Day Break

Thursday, 29 March 2018

Commercial Banks

Exhibit: Sector performance vs KSE-100 CY18TD

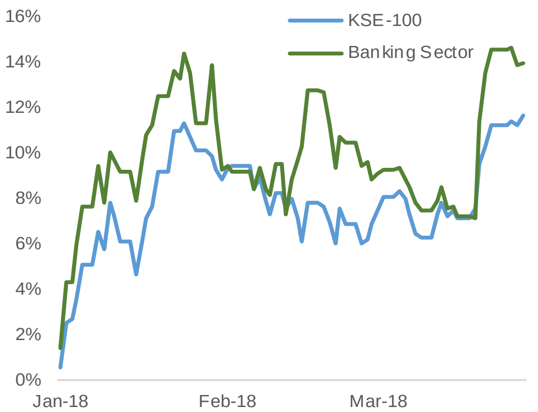
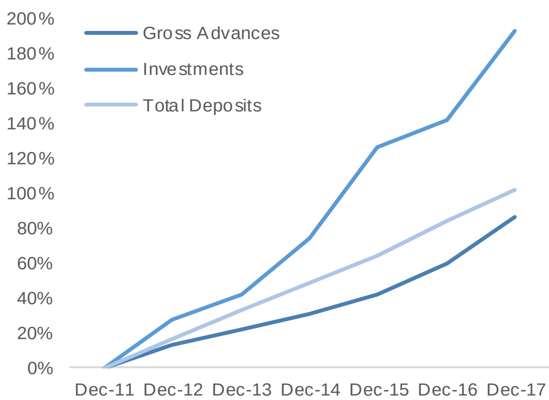


Exhibit: Growth in balance sheet items with CY11 base



Source: Company Financials, Bloomberg, PSX & IGI Research

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Commercial Banks

Sector profits fall to 3-year low; Macro tailwinds to drive sector profitability in coming years

- As per the data published by State Bank of Pakistan (SBP), banking sector profitability fell to PKR 158bn, lowest in past 3 years
- NPLs declined by PKR 12bn to PKR 593bn, roughly equaling CY11 level
- Banks under IGI coverage saw a significant drop in their profitability following a 3-year consecutive growth trend
- Asset preference remained skewed towards government securities (IDR 71.1%)
- Liquidity was met through steady deposit growth of 9.7% to PKR 9.6tn and higher bank borrowings (growth of +75.2%)
- Capital adequacy ratio for the sector declined by a meagre 10bps to 16.0% while CET1 ratio fell to 12.4%
- Going forward, we view monetary tightening amid deteriorating external account balance and rising fiscal borrowing requirement to provide much needed impetus to banks net interest income

Flattish revenue growth and rising operating expense dragged sector profitability in 2017

As per the data published by State Bank of Pakistan (SBP), banking sector profitability fell to PKR 158bn, lowest in past 3 years, owing to twin effect of stagnant revenues and rising operating expenses (OPEX). Total revenues rose 0.9%YoY but were outmatched by +9%YoY growth in OPEX, which together took cost-income ratio to 57%, up 400bpsYoY. At the same time, banks booked a provision charge of PKR 3.7bn, which although is 30% lower than last year, but still reduced profitability. Even after the disregarding the impact of HBL penalty, profits contracted by 4%YoY.

Balance sheet expansion continued coupled with improving asset quality

Despite rising advances (up +17%YoY), NPLs declined by PKR 12bn to PKR 593bn, roughly equaling CY11 level. Resultantly, infection ratio improved by 160bps to 8.4% - a decade low. Moreover, during the year investments rose by +16%YoY but the growth in investment remained skewed towards the shorter tenor, wherein, T-bills grew by PKR 1.4tn compared to decline in PIBs of PKR 227bn. Resultantly, investment yields fell to 6.6% from 7.3% in CY16. On the funding side, deposits grew by +10%YoY and balance sheet growth was supported by +61%YoY rise in borrowings. Similarly, the sector's book value continued to grow, with total equity up by +6%YoY. ROE was recorded at 11.5%, lowest since CY11, while On the other hand, capital strength of the sector remained relatively stable during the year, with CAR falling by 40bps to 15.8% and Tier 1 CAR declining to 12.9%, down a meagre 10bps.

Exhibit:
Key performance metrics of the banking sector

	CY11	CY12	CY13	CY14	CY15	CY16	CY17
Profit After Tax (PKR bn)	112	117	112	163	199	190	158
Non-Performing Loans (PKR bn)	592	618	607	605	605	605	593
Total Deposits (PKR bn)	6,244	7,291	8,311	9,230	10,389	11,798	13,012
Total Assets (PKR bn)	8,171	9,720	10,487	12,106	14,143	15,831	18,342
Equity (PKR bn)	784	873	943	1,207	1,323	1,353	1,381
IDR (%)	48.9	55.0	51.9	57.5	66.2	63.6	67.1
ADR (%)	53.6	52.2	49.5	48.2	46.4	46.6	50.1
Infection Ratio (%)	15.7	14.6	13.3	12.3	11.4	10.1	8.4
Coverage Ratio (%)	69.3	71.5	77.1	79.8	84.9	85.0	87.2
ROE (%)	15.1	14.1	12.4	16.1	15.6	14.4	11.5
ROA (%)	1.5	1.3	1.1	1.5	1.5	1.3	0.9
CAR (%)	15.1	15.6	14.9	17.1	17.3	16.2	15.8

Source: IGI Research, SBP

IGI coverage banks displyed similar performance

Banks under IGI coverage (HBL, UBL, MCB, NBP, ABL, BAHL, BAFL, FABL, AKBL and HMB) saw a significant drop in their profitability following a 3-year consecutive growth trend. A combined factor of flattish revenues and rising operating expense dragged down overall banks' pre-provision operating profits during the year. Although provision reversal did manage to rescue overall sector pre-tax profitability, but higher taxation on back of super-tax dragged down overall profits.

For Big5 (HBL, UBL, MCB, NBP and ABL) combined profitability saw a sharp yearly decline, thanks to a hefty penalty worth ~PKR 24bn on HBL. Resultantly, sector ROE fell to more than a decade low of 12.5%. Nevertheless, during the year, banks were able to grow their asset size by +16.5%YoY to PKR 13.3tn, helped by improved liquidity at hand. Much of the liquidity was met through steady deposit growth of 9.7% to PKR 9.6tn and higher bank borrowings (growth of +75.2%YoY) to PKR 2.2tn.

In terms of asset quality, banks' infection ratio dropped to 8.4% with loan sheet showing a strong growth of +15.3%YoY, taking gross ADR to 50.1%. Asset preference remained skewed towards government securities (IDR 71.1%). Banks' remained well capitalized during the year wherein, CET 1 registered at 12.4% and CAR printed 16.0%.

Lower capital gains a major setback on revenue side

A breakdown of banks' profitability reveals significant drop in capital gains realized during the year. Excluding capital gains, overall gross revenues posted a moderate growth of +2.6%YoY. Net interest income registered a sluggish +1.1% growth, thanks to rising cost of deposit and bank borrowings. Under non-funded income, fee commission printed a +11.3%YoY growth. However, treasury income (capital gains and dividend income) was down 9.9%YoY, restricting overall non-funded income growth (decline of 0.2%).

Exhibit:
Distribution of various income statement line items

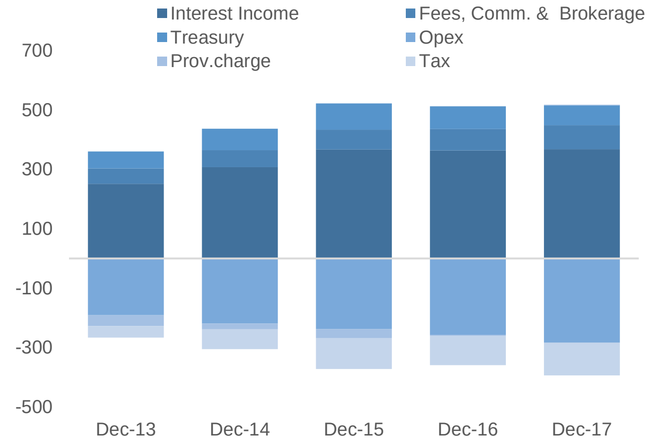
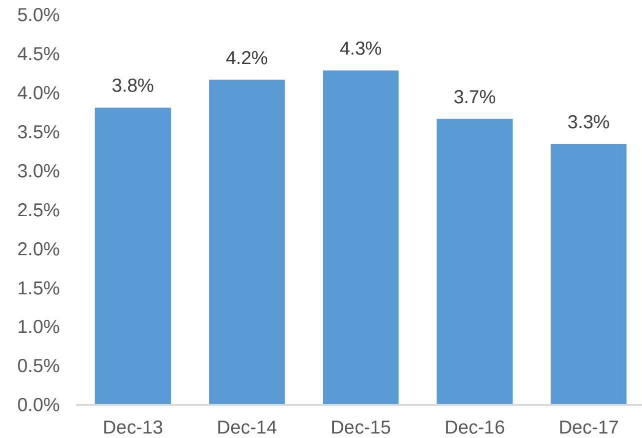


Exhibit:
Declining net interest margin



Source: IGI Research, Company Financials, Bloomberg

Expenses outpaced revenues but asset quality lent support to bottom-line

Admin expenses were one of the main reasons for earning contraction during the year, (up +10.1%YoY). As a result, sector cost-income ratio rose up to 53.8% compared to last year's 49.2%. Notably, higher costs include one-off expenses particularly in HBL and BAFL. Although a combined 436 branches (ex-NIB) were added during the year, but we view this in-line with historic trend. Key technical upgrade, product introductions and higher focus on alternative delivery channels (ADC) kept overall cost high.

During the year, Banks posted NPL provisioning reversals worth ~PKR 5.4bn, highest seen in a decade. Major contributors to large reversals include MCB and ABL bank (~PKR 4.9bn). Overall, sector NPLs rose to PKR 410bn with infection ratio further improving to 8.4%.

Exhibit:
Rising NPLs; NPLs down to CY13 level ex-NIB

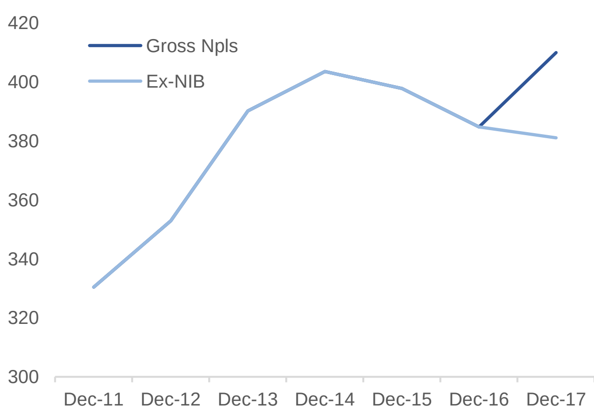
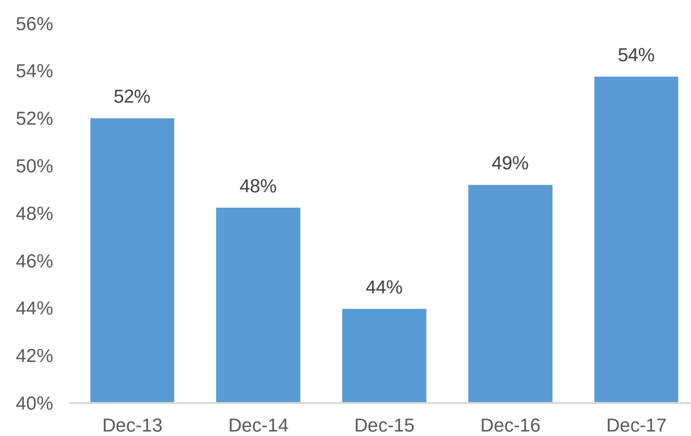


Exhibit:
Cost to income ratio has increased substantially owing to twin effect of static income and rising expenses

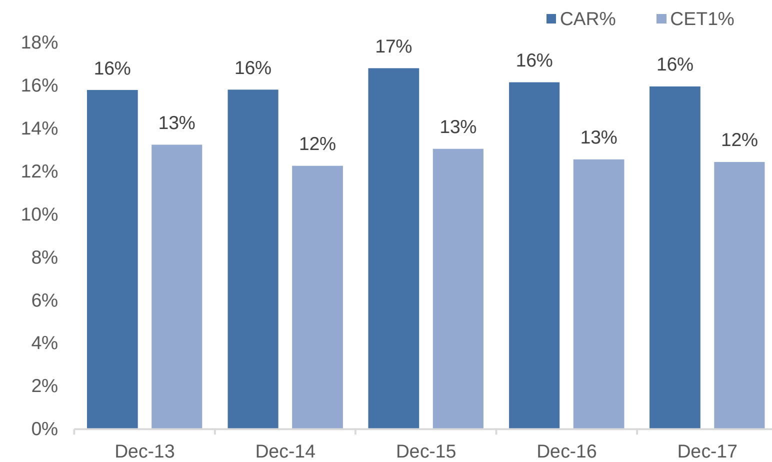


Source: IGI Research, Company Financials, SBP

Capital strength was maintained at a decent level

Total regulatory capital was up by +7.8%YoY, despite HBL penalty. However, capital adequacy ratio for the sector declined by a meagre 10bps to 16.0% while CET1 ratio fell to 12.4%. This is attributed to rising risk-weighted assets (RWA) which during the period grew by +9.1%, led by expanding loan sheet (up by +15.3%).

Exhibit:
Capital strength of the banking sector



Source: Company Financials, IGI Research

Exhibit:
Deposit growth faster in Mid-Tier banks; Earning asset growth favoring the Big-5 banks

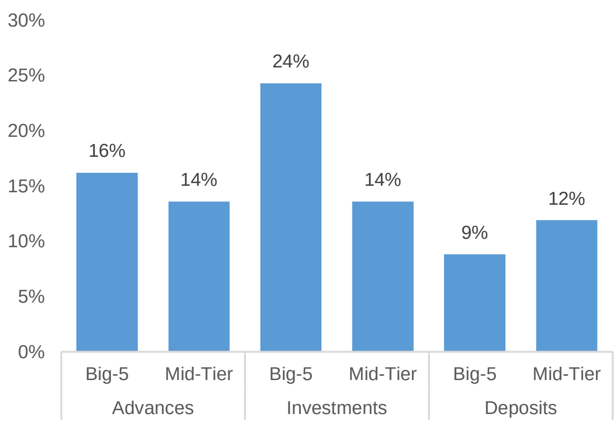
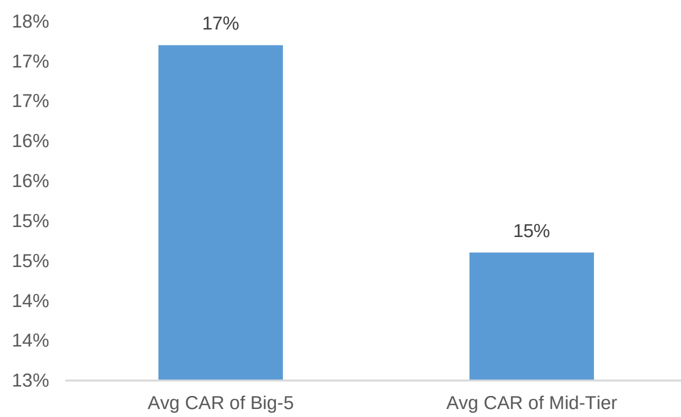


Exhibit:
Capital strength favoring larger banks



Source: IGI Research, Company Financials, Bloomberg

Outlook: Macro tailwinds to support profitability going forward

Going forward, we view monetary tightening amid deteriorating external account balance and rising fiscal borrowing requirement to provide much needed impetus to banks net interest income. On non-funded income, focus on ADCs and expanding loan sheet will certainly relieve some pressure off the declining treasury income. On opex, we see limited growth while declining NPLs and strong recovery ratio will keep overall provisioning charge rather muted.

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