Day Break

Monday, 16 April 2018

IGI Securities
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COMPANY UPDATE

Faysal Bank Limited
Commercial Banks

Recommendation		**BUY**
Target Price:		31.2
Last Closing:	13-Apr-18	25.5
Upside:		22.4
Valuation Methodology:		Residual Income / Asset based Valuation / Dividend Discount
Time Horizon:		Dec-18

Market Data

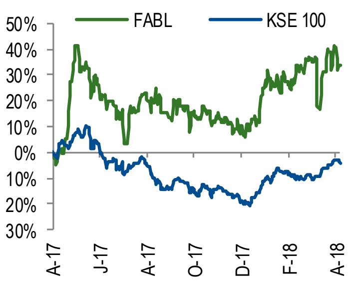
Bloomberg Tkr.		FABL PA
Shares (mn)		1,517.7
Free Float Shares (mn)		455.3
Free Float Shares (%)		30.0%
Market Cap (PKRbn | USDmn)	38.7	334.8
Exchange		KSE 100

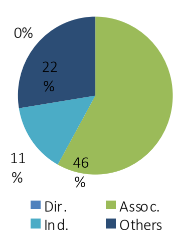
Price Info.	90D	06M	12M
Abs. Return	4.0	18.7	33.9
Lo	22.2	20.2	18.1
Hi	26.9	26.9	26.9

Key Company Financials
Period End: Dec

PKRbn	**CY17A**	**CY18E**	**CY19F**	**CY20F**
Total Revenue	19.6	21.9	25.6	28.1
Net Income	4.5	5.5	6.1	7.1
EPS (PKR)	2.97	3.62	4.02	4.67
DPS (PKR)	-	1.00	1.50	1.75
Total Assets	488.0	571.0	632.5	685.4
Total Equity	39.2	46.9	50.4	54.5
Key Financial Ratios				
ROE (%)	11.5	11.7	12.1	13.0
P/E (x)	8.6	7.0	6.3	5.5
P/B (x)	1.1	1.0	0.8	0.8
DY (%)	-	3.9	5.9	6.9

Relative Price Performance





About the Company

The Bank was incorporated in Pakistan on October 03, 1994 as a public limited company. The Bank is engaged in corporate, commercial and consumer banking. Ithmaar Bank B.S.C. a Bahrain based retail bank, is the parent company, holding 66.78% of the shareholding of the Bank.

Source: Bloomberg, PSX & IGI Research

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Commercial Banks

FABL: Well-thought-out strategy or mere bow to fate?

- Bank's profitability has more than doubled in 2017 to PKR 4.5bn since 2014 (PKR 2.1bn) when the new management took charge, led by management's a) focus on reducing overall operating expenses, and b) emphasis on expanding and simultaneously improving bank's asset quality.
- The bank as per management note, is now fully prepared to begin its conversion into full fledge Islamic bank and that the transformation process will be stepped up.
- However, we argue, transformation process will be tough and would require more than stipulated time, meaning FABL will continue to operate under similar strategy of its predecessors.
- We have revised our earnings estimates for FABL, and maintain a 'Buy' call on with Dec-18 target price of PKR 31/share.

Changing management

Faysal Bank Limited (FABL) has undergone a broad-based transformation since the new management took over back in 2014. Its fundamentals have improved dramatically in the past 3yrs. Profitability has more than doubled by 2017 to PKR 4.5bn and similarly ROE has doubled, expanding from an average of ~<7% in 2011-13 to average ~>13% in 2014-17.

In 2017, the management further stepped up its efforts. It has sharpened its focus on loan sheet growth with little compromise on quality, leading to speedy decline in its infection ratio. This strategy has conferred remarkable results with better credit quality and heightened profitability as well as strong capital adequacy. However, the management also indicated to step up transformation efforts into full-fledged Islamic bank by 2018. The current operational strategy of FABL, staying conventional and gradually building up its space in Islamic bank has worked relatively well so far. But, we think, given multitude of challenges both faced by the Islamic banking industry as a whole and FABL asset conversion side, transformation is unlikely to come by in the stipulated time frame, meaning FABL will continue to operate with its current strategy.

Estimates revised with earnings now projected to show a +16% cagr for the period 2018-21

With this in mind, we have revised our estimates for FABL, with earnings now projected to show a +16% cagr over the next 3yrs making it one of the strongest growth bank in our coverage banks. Bank's quality loan book expansion and improving operating efficiency would buoy up its ROE in years ahead. Bank ROE is projected to average ~14% over the next 3yrs. Using residual income approach, we value the bank at PKR 31.4/share which at current price of 25/share, offers a decent +22% upside.

Exhibit:

Key Financial Highlights

	2014A	2015A	2016A	2017A	2018E	2019F	2020F
EPS	1.4	2.8	2.8	3.0	3.6	4.0	4.7
DPS	-	1.00	-	-	1.00	1.50	1.75
Bonus	0.0%	15.0%	10.0%	15.0%	0.0%	0.0%	0.0%
BVPS	17.3	20.0	23.1	25.8	30.9	33.2	35.9

Source: IGI Research, Company accounts

Having a well-thought-out strategy has helped the bank double its profitability by 2017

To recall, bank's profitability has more than doubled in 2017 to PKR 4.5bn since 2014 (PKR 2.1bn) when the new management took charge. Looking back, we see two key features which stand out amongst others that led to this impressive progress; management's a) focus on reducing overall operating expenses, and b) emphasis on expanding and simultaneously improving bank's asset quality.

To put this in perspective, bank's opex has increased by a mere PKR 352mn over the past 3yrs or registered a <1% annualized growth since 2014. Similarly, efforts on credit recovery are visible as the bank was able to keep a lid on its overall NPLs (PKR 27.3bn in 2017 vs. PKR 27.6bn in 2014) despite an ~8% annualized growth in loan book. Moreover, accompanying growth in advances, bank's fee income registered a growth of ~14% p.a., raising its share to ~22% from ~15% of interest income back in 2014.

Exhibit:
FABL impressive earning flight

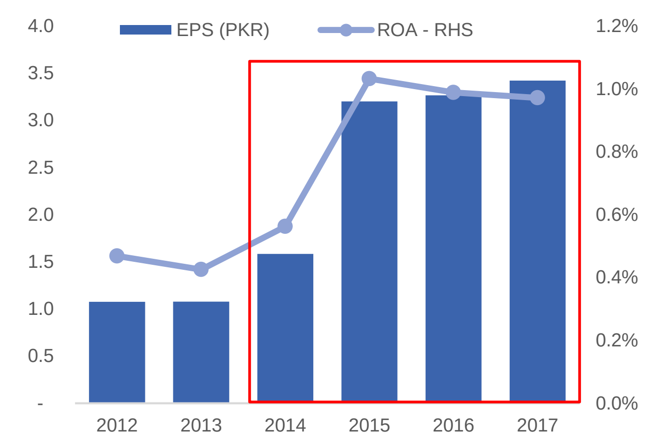
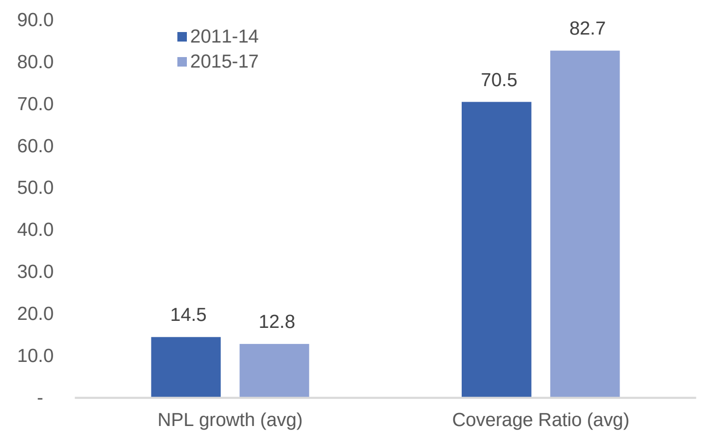


Exhibit:
Improving asset quality



Source: IGI Research, Company financials

New management new strategy

By Jun-17 the management of FABL was yet again changed and since then the new management has been capitalizing well on its predecessor's strategies. Under the new management the bank has increased its branch footing, adding nearly 50 branches in just a year's time compared to an average 18 added over a period of 5yrs. As a result, total bank's branch count stood at 405 of which 197 are Islamic branches and rising. As a result of this, bank's opex growth is relatively higher at ~8.5% by 2017-year end, when compared to 3yr historic average of 2%, but is still 181bps less than industry average growth of ~10.3%. Moreover, rising opex amid branch increase, has meant higher cost/income ratio, up by +311bpsYoY to 64% from 61% in 2016 and 58% in 2015.

Understandably aforementioned expansion was necessitated; firstly, to compete with mid-to-larger banks to aid in its CASA deposit growth so as to reduce high-cost deposit structure and secondly to propel its loan book. The strategy has paid-off well for FABL.

The increase in branch network has compensated well in terms of keeping deposit cost relatively flat

Looking at deposits, the bank roughly added PKR ~33bn in 2017, which translates into ~10%YoY growth (9.6% in 3yr average growth), which is in-line with industry deposit growth of ~10%. However, out of this PKR 33bn, roughly ~40% or PKR 13bn was non-remunerative (NR) current deposits which helped the bank to reduce its cost-of-deposits down by 20bpsYoY (181bps down since 2014).

Exhibit:

FABL has cut down its deposit cost from 5.0% in 2014 to 3.2% in 2017, amid rising portion of NR Deposits, but is still behind industry average

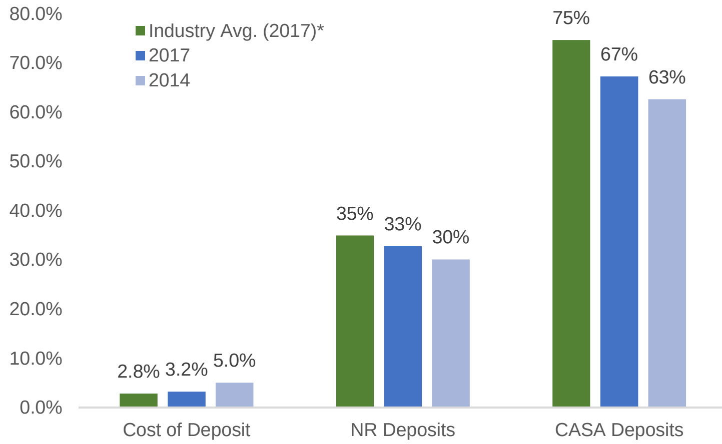
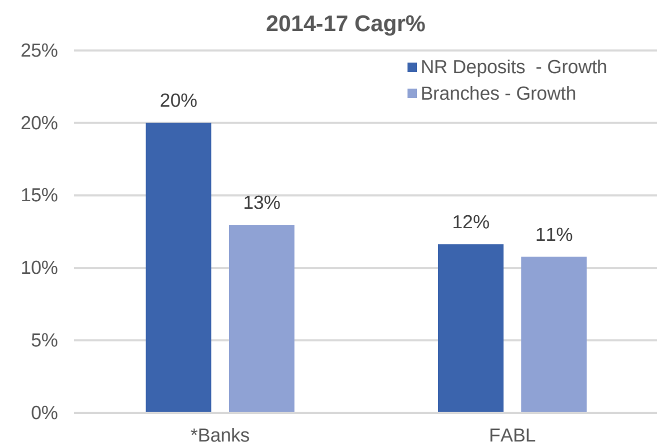


Exhibit:

Banks' branch / NR deposit has increased by a factor of 1.5x - for FABL expanding branch network will most likely increase its share of NR Deposits going forward



*Source: IGI Research, Company financials,*Banks=for comparison purposes we have used data for BAHL, HMB, AKBL*

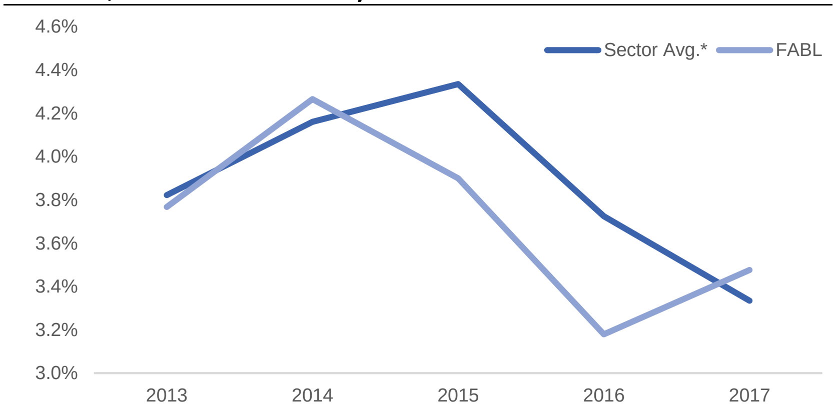
Nonetheless, we view there is more room for improvement in terms of further reducing cost-of-deposit. However, we think catching up pace is relatively modest but management's track to keep expanding its branching network (Faysal Bank to open over 100 branches Link) with a controlled cost, will help mobilize low-cost deposits.

Against the tide: Amid contracting sector NIMs, FABL NIMs increased by +30bps…

At core, the bank managed to increase its net interest margins (NIMs) by +30bpsYoY to 3.5%, making it one of only two banks in our coverage banks to have increased NIMs (HMB increased by a mere +8bpsYoY).

Exhibit:

NIMs have dropped considerably for overall sector amid monetary easing. However, for FABL it was relatively different



Source: IGI Research, Company financials, IGI Coverage banks

This is partially down to bank's stable interest bearing yield (3.56% in 2017 vs. 3.59% in 2016) but more to do with management's resourceful asset selection. The AD and ID ratios of industry averaged ~54% and ~62% respectively, while for FABL things were rather different. It's ADR by 2017 closed at ~60% and IDR at ~50%. This asset mix has worked in favor of the bank, such that amid falling sector earning yields due to high investment in government bonds, the bank managed to post a growth of +27bpsYoY to 7.17% in its earning yield compared to an average decline of 58bpsYoY to 6.69% witnessed in other banks.

…Thanks to higher than sector loan yield

Bank's higher earnings yield can be credited to its aggressive loan sheet expansion policy. In 2017, the bank gross advances increased by nearly PKR 26bn taking the incremental ADR to +79% (FABL deposit increased by PKR 33bn).

However, FABL is not alone in raising double-digit ADR, but ranks highest in terms of income generated from loan book. Income from advances nearly accounted for ~60% of the bank interest earnings, more than any other bank in our coverage. Moreover, the bank managed to earn an above industry average yield on its advances at ~8%, with second best BAFL 74bps lower at 7.29%.

This is primarily due to bank's credit portfolio tilted towards individual/retail segment, a territory which the bank has championed over the years. In 2017 alone, the bank loaned out roughly PKR ~8.5bn of the total PKR ~26bn to individual/retail segment, thus not just earning itself higher yield but also improving its loan recovery ratio, bringing its infection ratio down. The bank's gross NPLs declined by ~3bn in 2017 pulling its infection ratio down to 10.7%, a ratio last seen in 2009 and that too with a climbing coverage ratio; ~87% by 2017.

Exhibit:
FABL rising share of individual financing has helped the bank increase its recovery rate and simultaneously reduce its infection ratio

Gross Advances (PKRbn)	2014	2017	%cagr
Agri	21.5	22.1	1%
Textile	22.5	27.3	7%
Power/energy	32.3	44.3	11%
Individuals	20.7	29.0	12%
Others	108	127	6%
Total	204.7	249.7	7%
Classified Advances (PKRbn)	**2014**	**2017**	**%cagr**
Agri	1.2	1.5	7%
Textile	6.8	7.4	3%
Power/energy	3.0	2.9	0%
Individuals	2.2	2.4	3%
Others	16	13	-7%
Total	29.3	27.3	-2%
Recovery Rate (est.)	3%	7%	

Source: IGI Research, Company Financials,

Bank's transformation to fully Islamic bank seems to necessitate lower IDR

On investment, by 2017 bank's IDR dropped to ~48% (~67% in 2015) which is well below industry level of ~62%. As a result of which, FABL's yield on average investments stood at 6.4%, lower by a good ~55bps from sector average.

For FABL, part of the reason for having a low IDR is by default. The bank, similar to the sector, faced significant maturity of high yielding PIBs during the year 2017. As a result of which the excess liquidity available to banks later got placed with low-yielding treasury bills. On average, treasury bill/deposit ratio for our coverage banks increased from ~21% in 2014 to roughly ~36% in 2017, roughly translating into a change of PKR 2.1trn.

And secondly, the bank did not have higher PIBs on its investment book to start off with. 2017 began with bank having roughly PKR 54.5bn worth of PIBs which translates into ~16% PIB/deposits compared to average of ~31% for coverage banks. Hence when faced with maturity in 2017, there was little or less the bank could have done to uphold its IDR and subsequently its investment yield. By 2017 end, the bank was left with merely PKR 22bn worth of PIBs or ~6% percent of total deposit compared to ~26% for our coverage banks.

However, we think bank's in-process transformation from being partially Islamic to fully Islamic bank seems to necessitate this strategy. This is also true with rising Sukuk portfolio of FABL. As of 2017, total Sukuk stood at PKR 27.3bn which translates to Sukuk/deposit ratio of ~7.3% compared to ~2.5% for the sector (only BAFL was second to FABL at ~7.2%).

Islamic transformation a feeble affair; too quick and FABL may lose its 'Barkat'

To recall, as per Director's report in FABL annual accounts, the bank is now fully prepared to begin its conversion into full fledge Islamic bank and that the transformation process will be stepped up. The bank indicated a time line of 3-4years starting 2014 meaning by 2018 the bank will be fully transformed into Islamic bank (Switching operations: Faysal Bank to turn to the Islamic banking system link).

Progress on FABL Islamic Bank (IB) 'Barkat' is visible. After posting loss in previous year, FABL reported a profit of PKR 592mn in 2017, with an estimated ROE of 11.8%, roughly ~30bps above that of conventional at ~11.5%.

Exhibit:

FABL, IB highlights

	Unit	2016	2017	% Growth
Profit	PKRBn	(0.08)	0.59	n.m.
Cost-income	%	103%	81%	60%
ADR	%	68%	65%	41%
IDR	%	34%	36%	56%
Asset	PKRBn	56	84	49%
Deposit	PKRBn	48	70	47%
- CASA / total Deposit	%	85%	83%	
- Deposit /Branch	PKRBn	0.33	0.36	9%
Equity	Per Share	2.90	3.32	
ROE (conventional)	%	n.m.	11.47%	
ROE (IB)	%	n.m.	11.76%	

Source: IGI Research, Company Accounts

Much of this growth in IB profitability can be ascribed to high growth witnessed in its interest earning assets, up by +46%YoY (PKR 71bn at 2017), but despite a +47%YoY growth in deposit (PKR 72bn at 2017), lower cost-of-deposit helped the bank to increase its spreads to 4.2% in 2017 compared to 2.8% last year.

Earnings yield remained flat on YoY basis at 6.9%, key to which is bank's steadily growing financing. As of 2017, the bank's IB segment contributed nearly PKR 13bn to total of PKR 45.8bn worth of new financing, taking its ADR to ~65%, a +41%YoY growth. Although this growth in financing is promising, but in terms of total gross advances IB financing accounts for a mere 18%, up from last year's 14%, which is still low and even lower (at ~3.8%) when compared to overall Islamic banks' size of financing.

Although the Islamic banking in country is experiencing super-normal growth, but challenges remain plenty starting from

Exhibit:

Islamic banking industry and FABL Share

	2016	2017	2017
Total Assets (PKRbn)	**IB**	**IB**	**IB+CB**
FABL	56	84	488
Industry	1,147	1,352	1,352
FABL market share %	5%	6%	36%
Number of Islamic Banks	5	5	

Source: IGI Research, SBP, IB=full fledge Islamic banks

- Lack of investment: Sukuk market is growing but for a smaller bank like FABL, grabbing the share of new issue will be restricted.

- Financing: Although growing, but for FABL lack of product diversification - credit cards and personal loans have been the most profitable business for the bank along with conversion for secured and unsecured financing - possess some serious challenge.

- Lack of skilled human resource: For FABL, building up a skilled and IB product informed human resource, which is scarce, may be costly issue.

As of 2017, all full-fledged Islamic banks' total assets size stood at PKR 1,352bn compared to FABL IB asset size of PKR 84bn. This represents a mere 6.2% share, progressing from 4.9% last year; an impressive leap of +49%YoY. However, even with this growth the share of FABL IB is very small. With a growing Islamic Banking industry, FABL has a lot of catching up to do. As of 2017, total asset size of bank stood at PKR 488bn, meaning roughly PKR ~280-320bn (IGI estimates) worth of assets have to comply with shariah regulations, before it can finally convert to full fledge IB, which may take more time than previously estimated.

Outlook

In our view the current operational strategy of FABL - staying conventional and gradually building up its space in Islamic bank - has worked relatively well so far. Stepping up the process, the bank may expose itself to challenges and thus we believe the transformation process will take much longer. On operational strategy, we expect bank to continue expanding its loan sheet with a higher credit weightage for individual/personal given adequate capital size, which should help keep earning yields at elevated levels. On investments, there is little choice for the bank, treasury bills will continue to dominate investment portfolio in coming years. Recent branch expansion will help aid towards low cost-deposits, but will also lead to higher opex growth in coming years.

Recommendation; 'Buy' call intact, with a potential upside of +22%

We have used residual income approach to value the bank with a cost of equity of 14.5%. Based on our assumptions, our Dec-18 target price comes at PKR 31/share, offering a +22% upside from its current price of PKR 25/share.

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Recommendation	Rating System
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