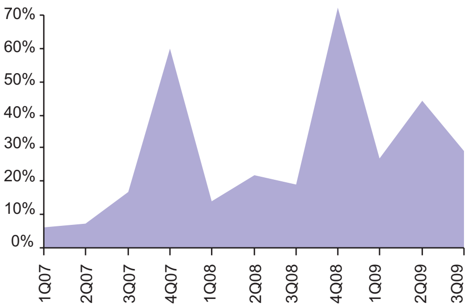


Source: Company Reports & IGI Research

Credit costs already peaked; AFS risk largely over

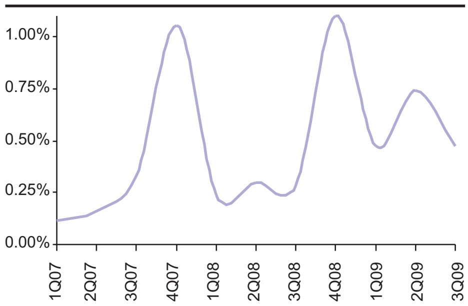
Trailing four quarters earnings were hit mainly by sharp rise in credit costs and impairment losses on equity investments. The burden on both counts has fallen substantially in 3Q CY09 at total provisions for our coverage banks declined by 38% QoQ while Provisions/Gross Advances ratio eased considerably by 26bps to 0.48%. Going forward, on the back of our outlook for reduced stress on asset quality, we believe provisions charges should move in-line with improving asset quality. Secondly, additional FSV benefit and upgrade of NPLs upon restructuring will further cushion credit provisions. Finally, absence of additional impairment losses on AFS securities will further lower provisioning requirement in the coming quarters.

Provisions/Operating Profits



Source: Company Reports & IGI Research

LLP/Gross Loans



Source: Company Reports & IGI Research

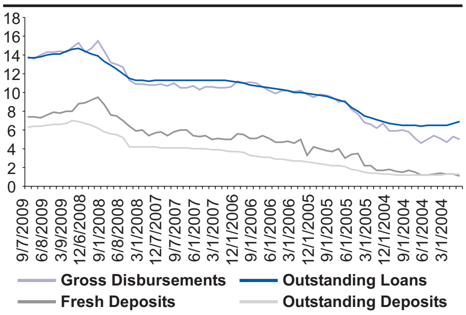
Quarterly earnings surprise in 4Q CY09 as well

The last quarter of CY08 was one of the worst for the banking sector in terms of profitability. Staggering increase in NPLs and the massive 60-70% decline in market value of banks AFS equity investment portfolio required banks to recognize record credit provisions and impairment losses in the P&L. For our coverage banks, the charge amounted to PKR 22.3bn higher 271% QoQ and 21% YoY. However, 46% or PKR 10.2bn of provisions were attributable to diminution in value of AFS investments which is no longer a concern. Secondly, the recent NPL growth has slowed down to 4-5% range and regulator has further eased effective provisioning requirements. Consequently, with no impairment charge expected and reduced credit provisions we expect 4Q CY09 to post strong growth.

Spreads firm at 7.51% in 10mo CY09

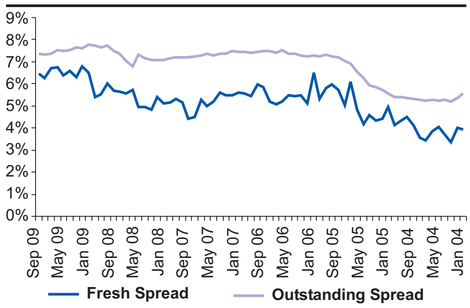
The banking system's average spread during 10mo CY09 is up 30bps YoY to 7.51% as compared to 7.21% in the corresponding period last year. During YTD CY09, the average cost of deposits surged 165bps to 6.57% while, backed by higher KIBOR, the average lending rate was up by 190bps to 14.28% - resulting in net spread expansion. However, the MoM trend posted a positive surprise as spreads inched up 9bps to 7.41% after bottoming out in Aug09. Since Aug09, asset yields are up 6bps as KIBOR upturned its decline while deposit costs are down 15bps as low credit appetite gives banks to adjust funding mix. Going forward, with our assumption of average KIBOR at 11.5-12% level and improved liquidity keeping deposits competition low; we expect spreads to remain sticky.

Lending & Deposit Rates



Source: SBP

Banks Spreeds

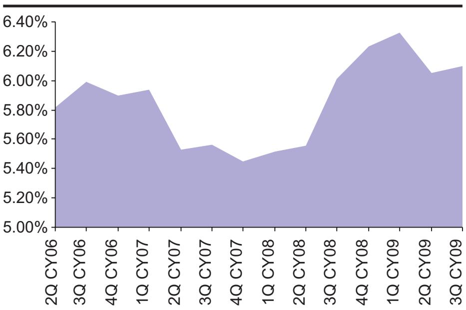


Source: SBP

NIM surprise on the upside in 3Q CY09

Net interest margins for our coverage banks stabilized during Jul-Sep09 at 6.1%; a marginal improvement of 5bps QoQ. The NIM stabilization mainly resulted from two factors. Firstly, the asset yields adjustment inline with lower market rates slowed as the KIBOR reversed its downtrend and stabilized around 12.5% level. Secondly, the major impetus came from the liability side as cost of funds declined during the period. Banks managed to lower their deposit costs by increasing the proportion of low cost CASA deposits and downward re-pricing term deposits inline with market rates. Assets yields are re-priced fairly quickly inline with market rates while deposit re-pricing takes place with a lag. Apart from relatively stable funding costs, lower NPL growth further aided NIM stabilization. Within our coverage banks, ABL and UBL posted the highest improvement in CASA mix at 5.2% and 6.0% respectively while NBP registered a decline of -5.8% in CASA deposits.

IGI Universe - Quarterly NIM Trend



Source: Company Reports & IGI Research

Improving CASA

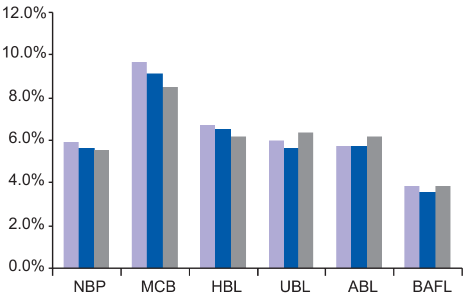
	NBP	HBL	UBL
Dec-08	69.0%	70.4%	59.0%
Sep-09	63.2%	72.0%	65.0%
Change	**-5.8%**	**1.6%**	**6.0%**

	MCB	ABL
Dec-08	81.4%	50.5%
Sep-09	84.0%	55.7%
Change	**2.6%**	**5.2%**

Source: Company Reports & IGI Research

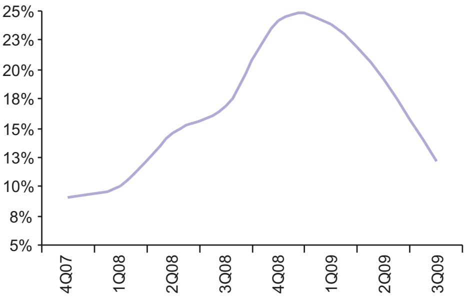
IGI Universe Trends – NIM and Non-fund Income

NIMs - IGI Universe



Source: Company Reports & IGI Research

IGI Universe - NII Growth



Source: Company Reports & IGI Research

NBP: Total revenues (NIM + non-fund) remained stable at PKR 39.9bn and PKR 13.98bn during 9M & 3Q CY09. During the third quarter, revenues were up 7% YoY and 9% QoQ mainly on account of higher interest income while non-interest income remained depressed in the 3rd quarter. During 3Q CY09, NBP's net interest income (NII) increased by a strong 21% YoY to PKR 9.7bn. The key driver behind NII growth is 17% rise in earning assets and an estimated 16bps NIM expansion over Sep08 levels. However, growth in interest based revenue was mostly offset by lower non-fund based income which declined 15% YoY to PKR 4.3bn. This decline comes mainly on the back of 40% lower dividend income from NIT and absence of non-recurring PKR 1bn tax refund gain which shored up the other income in Sep08.

HBL: HBL reported aggressive growth of 19% YoY in net interest income to PKR 31.9bn on the back of 60bps expansion in average NIMs to 6.5% and 10% growth in earning assets from Sep08 levels. However, 3Q CY09 number reveals a receding NIM outlook as asset yields adjust inline with declining market rates while cost of funding remains sticky. Meanwhile, non-fund income in 9M CY09 declined 10% to 8.4bn on account of lower FX gains and dividend income.

MCB: NII growth has been slowing due to declining asset yields and slow down in loan growth. MCB's 3Q net interest income increased 10% YoY but declined 5% QoQ to PKR 8.5bn on the back of slowing earning assets growth and lower net interest margin (NIM). MCB's NIM receded sharply by around 60bps to 8.4% during the third quarter on account of i) lower asset yields as loans adjust immediately to lower KIBOR while deposit repricing takes place with a lag ii) portfolio shift toward relatively low yielding government papers owing to pent-up credit growth iii) funding costs downward sticky due to 5% minimum deposit rule (47% saving deposits) iii) and subdued impact of downward repricing of term deposits as fixed deposit constitute only 16% of deposit mix.

UBL: Total pre-provision operating profits (PPOP) remained stable at PKR 19.57bn, 8% higher YoY but down 5% QoQ in 3Q CY09. The strength in operating earnings derives from stable NIM at 6.4% and effective operating cost controls. UBL's net interest income grew by 15% YoY to PKR 24.57bn on account of 8% growth in earning assets and higher asset yields. On the back of higher Kibor, the yield on earning assets went up 130bps to 12.1% which more than offset the negative impact from higher cost of funding at 5.7% (Sep08: 4.5%), resulting in marginal NIM expansion of 10bps to 6.4%. Meanwhile during 9M CY09, non-fund based income remained lackluster declining 11% YoY to PKR 8.7bn. This decline is mainly attributable to i) lower fee income down 15% YoY to PKR 4.66bn and ii) lesser gains on FX income due to reduced PKR volatility compared to last year. Whereas, the decline in fee based income ensues from lower corporate finance fees and 35% reduction in commission on consumer loans owing to net attrition in retail lending.

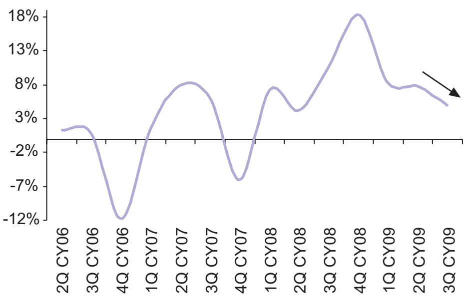
ABL: ABL's 9M CY09 net interest income grew aggressively by 38% YoY to PKR 13.6bn on the back of higher interest rate spreads and 16% growth in earning assets from Sep09 levels. The key driver behind revenue growth is an estimated 90bps YoY expansion in average NIMs to 5.8%. Non Interest Income increased by 61% YoY to PKR 4.7bn in 9M CY09 on higher fee income, dividend income and capital gain on sale of securities due to bull run in the stock market.

BAFL: During 9M CY09, BAFL posted weak operational performance as net interest income (NII) remained flat at PKR 8.1bn while the non-fund based income dipped 2% to PKR 4.1bn. Average NIMs during Jan-Sep09 declined 20bps to 3.8% as higher asset yields were more than offset by rise in cost of funding. However, from a quarterly standpoint, during 3Q CY09, interest margins posted a sequential improvement of 20bps due to rationalization of cost of funds on account of shedding some expensive term deposits, mobilized during the Oct08 liquidity crisis. Meanwhile, the non-interest income declined 2% YoY to PKR 4.1bn as a result of 11% decline in fee income. Reduction in fee based income ensues from slower core business activities and decrease in commissions on consumer loans owing to net attrition in retail lending.

Asset Quality – Stress seems to be easing off

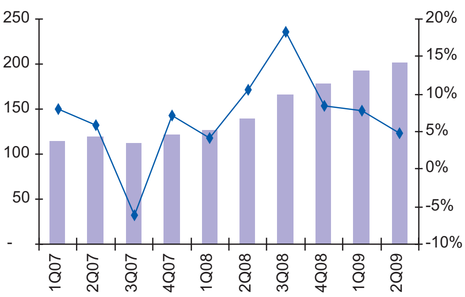
Recent quarterly data reveals sequential easing in fresh NPL accumulation as growth receded to 4.8% or PKR 9.3bn for our coverage banks, compared to average quarterly buildup of 8% QoQ growth or PKR 13bn in the 1Q and 2Q CY09. However, despite slowdown in NPL buildup, the NPL/Gross Advances ratio increased on account of seasonal contraction in loans during the 3rd quarter. NPL ratios for NBP, MCB and UBL and BAFL increased by 68-120bps QoQ while were flat for HBL and ABL. Going forward, we believe NPLs trajectory to continue improving on high base effect, improving fundamentals, benefits from rate cuts. However, NPL ageing effect still remains a concern.

IGI Universe: Quarterly NPL Growth Trend



Source: Company Reports & IGI Research

IGI Universe - NPL Growth



Source: Company Reports & IGI Research

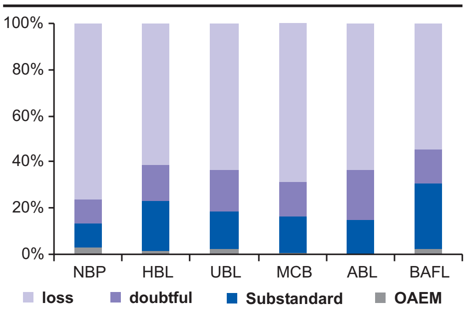
Further Relaxation of provisioning requirement

The State Bank of Pakistan (SBP) has provided another breather to the banking sector by further relaxing the effective provisioning requirements. The benefits include i) increasing FSV benefit of mortgage commercial & residential properties and pledged stocks by 10% (from 30% to 40%) against NPLs less than 3yrs old ii) 40% FSV benefit on industrial assets (excluding plant & machinery) iii) relaxing provisioning criteria for rescheduled NPLs by allowing to upgrade by one classification category; thus lowering the effective provisioning rate. The relaxation on the FSV front is likely to have the most impact on HBL and NBP estimated at PKR 1.7 and PKR 1.1 per share respectively.

Ageing of bad loans a bigger concern

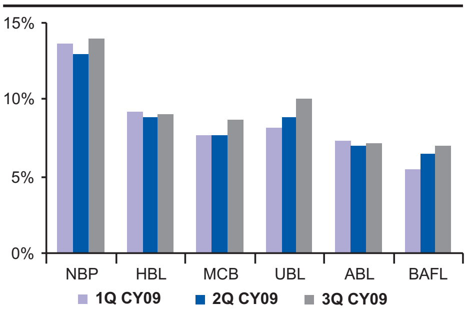
SBP loan classification is based on the classification of nonperforming loans into substandard loans (more than 90 days outstanding), doubtful (180–360 days outstanding) and loss loans (more than 360 days outstanding) with statutory provisioning requirements of 25%, 50% and 100% for the three categories respectively. For our coverage banks, NPLs in partial provisioning categories (Substandard & Doubtful) constituted 24%-45% of total NPLs with BAFL and HBL being most exposed to the ageing effect in the coming quarters. This trend indicates that in periods ahead, banks have to provision more for additional loan losses. Provision expense is likely to peak in CY09E owing to change in buckets i.e. loans going down to the loss category require additional provisioning.

IGI Universe - NPL Profile



Source: Company Reports & IGI Research

NPL Ratios



Source: Company Reports & IGI Research

Exposure to sensitive sectors on the decline

Pakistan banks have sizeable exposure to sensitive sectors including textile and retail segments. Recently, the sugar crisis and breaking up of cement cartel has brought the asset quality profile of these sectors in limelight as well. Although, banks have exposure in TFCs, loans to cement and sugar sectors constitute 2% each of the total loans and NPLs. Exposure to Textiles and retail is on the decline since CY07 and Textile and Consumer sector constitute 17.6% and 13% of total advances while their share in NPL is higher at 28.7% and 11.1% respectively. Within IGI Universe bank s BAFL (25%), UBL (23%) and NBP (16%) have the highest exposure to retail while HBL (20%) and ABL (20%) have the highest exposure to the risky textile sector.

Segment Exposure

	NBP	HBL	UBL	MCB	ABL	BAFL
Textile Loans (PKR bn)	67	96	66	35	45	30
Textile NPLs (PKR bn)	18.0	11.0	6.2	2.9	2.2	2.2
Textile (% of total loans)	15%	20%	17%	13%	20%	17%
Textile NPL Ratio	27%	11%	9%	8%	5%	7%
Retails Loans (PKR bn)	74.8	32.0	92.0	32.7	5.5	44
Retail NPLs (PKR bn)	3.0	1.0	8.5	1.4	0.2	2.5
Retail (% of total Loans)	16%	7%	23%	12%	2%	25%
Retail NPL Ratio	4%	3%	9%	4%	3%	6%
Cement Loans (PKR bn)	10,463	15,105	5,748	4,986	13,174	3,371
Cement NPLs (PKR bn)	2,506	500	32	0.3	n/a	3
Cement (% of total loans)	2%	3%	1%	2%	6%	2%
Cement NPL ratio	24%	3%	1%	0%	-	0%
Sugar Loans (PKR bn)	7,481	5,722	7,126	6,490	4,386	2,872
Sugar NPLs (PKR bn)	1,721	615	35	388		
Sugar (% of total loans)	2%	1%	2%	2%	2%	2%
Sugar NPL ratio	23%	11%	0%	6%	-	-

Source: Company Reports & IGI Research

Pakistan banks limited exposure to UAE

Amongst Pakistan banks, UBL is the only bank with strong presence in the UAE. Last week's announcement by Dubai World of debt restructuring and delaying payments has rattled domestic investors bringing in spotlight the risk of fresh UAE led NPLs hits for UBL. As per Sep09 financials, UBL's total international loan exposure is PKR 89bn out of which 67% or PKR 60bn is in UAE. The international portfolio mix includes 70% corporate while contribution from consumer constitutes 30%. The international loan book has 37% real estate exposure out of which 21% is project/infrastructure financing while 15% are mortgages. Meanwhile, specific exposure to DP world is USD 20mn or PKR 1.7bn which amounts to 2% of UAE book and 0.3% of total book.

We believe this negative trigger could weigh down on the share price in the short term. However, UBL's international portfolio has fared better than the domestic portfolio as no systemic hits have been reported till date while international NPL ratio at 5% is much lower compared to domestic NPL ratio at 12%. Moreover, around 90% of international NPLs are covered. As of Sep09 financials, the total overseas NPLs were PKR 4bn out of which around PKR 1.45bn were added in 9M CY09. Meanwhile, on the provisioning front (credit costs & Impairments) UBL has booked PKR 1.34bn provisions on the international portfolio.

IGI Universe Banks – NPLs and Provisioning

NBP: In terms of underlying performance, during the 3rd quarter NBP for the first time in YTD CY09 managed to register positive growth in pre-provision operating profits (PPOP) on year-on-year basis; up 6% YoY to PKR 8.5bn. However, loan loss provisions jumped by a stellar 112% YoY to PKR 3.56bn as compared to PKR 1.68bn earlier. NPL buildup continued at a steady pace with PKR 3.4bn added in this quarter (YTD: PKR 11.72bn). Moreover, although the QoQ NPL accretion was inline with our assumption of 5%; higher than expected provisioning charge is attributed to NPL ageing i.e. more than expected NPLs falling into the loss category than our base case forecast.

NBP's AFS equity investment portfolio exceeded the net book value providing potential for reversal of impairment charge. Hence, NBP booked a reversal of PKR 0.37bn recovering provisions booked in earlier quarters and reducing the net provisions by 10% to PKR 3.19bn. Secondly, NBP also utilized the recently allowed relaxation of 40% benefit of FSV of Industrial assets which reduced credit provisions by PKR 1.04bn (after-tax impact PKR 0.63 per share).

HBL: As of Sep09, HBL had PKR 45.2bn in non-performing loans on its books. That represents an increase of PKR 11.2bn or 33% YoY while the NPL ratio has surged to 8.9%. Hence, due to fresh NPL hits and NPL ageing, the provisioning expense surged 2.4x to PKR 6.5bn as compared to PKR 2.75bn earlier. However, 3Q CY09 data reveal easing asset quality pressures as QoQ NPL accretion and provisioning declined by 33% and 58% respectively. We expect credit provisions to peak in CY09E amid NPL ageing as 38% of NPLs are in substandard and doubtful category. Meanwhile, loan loss coverage improved 280bps to 74% in Sep09 as higher NPLs fell in the loss category due to ageing.

HBL holds 6.82% stake in Platinum Habib Bank of Nigeria; PHB Bank has witnessed deterioration in asset quality as a result of the market conditions in Nigeria. This will lead to the dilution of HBL's investment value in this holding. According to recently announced Sep'09 results (NOTE 6.2), the Central Bank of Nigeria (CBN) in its report dated October 02, 2009 has identified additional provisioning requirement against non performing loans of which HBL's share amounts to PKR 4bn. The additional provisioning will affect HBL's consolidated profitability in the 4Q CY09 as the value of investment is adjusted to reflect the investor's share of the net profit or loss of the associate (investee). The per share impact on consolidated P&L and book value amounts to PKR 2.5-3.0 per share.

MCB: The NPL accumulation which sustained at an alarming pace from Jun08 to Jun09, averaging 1.9bn per quarter, subsided as incremental NPL formation declined 48% to PKR 0.8bn. Given the current stabilization on the macro front, we expect sequential improvement in asset quality to continue in the coming quarters. During 3Q CY09, credit provisions were up 48% YoY, however, from a quarterly standpoint credit costs halved vis-à-vis 2Q CY09 to PKR 1.1bn. As of Sep09, MCB's NPL ratio stood at 8.6% while 68% of the NPLs were provisioned.

UBL: While operating performance remained steady, bottomline was down 28% YoY due to 142% increase in total provision charge to PKR 9.38bn. Credit losses were witnessed across the board with corporates constituting 42% of credit costs while 25% and 14% coming from consumer and international segments. The much talked about Middle East exposure is concentrated in UAE (70%) and comprises of 70% corporate and 30% consumer loans. There have been no extraordinary setbacks reported in real estate laden international portfolio and overseas NPL growth has been inline with domestic trends; however, future losses from international consumer portfolio remain a key risk to valuations. The gross NPL ratio increased by 270bps from Dec08 levels to 10% and in the coming quarters credit risk pressures are likely to persist albeit at a slower pace.

ABL: Quarterly data reveals significant slowdown in fresh NPL buildup down 64% QoQ leading to lower credit costs in the 3Q. ABL's asset quality has fared better than the sector with NPL growth at 21% and 15% in CY08 and 1H CY09 respectively, lower compared to the sector in the same timeframe. Lack of retail presence is a positive for ABL in the prevailing environment however; oversized textile exposure (20%) remains a key downside risk. Going forward, given receding asset quality pressures and loan growth picking up in CY10 we expect NPL ratio to declined to 6.5% and LLP/Loans to decline to 0.9%.

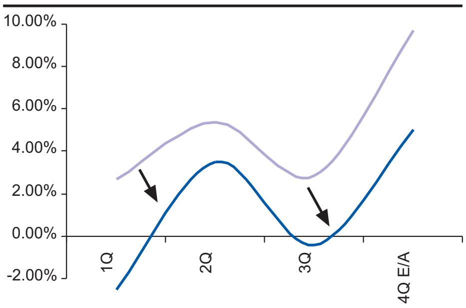
BAFL: In addition to a drag on revenue growth, BAFL's bottomline was further constrained by a massive 137% surge in provisions to PKR 2.2bn. In line with sectoral trends, slowing economic activities and rising interest rates resulted in fast paced NPL formation up by PKR 4.3bn or 48% YTD while the NPL ratio surged 260bps to 7.1%. Moreover, as of Sep09, BAFL's NPL coverage ratio stood at a low 60% and ageing of bad loans is a bigger concern. Currently, partial provisioning categories (Substandard & Doubtful) constitute 45% of total NPLs and provision expense is likely to peak in the following quarters owing to change in buckets i.e. loans going down to the loss category requiring 100% provisioning. However, the recently allowed FSV benefit is likely to provide some respite in terms of lower provisions as BAFL has yet to utilize additional 10% benefit on previously eligible collateral and 40% benefit of FSV of Industrial assets will reduce CY09E credit provisions by PKR 1.3-1.5bn (after-tax impact PKR 0.6-0.7 per share).

Lending and Deposit Growth

No respite in weakening loan growth

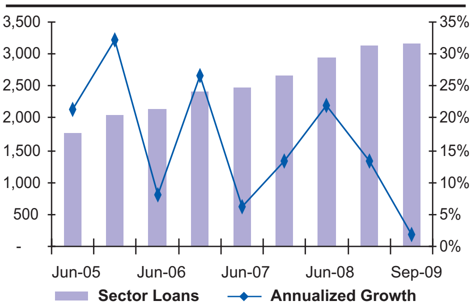
Loan growth in the system continued to weaken on both QoQ and YoY basis, with 3Q CY09 credit off-take down -0.5% to PKR 3.15tn. SBP data reveals that credit cycle has shown a significant downward shift with growth of just 0.4% in 9M CY09 as compared to 5yr average of CY03-CY08 of 12% on account of both demand and supply side bottlenecks. Although, the dull performance in 3Q was inline with established industry pattern of net retirement of credit by businesses in Jul-Sep period; however the quantum was noticeably sharper given a contraction in 3Q by -0.5% versus 5yr average QoQ growth trend of 2.9%. Sharp contraction in credit is attributed to decline in real GDP growth to 2-3% level, slower global recovery restraining exports, structural impediments like electricity/gas shortages and security issues, banks turning very cautious in lending practices on fears of asset quality, commodity prices sharply down YoY thereby lowering demand for working capital as well.

Quarterly Loan Growth



Source: SBP

Banking Sector Advances

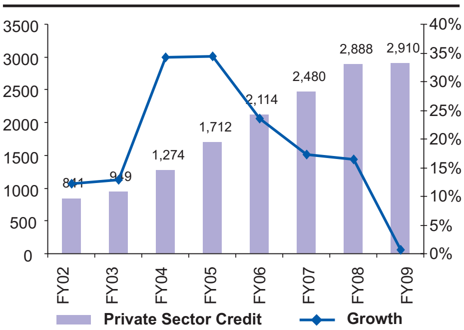


Source: SBP

Private Sector Lending slows sharply in YTD CY09

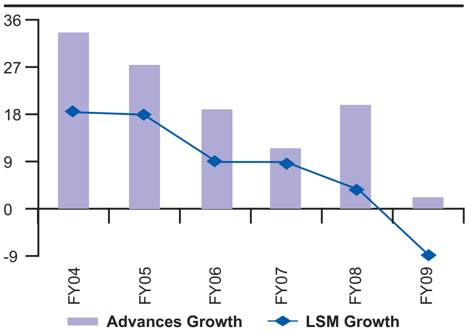
Private sector credit which has posted average 25% growth in FY03-FY08 remained sluggish YTD CY09 at PKR 2,907bn. Consequently, the share of private sector credit (PSC) in total credit declined from 61% to 53.3% in Nov09 due to sustained contraction in PSC as system liquidity flows into lending to government and public sector enterprises in CY09. Analysis reveals that the textile backed manufacturing sector which constitutes 57% of total private business loans witnessed sharp decline in credit on the back of disappointing performance of textiles. However, recent data reveals gradual recovery as LSM growth turned positive up 0.2% in 2M FY10 supported by the re-stocking of inventories and a small recovery in exports.

Private Sector Credit



Source: SBP

Manufacturing Sector



Source: SBP

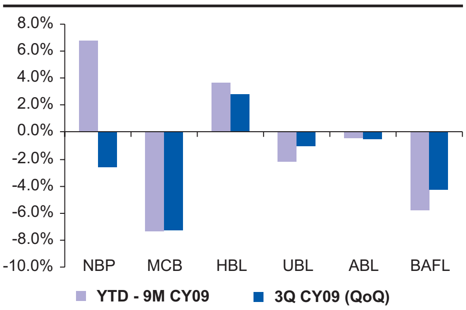
Lower working capital borrowings; Retail slide continues

As per SBP data during 3Q CY09, working capital loans which constitute around 50% of net system advances marked a decline of PKR 79bn mainly due to lower demand by Textiles, SMEs, and net retirement by sugar sector against pledged stocks. However, the declining trend in working capital loans was somewhat offset by increased disbursement in fixed investments which increased by 13.3bn during Jul-Sep09 mainly in the energy sector. Meanwhile, consumer credit which has been slowing down for past 2 years continues its downtrend; lower by 25% since Dec07 to PKR 278bn. The key reasons for the decline include i) high interest rates ii) inflationary pressures curbing purchasing power & demand for fresh loans and iii) banks cautious stance towards the high risk sector. Lastly, agri-credit is showing positive growth; rising by PKR 5.2bn or 9% during Jul-Oct CY09. SBP has set agricultural credit disbursement target of PKR 260bn in FY10 while the total outlay in FY09 by banks amounted to PKR 233bn.

Expected slowdown in loan growth for IGI Universe banks

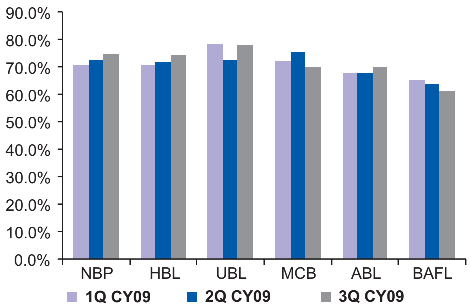
In line with sectoral trends, four of the six banks in our coverage (MCB, UBL, ABL, and BAFL) saw their loan book shrink in 9M CY09 in the range of -2.2% to -7.3% while NBP and HBL posted positive growth of 6.8% and 3.6% respectively. NBP being a government owned bank along with higher credit demand stemming from public sector led to high-paced loan growth focused on commodity operations. The positive implication of stalled lending growth was in the form of improved liquidity as the ADR ratio of our coverage banks eased.

IGI Universe - Advances Growth



Source: Bloomberg

Advances/Deposits Ratio



Source: Bloomberg

Outlook - Road ahead depends on how the recovery shapes up

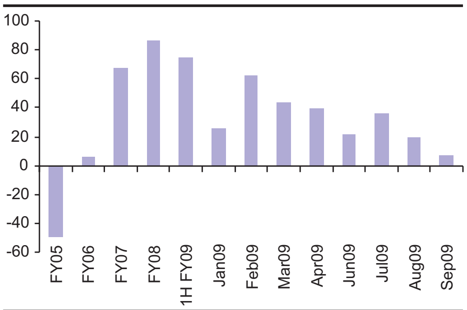
In terms of outlook, we have passed the trough of the economic cycle and leading indicators are showing signs of improvement given improved LSM sector, likely increase in global demand supporting exports, reduction in power deficit, lower credit risk & improved liquidity position of banks and declining interest rates. Against this backdrop, latest SBP data reveals that although the cumulative flow of credit to private sector during the first nineteen weeks of FY10 shows retirement of PKR 3bn, it has increased significantly in the past seven weeks by PKR 92bn. We foresee 4-5% growth in the 4Q inline with industry's established patterns for the last quarter. Secondly, although we have past the worst crisis, the credit offtake will depend on how economic recovery shapes up and we don't expect any strong reversion to historical growth averages in 20% range but more of a gradual uptick in credit expansion.

Deposit growth outstrips credit expansion

During 9M CY09, deposit growth outperformed the muted loan growth with fresh mobilization growing by 9.5% or PKR 362bn to PKR 4,162bn. Although deposit expansion remained slow in the 1Q CY09 at 2%; however, it picked up during the second quarter to an impressive 6.4% on the back of improvement in NFA position and lower NSS rates by 70-140bps in Apr09. Whereas in 3Q CY09, growth slowed to 1% as seasonal slowdown in advances eased funding pressures allowing banks to focus on improving the CASA mix by shedding expensive deposits picked up in Oct-Dec08 liquidity crisis.

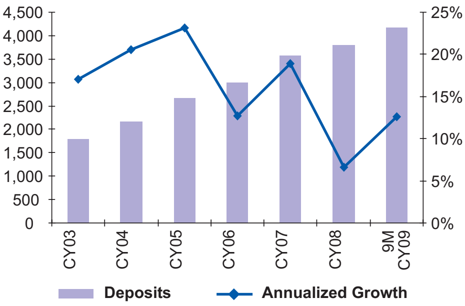
Savings mobilized by NSS declined sharply by 38% QoQ to PKR 62bn as compared to PKR 124bn and PKR 102bn in 1Q and 2Q CY09. Secondly, contraction in NFA of the banking system gradually eased as well due to relatively improved balance of payment position, persistent remittances momentum and fresh foreign portfolio inflows. These factors helped regain the growth momentum in line with historical trends at 7-8%. Of the banks in our coverage, NBP and MCB had the strongest deposit growth of around 10% while BAFL saw its deposits decrease by -2% during the period.

NSS Savings Decline



Source: SBP

Banking Sector Deposits

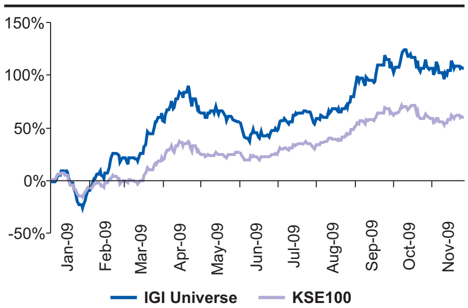


Source: SBP

Price performance - Key Outperformance Indicators Improve

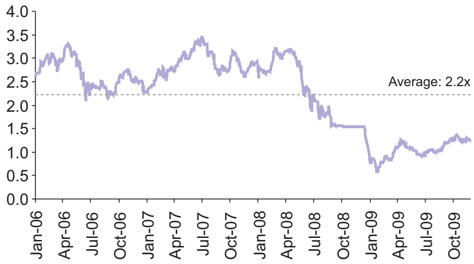
In 9M CY09, concerns over asset quality and slowing credit growth which were a major overhang on bank stocks are now receding as macro/NPL outlook continues to improve. The sector has re-rated from trough valuations in Feb09 and rallied on average by 107% in absolute terms while outperformed the benchmark KSE100 index by 47%. The share outperformance drivers including NIM, asset quality and earnings outlook are showing sequential improvement; however, we feels that most positives are priced in the current valuations. The banking sector is trading at PB fo 1.2x below 4yr PB average of 2.2x for IGI Universe. Despite the discount to LTM average we feel that credit risk, low loan growth and leading ROE under pressure still remain a major concern. We believe that overall sector is trading at fair multiples with some selective bargains on offer.

Sector Price Performance



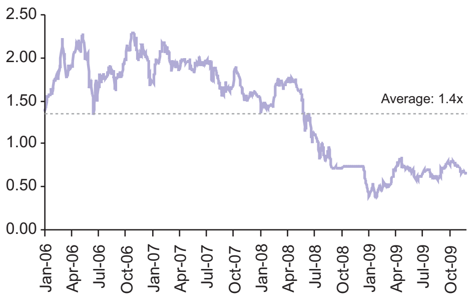
Source: Bloomberg

IGI Universe Banking Sector PB Band



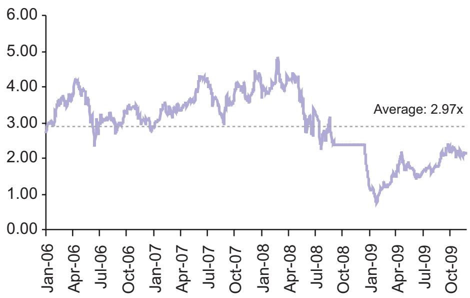
Source: Bloomberg

NBP PB Band



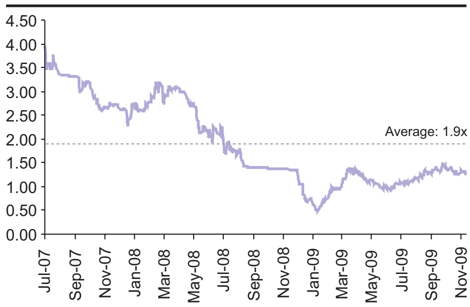
Source: Bloomberg

MCB PB Band



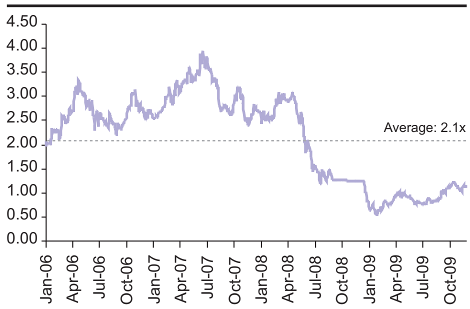
Source: Bloomberg

HBL PB Band



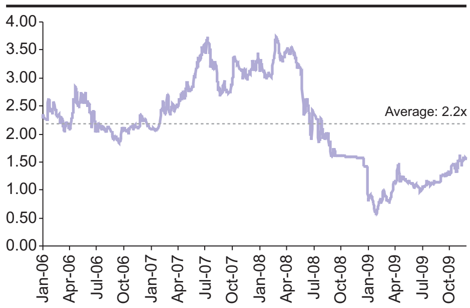
Source: Bloomberg

UBL PB Band



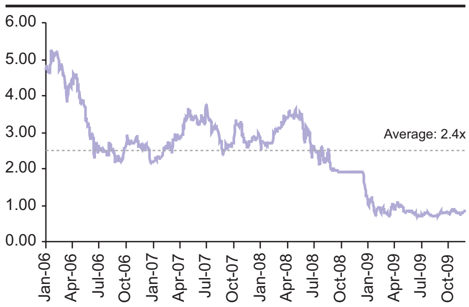
Source: Bloomberg

ABL PB Band



Source: Bloomberg

BAFL PB Band



Source: Bloomberg

Valuation and Rating

We have revised our valuation assumptions and estimates in light of the recent results. We have fine-tuned CY10-CY11 forecasts in view of third quarter results. Key changes include i) lower credit cost forecasts given NPL slowdown and further relaxation by the regulator ii) increased NIM forecasts iii) lower admin expense forecasts. We expect earnings for our cluster to decline 10% in CY09 while register strong earnings growth in CY10 at 24%. Our Gordon Growth valuations cost of equity is 18% while sustainable ROE ranges from 13-23%. The implied PB multiples range from 0.4-2.1x. We maintain a neutral stance on MCB, ABL and HBL while a Buy stance on NBP, UBL and BAFL. NBP currently trades at 30% and 50% discount to sector P/E and P/B and we feel stock offers positive risk-reward as lower operating profits and higher provisions are priced in. BAFL is showing sequential improvement in fundamentals while divestment of Warid Telecom stake is a key price trigger. We expect recent Dubai crisis to weigh down on UBL's share price in the short term but we maintain a positive outlook on LTM basis.

IGI Universe Banks

	CY07A	CY08A	CY09E	CY10E
Div Yield	4.9%	3.7%	4.6%	6.4%
P/E (x)	7.9	9.0	8.3	6.7
P/B (x)	1.6	1.5	1.2	1.1
ROE	23%	18%	16%	17%
ROA	2.1%	1.8%	1.6%	1.8%
NIM	5.5%	5.6%	5.9%	5.3%

Source: Company Reports & IGI Research

UBL - Financial Highlights **(Fair Value : 65)**

	CY07A	CY08A	CY09E	CY10E
EPS (PKR)	8.06	7.51	7.41	8.82
Div Yield	3.8%	3.1%	1.7%	6.3%
BVPS (PKR)	41.13	42.55	54.10	60.27
P/E (x)	7.18	7.71	7.82	6.57
P/B (x)	1.41	1.36	1.07	0.96
ROE	23%	17%	15%	15%
ROA	1.8%	1.4%	1.3%	1.4%
NIM	6.0%	5.8%	6.2%	5.6%

NBP - Financial Highlights **(Fair Value : 90)**

	CY07A	CY08A	CY09E	CY10E
EPS (PKR)	18.02	14.56	11.67	15.20
Div Yield	8.3%	7.9%	8.0%	8.7%
BVPS (PKR)	109.43	96.78	112.62	125.10
P/E (x)	3.81	4.72	5.89	4.52
P/B (x)	0.63	0.71	0.61	0.55
ROE	19%	14%	11%	13%
ROA	2.8%	2.0%	1.5%	1.7%
NIM	6.0%	5.9%	5.6%	5.1%

ABL - Financial Highlights **(Fair Value : 60)**

	CY07A	CY08A	CY09E	CY10E
EPS (PKR)	5.73	5.76	8.04	9.13
Div Yield	3.6%	3.6%	5.6%	6.2%
BVPS (PKR)	27.91	31.29	39.86	45.14
P/E (x)	10.88	10.83	7.76	6.84
P/B (x)	2.24	1.99	1.57	1.38
ROE	22%	19%	23%	21%
ROA	1.4%	1.2%	1.5%	1.5%
NIM	3.9%	4.1%	4.8%	4.2%

MCB - Financial Highlights **(Fair Value : 225)**

	CY07A	CY08A	CY09E	CY10E
EPS (PKR)	23.79	22.17	21.17	25.22
Div Yield	5.4%	3.9%	5.0%	5.5%
BVPS (PKR)	83.27	87.01	102.25	116.85
P/E (x)	8.82	9.46	9.91	8.32
P/B (x)	2.52	2.41	2.05	1.80
ROE	33%	26%	22%	23%
ROA	4.3%	3.6%	3.1%	3.3%
NIM	7.6%	8.0%	8.9%	7.8%

HBL - Financial Highlights **(Fair Value : 120)**

	CY07A	CY08A	CY09E	CY10E
EPS (PKR)	10.98	17.05	13.49	17.39
Div Yield	2.5%	3.8%	3.4%	4.2%
BVPS (PKR)	68.37	81.58	97.29	110.76
P/E (x)	10.85	6.98	8.83	6.85
P/B (x)	1.74	1.46	1.22	1.08
ROE	17%	22%	15%	17%
ROA	1.6%	2.2%	1.6%	1.8%
NIM	5.7%	6.0%	6.3%	5.8%

BAFL - Financial Highlights **(Fair Value : 15)**

	CY07A	CY08A	CY09E	CY10E
EPS (PKR)	2.32	0.96	1.44	1.97
Div Yield	5.9%	0.0%	3.7%	7.4%
BVPS (PKR)	12.02	12.63	17.64	19.37
P/E (x)	5.86	14.11	9.46	6.89
P/B (x)	1.13	1.08	0.77	0.70
ROE	22%	8%	9%	11%
ROA	1.0%	0.4%	0.5%	0.7%
NIM	3.6%	3.7%	3.6%	3.4%

Source: Company Reports & IGI Research

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Analyst Certification

I, Ahmed Raza Khan, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject, securities and issuers. I also certify that no part of our compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

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