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PAKISTAN
BANKS

REP-019
MARKET
VISTA

Risk mitigation continues; preference for large banks

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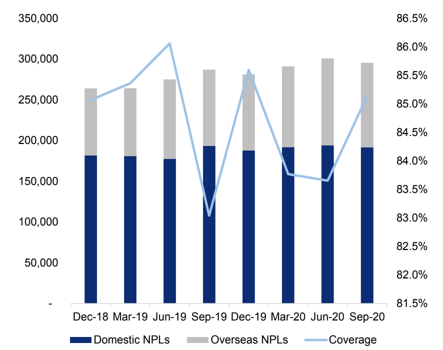
- **Loan quality continues to remain upbeat in the outgoing qtr, with total NPLs of our private banking universe (accounting for 59.4% of total industry advances) contracting 1.7% QoQ but marginally up 3.0%YoY to stand at PkR295.5bn, translating into an infection ratio of 6.1%.**
- **Charge ratio of our banking universe for 3QCY20 stands at 0.4% vs. 0.6% in the previous qtr, as banks continue to build loss buffers (PkR7.3bn provision booked in 3QCY20 over PkR15.2bn recorded in 2QCY20) but countered by higher recovery ratio (3QCY20: 1.3% vs. 1.0% in 2QCY20) as resumption of businesses and pick up in real estate activity played in bank's favor.**
- **Status Quo is expected in risk mitigation strategies in the near term where banks remain on the cautious side, examining and re-examining their loan book as COVID second wave grapple the country. Recoveries could pickup benefitting from higher market activity in real estate sector.**
- **Currently underperforming the broader index by 16.5%, banking sector is in for a run where, i) cheaper valuations (CY21F P/B: 0.8x), ii) resumption of dividend payouts, and iii) potential re-rating as seen historically as economy enters recovery phase (banks rerated by 10-20% in CY13-14).**

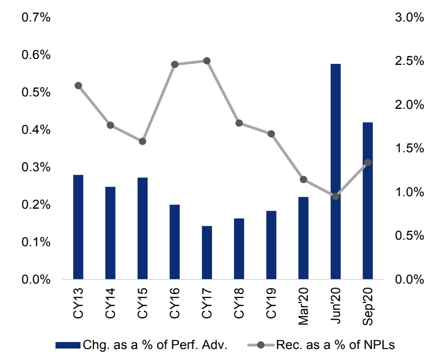
NPLs and Coverage



Source: Company Reports & AKD Research

NPLs on declining trend but banks continue to remain prudent: Loan quality continues to remain upbeat in the outgoing qtr with total NPLs of our private banking universe (c. occupying share of 59.4% in total industry advances), contracting 1.7%QoQ but marginally up 3.0%YoY to stand at PkR295.5bn, translating into an infection ratio of 6.1% (Including write-offs total NPLs remains flat QoQ). Importantly, both domestic and overseas centers witnessed NPLs backtracking with the former receding 1.3%QoQ/0.9%YoY whereas the latter registered 1.2%QoQ decrease in USD terms. That said, the sector still remains prudent in managing risks with PkR7.3bn provision booked in 3QCY20 over PkR15.2bn recorded in 2QCY20 (c. PkR22.5bn general provision) to mitigate potential credit headwinds (MCB and BAHL leads in countering risks relative to their lending portfolio with general provisions recorded in excess of PkR5bn during 9MCY20) as uncertainty persists with the increase in COVID cases (positivity ratio >5%). As a result, charge ratio of our banking universe for 3QCY20 stands at 0.4% vs. 0.6% in the previous qtr but countered by higher recovery ratio (3QCY20: 1.3% vs. 1.0% in 2QCY20) as resumption of businesses and pick up in real estate activity played in banks' favor.

Charge/Reversal Ratio (Qtr avg.)



Source: Company Reports & AKD Research

Prudent risk mitigation to remain in place as Pakistan grapple with COVID second wave: In the near term, we expect charge ratio to remain elevated as banks continue examining their loan book particularly in the aftermath of second wave in the country that could restrict economic activity compounded by seasonal slowdown. Additionally, expiration of regulatory relief period could aggravate situation though extension of relief cannot be ruled out. However, banking sector could continue realizing recoveries against problem loans with heightened market activity in the real estate sector and higher financing demand for expanding business lines (particularly under TERF) making debt swap arrangements feasible. Bank wise, we expect MCB speeding up recoveries from NIB NPL portfolio (relatively larger contribution of real estate in pledged assets), and HMB benefitting from asset sale (debt swap arrangements, non-banking assets stood at PkR2.6bn in Sep'20 vs. PkR414mn in Jun'20). On the other hand, UBL could carry higher provisioning costs as macros in GCC remains weak.

Sector banking on rerating story! Currently underperforming the broader index by 16.5%, banking sector is in for a run where, i) cheaper valuations (CY21F P/B: 0.8x), ii) resumption of dividend payouts, and iii) potential re-rating as seen historically as economy enters recovery phase (banks rerated by 10-20% in CY13-14). We have conservatively built provisioning costs of 1.0/0.7% in CY21/22F estimates accounting for risks of potential distort in NPLs trend as SBP and other Central Banks' (where Pakistan banks operate) relaxations conclude. We have preference for larger plays compared to mid tiers where we like HBL (earnings recovery, high exposure to economic activity — Dec'21TP: PkR157.6), UBL (CY21F dividend yield of 9.6% - Dec'21TP: PkR138.7/sh), and MCB (PIB book, recoveries from NIB portfolio supporting earnings — Dec'21TP: PkR211/sh).

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