Buy when there is blood on the streets!!

Target Prices

	PBV*	TP	Price	Upside	2MTR
HBL	1.54	199	169	17%	-14.2%
UBL	2.01	178	147	21%	-16.1%
MCB	2.13	273	235	16%	-27.6%
ABL	1.56	131	90	45%	-16.3%
BAFL	0.96	33	24	36%	-22.3%
BAHL	1.52	57	41	39%	-12.3%
HMB	1.18	41	28	48%	-21.3%

* Justified Price to Book Value

Initiate with Outperform- We initiate our coverage on the Pakistan banking sector with an Overweight stance. The recent fall in banking stocks (down 19% on avg. in the last two months) has created an excellent entry point, where P/B's, P/E's and dividend yields are now at their cheapest in the last two years.

Investment Case- We forecast that **medium-term pressure on NIMs** is non-existent; upto July 2016, lower DR will actually increase profitability for most banks, due to heavy investment in Pakistan Investment Bonds (PIBs). Infact, **we expect strong earnings growth of 19% in CY15**. However, where we differ more significantly from consensus is in earnings momentum beyond CY15; the market expects earnings to decline in CY16 and CY17, whereas we estimate CY16 to be a low growth year, with resumption of growth in CY17. Our estimates are premised on two crucial insights. Firstly, **some banks have built up a large portfolio of longer term 5 and 10 year bonds**, which limits the maturities in July 2016. Secondly, the re-investment risk post July 2016 is greatly exaggerated; we estimate that **CPI inflation will revert to around 8.0% levels by July 2016**, even if inflationary pressures remain below historical norms. With CPI inflation at 8.0%, DR would revert to around 10% levels by 3QCY16. And the fiscal deficit continues to expand, banks to be able to reinvest their maturing PIB holding into freshly issued PIBs at double-digit yields by that time.

Catalysts- As strong earnings come through in the quarters ahead, we expect the market to recalibrate its view on the banking sector. Furthermore, as focus on yield stocks intensifies and broadens, we believe investors **will begin to appreciate that banks should now form the mainstay of a dividend yielding portfolio; selected banks are now offering close to double digit dividend yields.**

Valuation- We have valued banks using a justified P/B approach. On multiples, Pakistan banks are now trading at P/B multiples well below their historical averages. On a forward P/E basis, selected banks are now trading below 5x, offering strong value in an improving macro environment.

Risks- A narrowing of the interest rate corridor due to introduction of a Target Rate would squeeze NIMs for the banking sector. However, we estimate that banking stocks offer strong value (particularly ABL and HMB), even if a 50bp reduction in the interest rate corridor was to transpire.

Figure 1 – Earnings estimates more sanguine than consensus, particularly in CY16 & CY17

EPS	CY14A	CY15E	CY16E	CY17E
HBL	21.6	20.9	22.1	24.7
UBL	17.9	20.2	21.1	24.5
MCB	21.9	24.8	25.1	27.2
ABL	13.1	15.6	15.8	17.0
BAFL	3.6	5.3	5.0	5.7
BAHL	5.7	7.4	7.6	8.0
HMB	4.7	5.5	5.7	6.2

Figure 2 – Low P/B's provide investors with a margin of safety

Price to book	CY14A	CY15E	CY16E	CY17E
HBL	1.47	1.36	1.27	1.19
UBL	1.43	1.34	1.24	1.15
MCB	2.01	1.86	1.75	1.63
ABL	1.27	1.21	1.11	1.01
BAFL	0.86	0.83	0.77	0.71
BAHL	1.39	1.26	1.14	1.04
HMB	0.83	0.78	0.74	0.70

Figure 3 – Low PER's indicate significant upside

Price to earnings	CY14A	CY15E	CY16E	CY17E
HBL	7.8	8.1	7.7	6.8
UBL	8.2	7.3	7.0	6.0
MCB	10.8	9.5	9.4	8.6
ABL	6.9	5.8	5.7	5.3
BAFL	6.9	4.6	4.9	4.3
BAHL	7.2	5.5	5.4	5.1
HMB	5.8	5.0	4.8	4.4

Figure 4 – P/B's at a significant discount to long-term averages

P/B	Current	1 yr avg	2 yr avg	5 yr avg
HBL	1.50	1.91	1.66	1.39
UBL	1.30	1.94	1.71	1.32
MCB	2.00	2.70	2.59	2.14
ABL	1.30	1.84	1.63	1.48
BAFL	0.90	1.23	1.12	0.90
BAHL	1.40	1.87	1.70	1.61
HMB	0.90	1.25	1.04	0.92

Source: Company Financial Statements & Next Research

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More sanguine earnings outlook than consensus

Figure 5: Avg. growth of 19% in CY15

Bank	CY14A	CY15E	CY16E	CY17E
HBL	21.6	20.9	22.1	24.7
UBL	17.9	20.2	21.1	24.5
MCB	21.9	24.8	25.1	27.2
ABL	13.1	15.6	15.8	17.0
BAFL	3.6	5.3	5.0	5.7
BAHL	5.7	7.4	7.6	8.0
HMB	4.7	5.5	5.7	6.2

Source: Company Financial Statements & Next Research

Medium-term pressure on NIMs is non-existent

Despite some concerns, we forecast that medium-term pressure on NIMs is non-existent; upto July 2016, lower DR will actually increase profitability for most banks, due to heavy investment in Pakistan Investment Bonds (PIBs). In many cases, the maturity of interest sensitive liabilities exceeds that of interest sentive assets in CY15, which allows them to increase NIMs in a low DR environment. Simply put, it boils down to this; if a bank has PIB holdings in excess of its current account deposits, the re-pricing impact of a lower DR will be greater on the liability side, and less on the asset side.

Figure 6 –Maturity profile of assets and liabilities (PKR Bn)

Maturity Profile															
	ASSETS					LIABILITIES					Gap				
Bank	less than 1 year	From 1 to 2 years	From 2 to 5 years	Over 5 years	Total	less than 1 year	From 1 to 2 years	From 2 to 5 years	Over 5 years	Total	less than 1 year	From 1 to 2 years	From 2 to 5 years	Over 5 years	Total
HBL	1,204	102	190	101	1,597	1,071	8	19	8	1,106	133	94	171	93	491
MCB	479	135	133	56	804	507	4	0	-	512	(28)	131	133	56	292
UBL	525	124	138	110	897	583	4	18	9	614	(59)	119	120	102	283
ABL	423	131	115	22	691	394	8	162	2	565	30	123	(47)	20	126
BAFL	424	100	70	22	616	433	1	1	1	436	(9)	99	69	21	180
BAHL	346	49	77	39	511	363	4	9	1	377	(16)	45	67	39	134
HMB	239	37	21	47	345	239	3	9	3	253	0	34	13	44	91

Source: Company Financial Statements

...and the July-16 re-investment risk is also greatly exaggerated

Although the sustenance of CY15 earnings momentum is broadly acknowledged on the street, where we differ more significantly from consensus is in earnings momentum beyond CY15. Consensus expects earnings to decline in CY16 and CY17, whereas we expect stable earnings in CY16, and growth to resume in CY17. Our non-consensus estimates are premised on two crucial insights. Firstly, many banks have built up sizeable positions in the 5 year and 10 year PIBs, which will not be maturing in July-16, as can be seen in Table 7 below.

Figure 7: Significant Positions in 5 & 10 yr PIBS

PIB allocation	<2 yrs	2-5 yrs	>5 yrs	Total
HBL	20%	51%	29%	100%
MCB	47%	37%	16%	100%
UBL	31%	38%	31%	100%
ABL	50%	42%	8%	100%
BAFL	50%	38%	12%	100%
BAHL	29%	48%	24%	100%
HMB	37%	18%	45%	100%

Source: Company Financial Statements

Secondly, the re-investment risk post July 2016 is greatly exaggerated; we estimate that CPI inflation will revert to around 8.0% levels by July 2016, even if inflationary pressures remain below historical norms (we assume a 0.65% MoM increase in CPI from July 2015 onwards, compared to a five year avg. MoM increase of 0.75%). With CPI inflation at 8%, DR would revert to around 10% levels by 3QCY16. And as the fiscal appetite for borrowing remains strong, banks will be able to reinvest their maturing PIB holding in July 2016 into freshly issued PIBs at double-digit yields by that time.

Increasingly attractive dividend yields have been ignored

In our opinion, a key catalyst for strong price performance in the months ahead will be the realization (which has been relatively ignored in the last few months) that banks are now high dividend yielding stocks. Selected banks (UBL, BAFL, BAHL, and HMB) are offering close to double-digit yields, a premium to the prevailing discount rate. Historically, dividend yields of banks have been significantly below the discount rate. Figure 8 highlights how significantly the dividend yield- to DR spread has changed from Oct-14 to date. In sharp contrast, traditionally high dividend yielding stocks (IPPs and fertilizer companies) have out-performed handsomely in the last few months, Compared to IPP's, with their high payout ratios, banks paying between 50-65% of their profits. The yield-growth combination offered by banks is superior to most sectors at the KSE currently. Once the panic abates, we expect investors to start appreciating the high dividend yields banks are currently offering.

Figure 8 – Banks should now form the mainstay of a dividend yielding portfolio

Bank	Payout ratio	Current Yld	Yield in Oct-2014	Spread to DR- Current	Spread to DR- Oct-14
HBL	62%	7.4%	6.5%	-0.57%	-3.53%
UBL	64%	9.1%	7.2%	1.09%	-2.82%
MCB	65%	7.0%	5.8%	-1.04%	-4.18%
ABL	51%	8.5%	7.3%	0.51%	-2.66%
BAFL	47%	10.3%	9.5%	2.29%	-0.54%
BAHL	50%	8.9%	8.8%	0.93%	-1.19%
HMB	50%	9.8%	9.4%	1.82%	-0.60%
HUBC	95%	10.8%	14.3%	2.80%	4.31%
KAPCO	90%	12.8%	16.4%	4.84%	6.44%
NCPL	90%	10.3%	13.0%	2.29%	2.99%
NPL	75%	10.2%	14.2%	2.22%	4.16%
FFC	90%	11.1%	13.1%	3.15%	3.08%

Source: Company Financial Statements & Next Research

Valuation

Our target prices, based on a justified P/B methodology, point to significant upside in most banking stocks. ABL, BAFL, BAHL, and HMB, provide the most significant upside from current levels. Our risk-free rate assumption is 9.5% and equity risk premium is 6.0%. We have assumed an average DR of 8% in CY15, 9% in CY16, and 10% from CY17 onwards.

Target Prices

	PBV*	TP	Price	Upside	2MTR
HBL	1.54	199	169	17%	-14.2%
UBL	2.01	178	147	21%	-16.1%
MCB	2.13	273	235	16%	-27.6%
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BAHL	1.52	57	41	39%	-12.3%
HMB	1.18	41	28	48%	-21.3%

*Justified Price to Book Value

Relative valuation metrics, such as P/E, P/B and dividend yield are also extremely attractive as shown below. Our analysis indicates that the sector is trading at a 22%, 18%, and 4% discount to its historical P/B on a 1 year, 2 year, and 5 year basis respectively.

Figure 9 – Low PER's indicate significant upside

Price to earnings	CY14A	CY15E	CY16E	CY17E
HBL	7.8	8.1	7.7	6.8
UBL	8.2	7.3	7.0	6.0
MCB	10.8	9.5	9.4	8.6
ABL	6.9	5.8	5.7	5.3
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BAHL	7.2	5.5	5.4	5.1
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Figure 10 – Low P/B's provide investors with a margin of safety

Price to book	CY14A	CY15E	CY16E	CY17E
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BAFL	0.86	0.83	0.77	0.71
BAHL	1.39	1.26	1.14	1.04
HMB	0.83	0.78	0.74	0.70

Risks; possible narrowing of interest rate corridor

A potential risk for the sector is a narrowing of the interest rate corridor, once the SBP finalizes the Target Rate methodology. It is too early at this stage for us to comment on the likelihood of such a scenario; however, below we provide the EPS and target prices in case of a 50bp reduction in the interest rate corridor. The impact is most significant on BAFL and BAHL, whilst ABL and HMB stand out as the banks with the most TP upside in such a scenario.

Figure 11 – EPS assuming 50bps narrowing of interest rate corridor

	EPS			
	CY14A	CY15E	CY16E	CY17E
HBL	21.6	19.7	20.7	23.2
UBL	17.9	19.5	20.3	23.5
MCB	21.9	23.6	23.8	25.7
ABL	13.1	14.8	14.9	15.9
BAFL	3.6	4.9	4.5	5.1
BAHL	5.7	6.9	6.9	7.2
HMB	4.7	5.2	5.3	5.8

Figure 12 – ABL and HMB provide highest potential upside

	Valuation			
	P/B	TP	Mkt Price	Upside
HBL	1.41	181	169	7%
UBL	1.90	168	147	14%
MCB	1.98	253	235	7%
ABL	1.42	119	90	32%
BAFL	0.78	27	24	12%
BAHL	1.28	48	41	17%
HMB	1.06	36	28	32%

Source: Company Financial Statements & Next Research

APPENDIX 1

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