Aug’20: Spreads falling below 5% mark

- Banking sector spreads for Aug’20 stood at 4.88% - falling below 5.0% mark for the first time after 23Ms, taking 3Q’TD avg. spread to 4.94% vs. 5.53/5.42% in 2QCY20/1QCY20. Fresh spreads witnessed a marginal uptick on a sequential basis in Aug’20, +35bps to 4.42%. Consequently, 8MCY20 avg. spread stands at 5.34% vs. 5.68% in the same period last year.

- Complete reflection of interest rates on asset yield would come in the current month (Sep’20) further shrinking the spreads, in our view. However, some solace can be gained from repricing of fixed deposits in the near term.

- Investment book of banks have again gained prominence in determining the extent of impact of spreads shrinkage on Net Interest Margins where we believe MCB and BOP to have played the cycle well with unrealized gains as a % of Govt. securities (AFS and HFT category) standing at 3.6% and 3.4% respectively vs. avg. 2.0% of other banks.

- AKD banking universe (ex. NBP and BOP) is currently trading at a CY21F P/B of 0.8x, where abstract factors such as, i) sector being a proxy for Pakistan’s growth story and hence could undergo re-rating, ii) subsidiing of foreign outflows (Sep’20TD outflow: US$25.8mn vs avg. monthly FIPI corporate outflow of US$52.1mn), and iii) dividend yield of 8.0% could attract interest in the sector.

Banking sector spreads down to 4.88% in Aug’20: Banking sector spreads for Aug’20 stood at 4.88% - falling below 5.0% mark for the first time after 23Ms, taking 3Q’TD avg. spread to 4.94% vs. 5.53/5.42% in 2QCY20/1QCY20. Fresh spreads witnessed a marginal uptick on a sequential basis in Aug’20, +35bps to 4.42% largely attributable to low cost deposit mobilization. Credit spreads on fresh lending though contracted to 0.6% over 3MKIBOR ebbing away from ~1.5-2.0% spread booked by banks in past 4Ms which we believe to be a function of a push for lending growth as Govt. draws back COVID-19 related restrictions providing much-sought certainty to economic participants and banks ease their risk management barometer that have partially played a part in suppressing advances growth (down 2.5% since Mar’20). Another key point to highlight is the significant reduction in pace of adjustments on outstanding spreads (Aug’20: -ve 0.10% vs.4M avg. --ve 0.74%) as lending yields price in interest rates and providing an indication of a new base forming in the near term. Consequently, 8MCY20 avg. spread stands at 5.34% vs. 5.68% in the same period last year.

Investment book gaining prominence as core spread contracts: Complete reflection of interest rates on asset yield would come in the current month (Sep’20) further shrinking the spreads, in our view. However, some solace can be gained from repricing of fixed deposits in the near term. Moreover, with the regulator pushing banks for reshaping core strategy from a ‘liability-driven’ approach to an ‘asset-driven’ approach taking cue from the Central Bank compelling banks to roll out at least 5% of their overall private sector lending to “Construction and Housing” sector by CY21 could additionally dampen spreads but in a medium run. In this backdrop, Investment book of banks have again gained prominence in determining the extent of impact of spreads shrinkage on NIMs where we believe MCB and BOP to have played the cycle well with unrealized gains as a % of Govt. securities (AFS and HFT Category) standing at 3.6% and 3.4% respectively vs. 2.0% avg. of other banks in our universe. Further, Govt. resolve in addressing power sector structural issues could indirectly benefit banks where a potential one-off large clearance could result in banks locking-in better spreads as seen in CY14.

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 Pakistani 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) subsidiing of foreign outflows (Aug’20 outflow: US$5.88mn vs avg. monthly FIPI 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 supporting earnings).
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