Credit risks manageable; preference for larger banks

- Benefitting from regulatory relaxations, loan quality remains convincing with total NPLs of private banks in our universe standing at Pkr300.7bn in Jun’20 (+3.3%YoY/ +7.0% since Dec’19). Overseas NPLs recorded a sharp uptick to US$634.2mn in Jun’20 vis-à-vis US$603.8mn in Dec’19, primarily attributable to classification of a single party loan in Middle East.

- Most banks in our universe, following active risk management, subjectively booked loss reserve for potential weakening of loan portfolios. As a result, fresh credit charge jumped 0.6% during the quarter, its highest quarterly level since CY13. Recovery pipeline contracts though COVID-19 related disruptions could have additionally slowed the process (Jun’20 Reversals/NPLs: 1.0% vs. 5y avg. 1.8%).

- We flag risk of distort in NPLs trend as SBP and other Central Banks’ (where Pakistan banks operate) relaxations conclude. However, recoveries can gain momentum as activity in real estate picks up, softening provisioning costs overall.

- AKD private banking universe trades at a CY21F P/B of 0.8x, fairly valued based on historical trading multiples and ROE of 12.5%. However, abstract factors such as, i) sector being a proxy for Pakistan’s growth story and hence could undergo re-rating, ii) subsiding of foreign outflows, and iii) dividend yield of 8.0% could attract interest in the sector.

Subjective provisioning uplifting provisioning costs: Benefitting from regulatory relaxations, domestic loan quality remains convincing where domestic NPLs of private banks in our universe stands at Pkr194.3bn, flat QoQ/ +3.5%CYTD. Overseas NPLs recorded a sharp uptick to US$634.2mn in Jun’20 vis-à-vis US$603.8mn in Dec’19, attributable to classification of a single party in Middle East and certain subjective classifications. As such, total NPLs of private banks in our universe stood at Pkr300.7bn in Jun’20 (+3.3%YoY/ +7.0% since Dec’19). Tracking fresh credit charge to performing advances since CY13, the charge ratio for our private banking universe for 2QCY20 stands at 0.6% — highest qtr level since CY13 — where following active risk management most banks in AKD universe subjectively booked loss reserve for potential weakening of loan portfolios. On the other hand, recovery pipeline contracted though COVID-19 related disruptions could have additionally slowed process (Jun’20 Rev/NPLs: 1.0% vs. 5y avg. 1.8%).

Fresh charge could remain elevated in the short run but recoveries could come in handy: Charge ratio is expected to remain elevated in the short term as banks examine their loan portfolios (particularly as restrictions ease-off), capitalizing on brief surge in core income. It should remain manageable in the medium run in our view, accredited to Govt. kick starting economic activity and regulator responding to suppress risks. Other factors include, i) borrowers requesting relief on specific loans as opposed to entire loan portfolio (as per discussion with the management of various banks), ii) improvement in quality and performance of liens (Fixed Assets/Real Estate share in overall pledged assets of advances: 15.6/14.5% in Dec’19), and iii) higher share of public sector loans (CY19: 26.0% vs. 13.7% in CY08 exc. Govt. owned banks). That said, the vibrant activity in the construction sector would assist banks in ramping up loan recoveries, extending the reversal pipeline which should subside overall credit costs.

Sector banking on rerating story! AKD private banking universe is currently trading at a CY21F P/B of 0.8x where plotting CY21F ROE of 12.5% over historical trading multiples, we believe the sector to be fairly valued. We have conservatively built provisioning costs of 0.7/1.0% in CY20/21F estimates accounting for risks of potential distort in NPLs trend as SBP and other Central Banks’ (where Pakistan banks operate) relaxations conclude. However, abstract factors such as, i) sector being a proxy for Pakistan’s growth story and hence could undergo re-rating (during CY10-12 — economic recovery period — sector re-rated by avg. 17.5% while over CY15-17— economic growth period — sector rerated by avg. 19.7%), ii) subsiding of foreign outflows (Aug’20 outflow: US$53.88mn vs avg. monthly FPI corporate outflow of US$52.1mn), and iii) dividend yield of 8.0% could attract interest in the sector. We have preference for larger banks compared to mid tiers where we like HBL (earnings recovery, high exposure to economic activity), UBL (CY21F dividend yield of 9.6%), and MCB (PIB book, recoveries from NIB portfolio support earnings).
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