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PAKISTAN
BANKS

REP-019
MARKET
VISTA

Sector exhibiting robust asset quality

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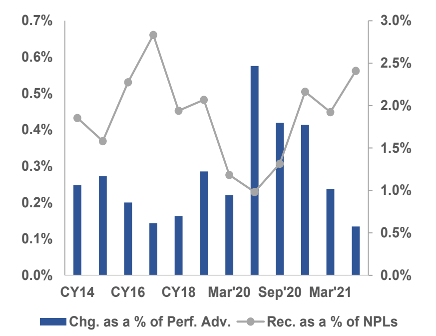
- **Banks under our coverage — representing 60.8% of industry advances — have witnessed significant contraction in NPLs buildup with infection ratio spiraling down to 5.3% in Jun'21 compared to 5.9% at the start of the year.**
- **In absolute terms, NPLs stand at PkR292.0bn, down 3.0% since the beginning of the year whereas normalizing for currency appreciation transpired in 1HCY21, NPLs have remained flat. A closer look featured offsetting trends between domestic NPLs (down 4.1% in 1HCY21) and overseas NPLs jumped 4.0% (ex. of exchange rate gains) - attributable to resurging asset quality issues in UBL international loan book.**
- **Banking spreads for Aug'21 clocked in at 4.3% flat MoM, undergoing seasonal dynamics. Fresh spreads stood at 4.52% compared to 4.90% as banks pushed to capture financing demand (advances: +0.7%MoM vs. avg. 0.2%MoM in Aug since 2002).**
- **From investment perspective, banking sector has returned –ve 2.0% however, with the Central Bank moving the needle and signaling further rate hikes, the long-gone interest should return in the sector which would be magnified in our view as Govt. caps Pakistan's growth trajectory necessitating move to value stocks. We like mid-tiers over top-tiers which are likely to face pressure on account of MSCI-related rebalancing.**

Stronger macro functioning reflecting domestic NPLs trend: Banks under our coverage — representing 60.8% of industry advances — have witnessed significant contraction in NPLs buildup with infection ratio spiraling down to 5.3% in Jun'21 compared to 5.9% at the start of the year. In absolute terms, NPLs stand at PkR292.0bn, down 3.0% since the beginning of the year whereas normalizing for currency appreciation transpired in 1HCY21, NPLs have remained flat. A closer look featured offsetting trends between domestic NPLs (down 4.1% in 1HCY21) and overseas NPLs jumped 4.0% (ex. of exchange rate gains), while domestic performance is a product of stronger domestic macro functioning. As a consequence, reversals have exhibited a stronger trend since 4QCY20, with latest quarter recording recoveries at 2.4% of opening NPLs, highest since 2017. Accretion in overseas NPLs has again brought UBL's international loan book to the fore where asset quality after exhibiting improvement in previous 4Qs, registered increase in NPLs by 7.0% in US$ terms. Coverage ratio on the domestic book (ex. of general provisions) stands at a healthy 90.3% (+3.3ppt in 1HCY21) while provisioning on overseas book is at 81.0% (slightly down 0.8ppt since the beginning of CY20).

Banking sector spreads at 4.3% in Aug'21 — Banks pushing financing growth: Banking spreads for Aug'21 clocked in at 4.3% flat MoM, undergoing seasonal dynamics. Fresh spreads stood at 4.52% compared to 4.90% as banks pushed to capture financing demand (advances: +0.7%MoM vs. avg. 0.2%MoM in Aug since 2002) with authorities disincentivizing investments in Govt. papers, though some impact was nullified through reduction in cost of fresh deposits (3.07% in Aug'21 vs. 3.23% in Jul'21). This was also evidenced through falling credit spread (Fresh lending spread minus 3M KIBOR) which for Aug'21 stood at 45bps vs. 96bps in Jul'21—the lowest since Feb'20. 8MCY21 avg. spread stand 4.4% compared to 5.3% in the same period last year.

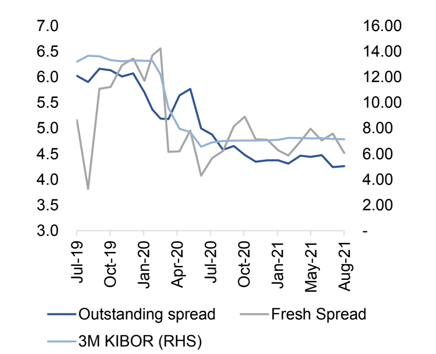
Investment Perspective — Interest should return in banking space: Banking spreads in coming months are expected to be underlined by lagged impact of movement in benchmark rates on asset side. The impact is magnified where interest rate curve has become steeper since the announcement of MPS with 3MKIBOR to Policy rate and 6M to 3M KIBOR differential widening by 7bps and 10bps respectively. However, volumetric growth in balance sheet should offset possible decline in core margins in the near term. From investment perspective, banking sector has returned –ve 2.0% however, with the Central Bank moving the needle and signaling further rate hikes, the long-gone interest should return in the sector which would be magnified in our view as Govt. caps Pakistan's growth trajectory necessitating move to value stocks. We have our liking for mid-tiers in the near term where we believe MSCI-related rebalancing could keep top-tier banks' performance in check. Loss reserves built vis-à-vis COVID are still being maintained by most players in our universe which provides us comfort on capital front on implementation of IFRS-9 (expected from CY22).

Fresh charge and recoveries trend



Source: Company reports & AKD Research

Banking sector spreads



Source: SBP & AKD Research

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- Equity & Asset return based methodologies (EVA, Residual Income etc.)

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