

Banking Sector Update

Investment Summary

We lower our sector stance to Neutral from Buy

After the recent vertical take-off in share prices, we downgrade our rating on Pakistan banks to Neutral from Buy. The banking sector, inline with broad market index, has more than doubled in YTD CY09 and IGI Universe has rallied 72-106% in absolute terms and has outperformed the benchmark KSE100 index by 12-46%. At current levels, we believe the current rally is overdone and our coverage banks are 10-15% overvalued vis-à-vis our Dec09 target price estimates.

Share price performance largely macro-driven

Improved macro environment with lower interest rates, inflation coming down to single digit range, narrowing trade gap, improved balance of payments position and shoring up of FX reserves amongst other positives; more so than core business growth or operating profit outlook has driven the PE & PB based re-rating from trough valuations of 0.5x & 4x to 1.4x & 8.2x respectively. However, notwithstanding the fact that re-rating to fair multiples was justified; we believe market has turned overly-optimistic in discounting the sectoral risks, and banks are rallying on speculation, while fundamental upside has exhausted.

Core business activity slowing; P&L headwinds remain

Banking sector earnings which are already down 25% YoY in 1H CY09 and are not likely to improve in the third and fourth quarters given key challenges including passive credit growth, shrinking margins, higher credit costs and inflation driven intermediation costs. Consequently, sector ROE and ROA has plunged to 9.7% & 1.0% in Jun09 as compared to 5yr average of 18.3% and 1.5% with no bounce back expected in the near term. Hence, downturn in core operations and dearth of growth prospects can invariably be the catalyst for end to bank-sector share price rally.

NPL growth slows but credit costs disappoint

Recent Non-performing loans (NPLs) data released by the SBP reveals that rate of incremental NPL growth slowed significantly in 2Q CY09 to 6% QoQ to previous five quarters average of 19%. However, despite slowing NPL build-up, ageing of bad loans is a bigger concern. Partial provisioning categories (Substandard & Doubtful) constitute a 45% of total NPLs and provision expense is likely to peak in CY09E owing to change in buckets i.e. loans going down to the loss category requiring 100% provisioning.

No further impairment losses on AFS securities likely

In recent quarters, banking sector has booked impairment charges against decline in market value of their AFS equity investment portfolio. As at Jun09, banks in our coverage had remaining impairment loss at 0-11% of equity investment book value. However, during the 3Q CY09 KSE100 index has rallied 35%; hence, we don't expect any further impairment losses being booked in the future instead we expect reversal of impairment charges which will help offset higher credit costs in 2H CY09. Within our coverage banks, MCB & ABL are likely to have the highest expected reversal in impairment charge amounting PKR 0.90 per share and PKR 1.11 per share respectively.

Rich valuations – Near-to-medium term positives priced in

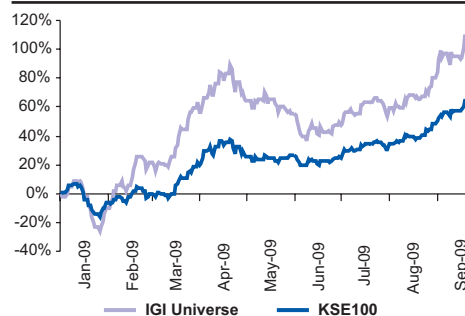
Our Gordon Growth valuations cost of equity is 18% while sustainable ROE ranges from 13-22%. The implied 'Exit PB multiples' range from 0.8-2x. We think risk of deceleration has increased particularly by the fact that our coverage banks (NBP, HBL, UBL, MCB, ABL, BAFL) stock prices have peaked. We maintain a neutral stance on NBP, UBL and BAFL while an underweight stance on HBL and MCB and buy stance on ABL.

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Sector Price Performance



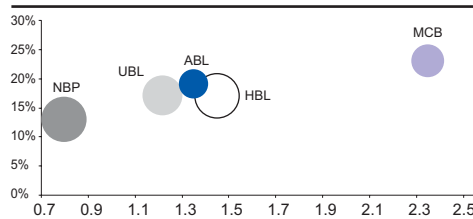
Source: Bloomberg

IGI Universe Banks

	CY07A	CY08A	CY09E	CY10E
Div Yield (%)	5.0%	4.8%	5.5%	6.3%
P/E (x)	8.2	8.0	8.2	7.3
P/B (x)	1.7	1.6	1.4	1.2
ROE (%)	23%	20%	17%	17%
ROA (%)	2.4%	2.1%	1.8%	1.8%
NIM	5.9%	6.0%	6.0%	5.1%

Source: Company Reports & IGI Research

ROE-PB Comparison



Source: IGI Research

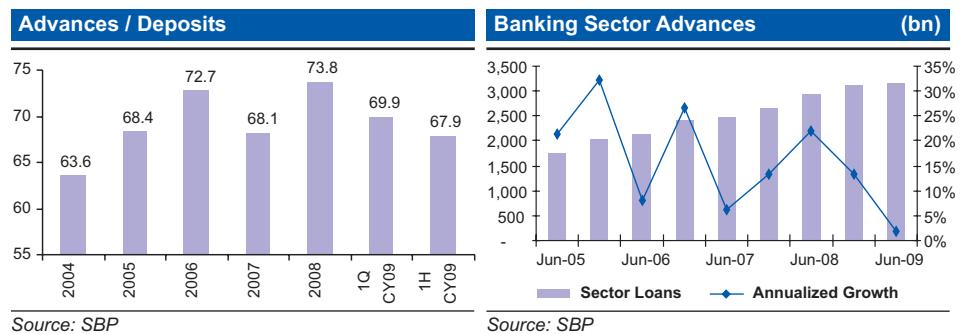
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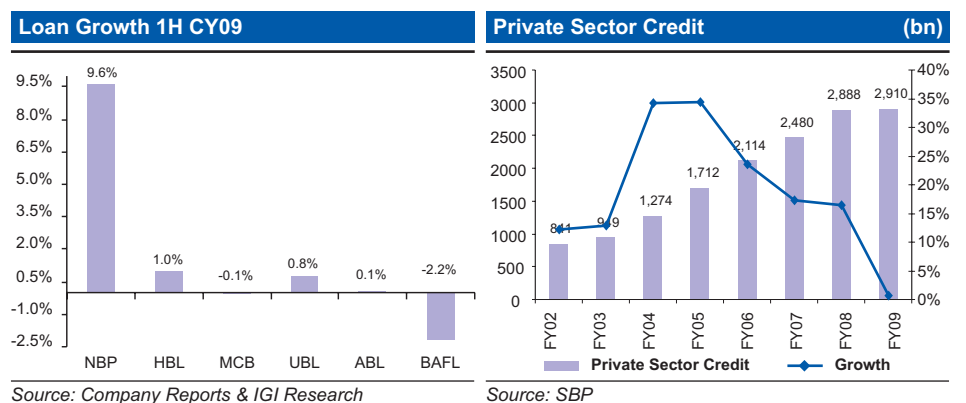
Lending and Deposit Growth

Pent-up demand for credit in 1H CY09

After witnessing robust loan growth at 5yr CAGR of 22% in CY03-08, a slowdown in credit growth is being witnessed since the start of CY09. The divergence from long-term growth trend was inline with expectations and ensued from both demand-side and supply-side factors. Credit demand across all sectors dwindled during 1H CY09 on the back of unfavorable economic conditions including (i) higher interest rates (ii) slowdown in domestic economic activity with manufacturing sector down 8.2% in FY09 (iii) Subdued capex cycle by corporates (iv) Lower working capital requirements due to unraveling in global commodity prices and (v) lower trade related loans amid global recession. Secondly, the high risk consumer finance which constitutes around 10.5% of loan book witnessed further consolidation declining by 8% and 20% respectively from Dec08 and Dec07 levels. Meanwhile, on the supply side, constraining factors include (i) banks adopting extremely cautious lending stance given mounting default risk (ii) increased government borrowing tending to crowd out private credit, while some re-classification of circular debt related loans into investment category also contributed to the decline in advances.



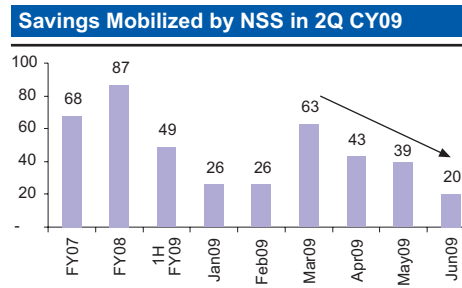
Consequently, overall credit growth came to a standstill in 1H CY09 with banking sector's gross advances almost flat YTD at PKR 3,168bn as of Jun09. Moreover, private sector credit which has posted average 25% growth in FY03-FY08 remained sluggish YoY at PKR 2,907bn in FY09. However, loans to public sector enterprises (PSE) increased by 12% to PKR 218bn as the energy chain restored to short term financing to overcome the circular debt liquidity crunch. As a result, all banks in our coverage except for NBP posted flat or declining advances growth in 1H CY09. NBP, being a public sector bank, witnessed loan growth of 9.6% mainly due to rising government / PSE borrowing including short term lending to energy chain to overcome the circular debt crisis.



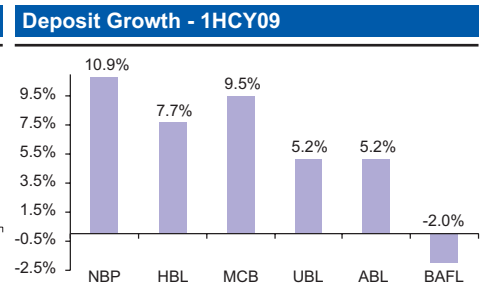
Going forward, we don't expect any strong resurgence in advances growth in the near term on the back of limited avenues except power, commodity and some seasonal demand coupled with banks risk averse stance. However, we foresee 4-5% growth in the 4Q inline with industry's established patterns for the last quarter and improved economic backdrop, lower credit risk and declining interest rates.

Deposit growth outpaces credit expansion

During 1H CY09, deposit growth outperformed the muted loan growth with fresh mobilization growing by 8.4% or PKR 319bn to PKR 4,120bn. Although deposit expansion remained slow in the 1Q CY09 at 2%; however, it picked up during the second quarter to an impressive 6.4% on the back of improvement in NFA position and lower NSS rates by 70-140bps in Apr09. Owing to lower rates in the 2Q CY09, savings mobilized by NSS declined 18% QoQ to PKR 102bn as compared to PKR 124bn in 1Q CY09. Secondly, contraction in NFA of the banking system gradually eased as well due to relatively improved balance of payment position, persistent remittances momentum and fresh foreign portfolio inflows. These factors helped regain the growth momentum in line with historical trends at 7-8%. Of the banks in our coverage, NBP and MCB had the strongest deposit growth of around 10% while BAFL saw its deposits decrease by -2% during the period.



Source: SBP

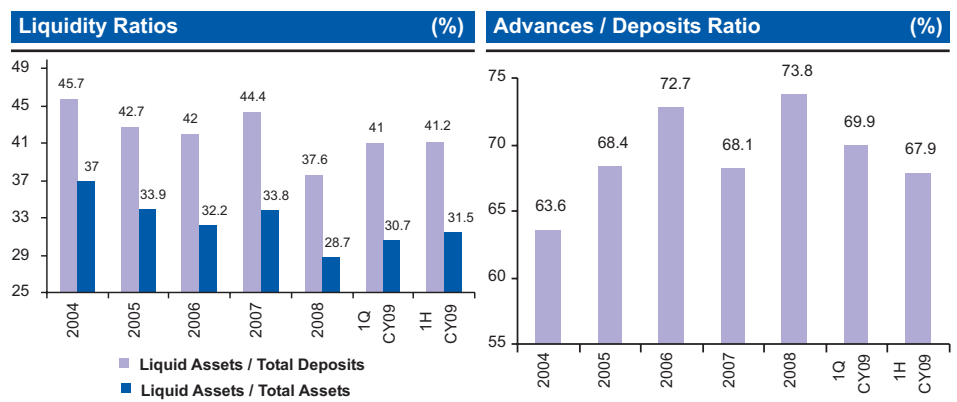


Source: Company Reports & IGI Research

Improved liquidity – slowdown in lending to give respite

The positive implication of stalled lending growth was in the form of improved liquidity in the system. In stark contrast to the severe liquidity risk of 4Q CY09 where excess liquidity over required reserve dipped to less than 2%, indicators have significantly improved. Banking sector has seen considerable easing as the advances-to-deposits ratio (ADR) declined significantly by 590bps to 67.9% in Jun09 as compared to 73.8% in Dec08.

Consequently, the Liquid assets/ Total assets (L/A) and Liquid Assets / Total Deposits (L/D) ratios improved 260bps and 360bps to 31.5% and 41.2% respectively in Jun09. The historical averages for L/A & L/D are 34.2% and 43.7% respectively. Although, liquidity position is below past levels but recent position gives a clear signal of rapidly improving liquidity maintained by banks compared to 4Q CY08 crisis. This generally better liquidity position will assist lending growth when the operating environment improves and the lending appetite rebounds.



Source: SBP

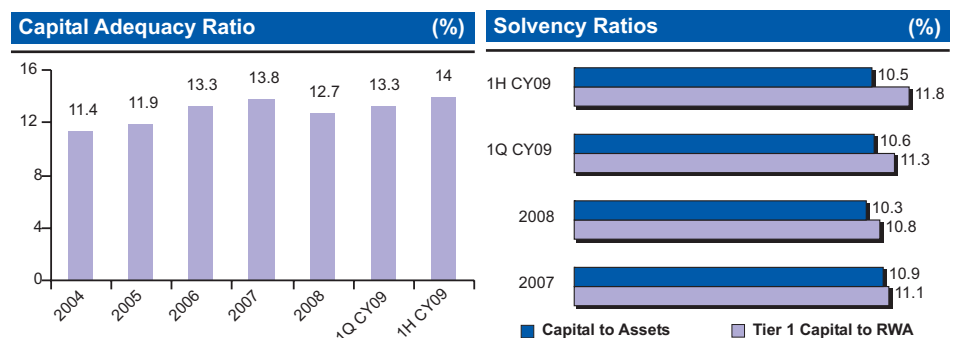
Source: SBP

Investments jump by 31% in 1H CY09

With ample liquidity in the system, high NPL risk restricting lending, and declining interest rate scenario pushed banks to park excess funds in the investments portfolio. As a result, the investments surged 31% to PKR 1,348bn in Jun09 with major contribution into government papers and PKR 81bn in TFCs of power companies. The fast paced growth in the investments has resulted in Investments/Deposit ratio (IDR) jumping 560bps to 32.4% as compared to 26.7% in Dec08. Going forward, with lackluster demand for private sector credit and sustained borrowing needs of the government, investments share in the asset mix is likely to remain high.

Capital adequacy ratio improved to 13.5%

The solvency profile of Pakistan banks has generally remained strong backed by SBP's desire to keep financial sector strong to absorb shocks. During the 1H CY09, the key solvency indicators of all banks improved due to decline in the risk weighted assets on the back of shifting asset mix towards government securities away from risky lending portfolio. The CAR improved to 13.5% as compared to 12.7% in Dec08 while Tier I capital / RWA ratio comfortably placed at 11.8% in Jun09.

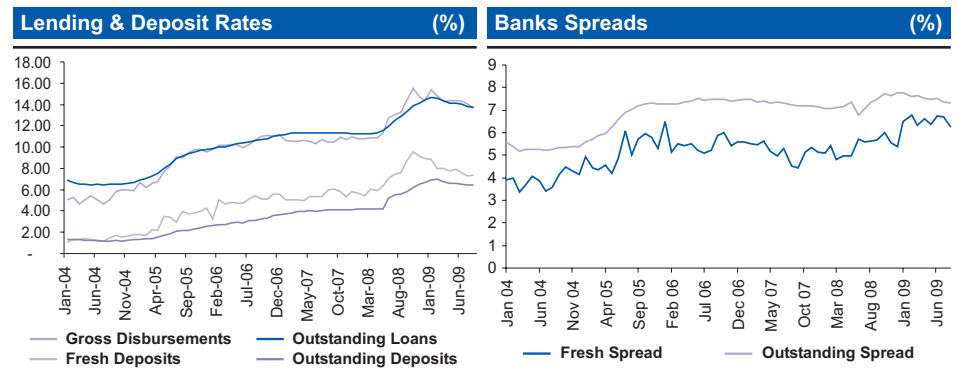


Source: SBP

Source: SBP

Interest rate spread declines on lower KIBOR

The banking system average spread during 8mo CY09 was up 42bps YoY to 7.53% as compared to 7.11% in the corresponding period last year. During YTD CY09, the average cost of deposits surged 200bps to 6.64% while, backed by higher KIBOR, the average lending rate was up by 267bps to 14.39% - resulting in net spread expansion. However, the MoM analysis reveals a declining trend as spreads peaked in Jan09 at 7.78% and declined ever since to 7.32% in Aug09. The spread compression is due to lower asset yields while cost of deposits remains sticky owing to imposition of minimum rate of 5% on PLS deposits.



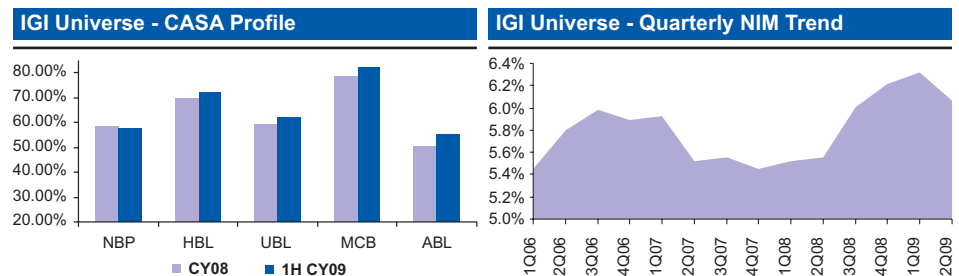
Source: SBP

Source: SBP

NIM contraction imminent and drag on profitability

During the 1H CY09, the net interest income of the banking sector showed significant increase of 19% YoY due to higher KIBOR and 10% growth in earning assets. However, quarterly NIMs peaked out during 1Q CY09 and are now following a downtrend with interest rates moving southwards. For IGI Universe banks, trend reveals that average NIMs peaked at 6.3% in 1Q CY09 and during the second quarter, due to lower KIBOR, NIMs declined on average by 20bps to 6.1%.

Going forward, sharp contraction in asset yields during 2H CY09 should weigh in on future NIM trends creating a drag on operating profits. However, we believe large banks (especially Tier I with sizeable CASA profile) have some cushion to trim deposit costs. Our assertion is based on the fact that given stalled credit demand and improved system liquidity; banks face limited pressure on the funding side. This trend is clearly visible in 2Q CY09 numbers for banks in our coverage in which CASA profile improved on average by 240bps as compared to Dec08 levels. ABL managed the largest improvement in CASA profile by 470bps to 55.2% while the CASA deposit base of NBP declined by 110bps to 57.7%.



Source: Company Reports & IGI Research

Source: Company Reports & IGI Research

NIM Trends – IGI Universe Banks

NBP: NBP’s net interest margins (NIM) declined by 83bps YoY and 24bps QoQ to 5.65%. Meanwhile, net interest income remained flat at 18.9bn during the first half. This was mainly driven by 205bps spike in funding costs to 5.05% in Jun09 on the back of minimum 5% rate on PLS and higher term deposits. NBP has around 38% public sector / government deposits and the circular debt driven crunch resulted in withdrawal of these low cost deposits by the power sector. Hence, NBP had to resort to expensive fixed term deposits for liquidity management. Term deposits as a proportion of total deposits surged 530bps YoY to 26% in Jun09. Going forward, we expect NIMs to decline 40bps in CY09-CY10E and stabilize at 5% level.

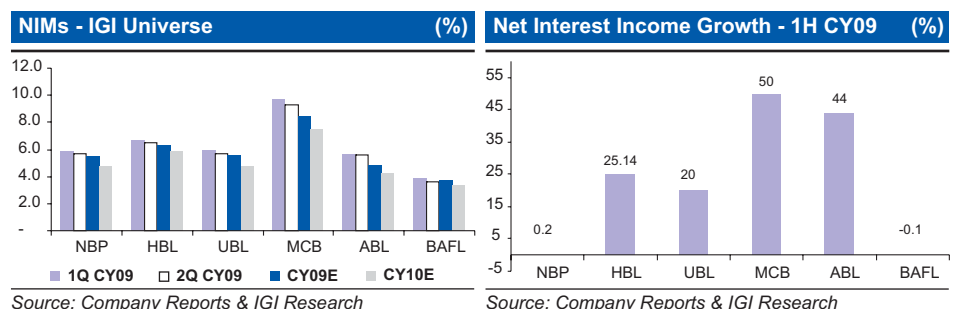
HBL: HBL posted aggressive growth of 25.2% YoY in net interest income to PKR 21.4bn on the back of 93bps expansion in average NIMs at 6.7% and 11% growth in earning assets from Jun08 levels. However, 2Q CY09 number reveals a receding NIM outlook as asset yields adjust inline with declining market rates (6mo KIBOR down 395 bps) while cost of funding remains sticky.

MCB: MCB posted phenomenal growth of 49% YoY in net interest income (NII) to PKR 18.08bn on the back of 228bps expansion in average NIMS to 9.5% and 8% growth in earning assets from Jun08 levels. Meanwhile, 2Q CY09 numbers reveal 35bps decline in NIM to 9.3%. For 2H CY09E, we expect interest margins to stabilize around 8% level.

UBL: UBL’s average NIM during the first half remained stable at 6.3% due to higher KIBOR and 15% growth in earning assets. As a result, net interest income (NII) grew by 20% to PKR 15.83bn as compared to PKR 13.22bn in the corresponding period last year. However, 2Q CY09 NIMs declined 20bps to 6.2% and NII declined 12.2% to PKR 6.82bn as compared to PKR 7.77bn in Mar09. In the second quarter, yield on earning assets fell by 80bps; however, downward re-pricing of expensive term-deposits trimmed cost of funding by an impressive 60bps QoQ keeping NIM compression under control.

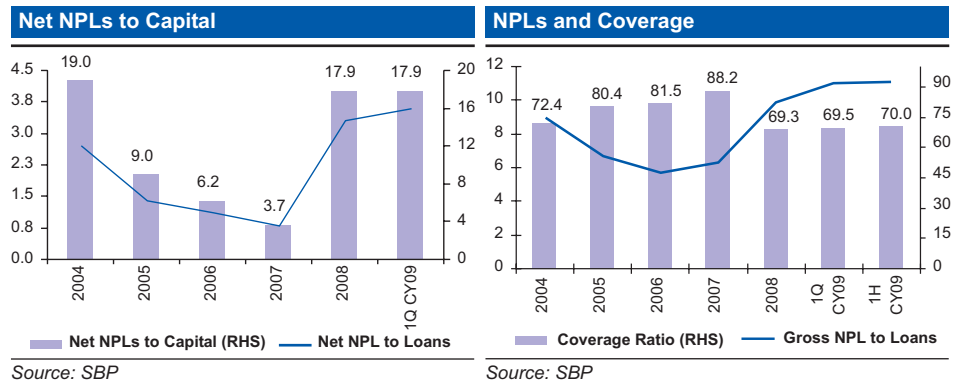
ABL: Total revenues (NIM + non-fund) grew aggressively by 53% YoY to PKR 12.05bn on the back of higher interest rate spreads and 17% growth in earning assets from Jun08 levels. The key driver behind revenue growth is an estimated 130bps YoY expansion in average NIMs to 5.6%.

BAFL: BAFL has the lowest NIM at 3.8% within our coverage banks which is almost 50% less than Tier I bank NIMs at around 6-7%. The key reason curbing NIM expansion is higher cost of funds which averaged 8.6% during 1H CY09. Aggressive deposit mobilization at the cost of low NIMs has enabled BAFL to grow its asset and deposit base at 5yr CAGR of around 30%. Going forward, we forecast a receding NIM outlook at 3.5% as asset yields adjust inline with declining market rates and overall profitability to remain under pressure with recovery expected in CY10E.



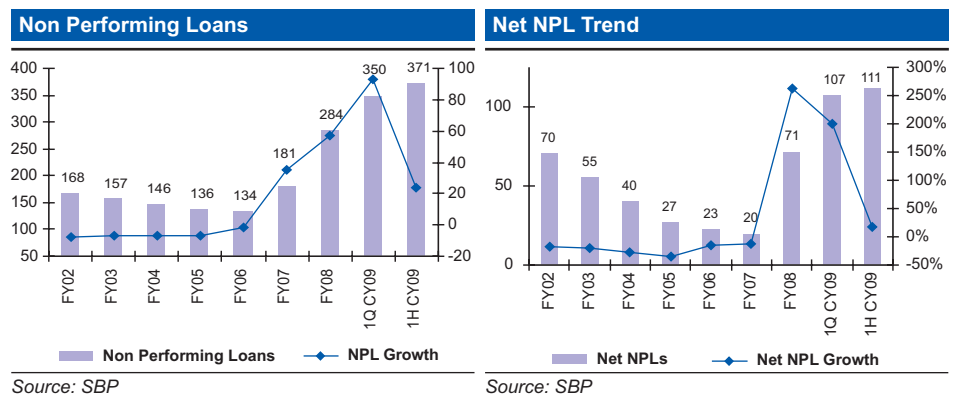
Rising NPLs signal a build-up in asset quality risks

From a systemic perspective, we believe NPL trends are alarming and asset quality weakening has emerged as the foremost downside risk facing banks. Overall asset quality of banks started deteriorating at a fast pace during CY08. Aggressive loan growth during past few years, macro vulnerabilities, slowing economic activities, rising interest rates, and high inflation has contributed to this trend. As a result, banking sectors NPLs grew by 57% and 22% in CY08 and 1H CY09 to 9.3% and 11.1% of gross advances respectively. The soaring NPLs enhanced the provisioning charge of the banking sector which has surged 52% YoY to PKR 41bn in the 1H CY09.



Declining trend in fresh NPL accrual rate

NPLs of the banking system are largely cyclical in nature and recent SBP data reveals that with the recent improvement in macroeconomic fundamentals, fresh NPL additions have started to ease considerably. In 2Q CY09, the NPL addition for commercial banks slowed to PKR 22bn as compared to a staggering PKR 65bn in the first quarter. Going forward, we believe the growth in NPLs is likely to moderate on the back of high base effect and improving fundamentals but NPL ageing effect is a bigger concern.



Seasoning Effect: Ageing of bad loans a bigger concern

SBP's categorization is based on the classification of nonperforming loans into substandard loans (more than 90 days outstanding), doubtful (180–360 days outstanding) and loss loans (more than 360 days outstanding) with provisioning requirements of 25%, 50% and 100% for the three categories respectively. SBP data reveals that NPLs in partial provisioning categories (Substandard & Doubtful) constituted 45% of total NPLs from 32% level a year earlier. This trend indicates that in periods ahead, banks have to provision more for additional loan losses. Provision expense is likely to peak in CY09E owing to change in buckets i.e. loans going down to the loss category require 100% provisioning.

Exposure to sensitive sectors remain large, despite sharp decline

Pakistan banks have large exposure to sensitive sectors including textile and consumer segments. Although the share in total loans is on a decline since CY07 yet the exposure constitute a sizeable chunk of IGI Universe banks. Textile and Consumer sector constitute 19.3% and 10.5% of total sector advances while their share in NPL is higher at 30% and 11.6% respectively. Within IGI Universe banks BAFL (25%), UBL (23%) and NBP (16%) have the highest exposure to retail while HBL (20%) and ABL (20%) have the highest exposure to the risky textile sector.

Segment Exposure - Dec08 (bn)						
	NBP	HBL	UBL	MCB	ABL	BAFL
Textile Loans	67	96	66	35	45	30
Textile NPLs	18.0	11.0	6.2	2.9	2.2	2.2
Textile (% of total loans)	15%	20%	17%	13%	20%	17%
Textile NPL Ratio	27%	11%	9%	8%	5%	7%
Retails Loans	74.8	32.0	92.0	32.7	5.5	44
Retail NPLs	3.0	1.0	8.5	1.4	0.2	2.5
Retail (% of total Loans)	16%	7%	23%	12%	2%	25%
Retail NPL Ratio	4%	3%	9%	4%	3%	6%

Source: Company Reports & IGI Research

Potential extension of FSV benefit on the cards

In Jan09, SBP provided a breather to the banking sector, relaxing the NPL provisioning criteria, by allowing 30% Forced Sale Value (FSV) benefit against pledged mortgaged commercial and residential properties effective Dec08 excluding industrial land and properties for NPLs less than 3yrs old. Within the IGI Universe, UBL and NBP are the only banks that have utilized the partial FSV cushion in the form of lower provisioning expense while MCB, HBL and ABL have not yet availed the benefit.

Recent news reports suggest that the regulator might extend the FSV benefit to collateralized plant and machinery which is currently ineligible. If allowed this will lower the provisioning expense for banks significantly and result in upward revision in earnings by 5-15%. The biggest beneficiary amongst IGI Universe banks would be UBL and HBL.

Bad Debts tax credit could be raised from 1% of advances

In the Finance Bill 2009, banks were re-allowed deduction on account of bad debts for tax purposes albeit with a cap of 1% of total advances. The measure was intended to be a positive for banks as it allowed higher provisions consideration for tax accounting thus reducing the overall tax expense. However, looking at CY08 figures for top 5 banks it is evident that 1% rule only provides a partial cushion as average Provisions / Gross Advances ratio was 1.3% in CY08 and is likely to surge to 1.8% in CY09E. Hence, according to anecdotal evidence, there is reasonable probability that the regulator may raise the ceiling of allowable provisions credit for tax purposes from 1% to 1.5-2%. This move will have a positive impact on both earnings and cash flows of banks with the most favorable impact on every bank in our coverage as every bank in IGI Universe is expected to have provisions / gross advances ratio above 1.5%.

Provisions/Loans CY08					
Bank	Gross Advances	Classified Advances	Provision Expense (LLP)	LLP/Loans CY08A	LLP/Loans CY09E
NBP	457,957	56,503	10,634	2.3%	1.80%
HBL	484,452	40,035	6,904	1.4%	1.70%
UBL	398,085	28,901	4,514	1.1%	1.60%
MCB	273,221	18,269	1,335	0.5%	2.00%
ABL	223,640	13,772	1,375	0.6%	1.60%
BAFL	198,812	8,934	2,036	1.0%	1.50%

Source: Company Reports & IGI Research

Reversal of Impairment charge expected in 2H CY09

The massive 60-70% decline in market value of banks AFS equity investment portfolio during 2H CY08 and 1Q CY09 required banks to recognize impairment provisions against investments in the P&L. As at Jun'09, the total impairment loss yet to be charged was in the range of 0-16% of quoted investment portfolio. However during the 3Q CY09, KSE100 index has rallied 35%; yielding significant gains on listed investments. Hence, we don't expect any further impairment losses being booked in the future instead we expect reversal of impairment charges which will help offset higher credit costs in 2H CY09. Within our coverage banks, MCB & ABL are likely to have the highest expected reversal in impairment charge amounting PKR 0.90 per share and PKR 1.11 per share respectively.

Impairment impact on banks							(mn)
	Quoted Investment	Provision booked	Impairment loss (June09)	Net book value	Expected market value 2H CY09E	After-Tax per share impact	
NBP	2,747	885	436	1,426	2,068	0.12	
MCB	8,189	3,291	856	4,042	5,861	0.91	
UBL	5,881	2,216	589	3,076	4,306	0.37	
HBL	3,540	1,977	-	1,563	2,188	0.45	
ABL	7,285	2,123	254	4,908	6,380	1.11	

Source: Company Reports & IGI Research

IGI Universe Banks- 1H CY09 NPLs and Provisioning

NBP: NBP's asset quality deterioration has exceeded the pace of the banking sector, ringing in at 12.9% compared to the sector NPL ratio of 11% in Jun'09. However, NBP's high coverage ratio (77%) compared to peers provides safety net to absorb loan losses.

HBL: As of Jun09, HBL bank had PKR 43.5bn in non-performing loans on its books. That represents an increase of PKR 15bn or 51% YoY while the NPL ratio has surged to 8.9%. Hence, due to fresh NPL hits and NPL ageing the provisioning expense increased by 4.5x to PKR 5.15bn as compared to PKR 1.14bn earlier. Meanwhile, loan loss coverage improved 280bps to 74.3% in Jun09 as higher NPLs fell in the loss category due to ageing.

MCB: MCB's Gross NPLs grew by 14% from Dec08 levels to PKR 20.86bn. Stagnant lending book and fast paced growth in non-performing loans in recent quarters has led the NPL ratio to jump by 90bps to 7.6%. Hence, the provisioning expense surged 168% to PKR 3.9bn as compared to PKR 1.45bn earlier.

UBL: NPLs grew by 28% while the Gross NPL ratio was up by 150bps to 8.8%, Net NPL ratio jumped 30bps to 2.9% and the coverage ratio stood at 70.5% from Dec08 levels. As a result, provisions surged to PKR 6.6bn with 50% provisions coming from corporate, 24% from consumer and 11% each from commercial & international portfolio. UBL's total consumer exposure (local & international) stands at PKR 55-60bn while Real Estate (RE) exposure in ME at PKR 30-35bn (including consumer RE).

ABL: ABL's asset quality profile started deteriorating at a fast pace since Jun08; however, in relative terms the bank has fared better than the sector with NPL growth at 20.7% and 10% in CY08 and 1H CY09 respectively, lower as compared to 57% and 31% for the banking sector in the same timeframe. Lack of retail presence is a positive for ABL in the prevailing environment however; oversized textile exposure (20%) remains a key downside risk. Growth in non-performing loans coupled with limited FSV benefit has resulted in provisioning expense to surge in the recent quarters and credit costs jumped to PKR 2.5bn during 1H CY09.

BAFL: The non-performing loans (NPLs) more than doubled from Dec07 levels to PKR 12.51bn while the NPL/Gross advances ratio surged to 6.4% in Jun09. As per Dec08 detailed accounts, two key risk segments namely consumer and textile constituted 25% and 17% of the loan book. Meanwhile, in terms of relative valuation BAFL's NPL ratio is still efficient amongst peers and much lower than sector average of 11%.

What Do 1H CY09 Earnings Tell Us?

The overall profitability on commercial banks in 1H CY09 dipped 25% YoY which is significant enough to dent confidence. The key reason behind the plunge in profitability is the record increase in credit costs which increased by PKR 41bn as of Jun09. Secondly, the administrative expense growth remained strong due to inflationary pressures averaging at 19% YoY coming from i) rising wage pressures ii) higher rental & fuel costs iii) expansion and renovation of branches amongst other factors. As a result, the cost / income ratio has crept up to 49%. This resulted in banking sector ROE and ROA to drop to 1% and 10% respectively as compared to 5yr average of 1.8% and 18.2%.

Net Interest Income up 20% YoY; down 13% QoQ

The analysis of 1H CY09 profitability reveals that the net interest income (NII) increased significantly by 20% YoY to around PKR 120bn. Despite higher funding costs due to liquidity crunch and 5% minimum rate on PLS accounts; higher average KIBOR (14.7%) resulted in robust growth in NII. However, during 2Q CY09, interest rates eased significantly by 300bps resulting in downward re-pricing of asset yields. This resulted in 13% QoQ decline in NII to PKR 56bn. Going forward, with little room to cut funding costs and expected further easing in KIBOR banking sector NIMs are likely to remain under pressure.

Non-interest income growth flat in 1H CY09

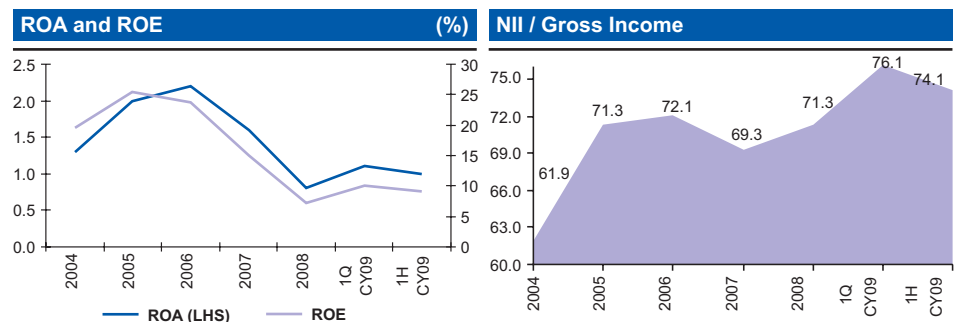
Meanwhile, growth in non-interest income remained sluggish owing to lower capital market related income. However, 50% increase in FX income kept non-interest income comparable with last year at around PKR 40bn. Sluggish non-interest income resulted in the share of non-fund income in gross income decline to 25.9% in Jun09 as against 28.7% in Dec08.

Cost efficiency

Since Dec07, the cost/income ratio of the banking sector has jumped a massive 670bps to 49.3% while the operating expenses surged 19% YoY in Jun09. However, shrinking margins and higher credit costs forced banks to concentrate on cost rationalization in an effort to support the bottomline. IGI Universe banks did a good job of controlling costs QoQ, which led to a decline in cost/income ratio by 133bps to 36.9%. Amongst our coverage banks, MCB and HBL did an impressive job in cutting costs in 2Q CY09 while NBP, ABL and UBL lagged behind on this front.

FX dealing gains buoy non-interest income

During 1H CY09, despite lower dividend and capital gains income, banking-sector's non-interest income remained inline with 1H CY08 levels on the back of strong fee income and record growth in gains from FX dealings. The strong exchange gains resulted from unusual volatility in PKR during 2H CY08 and 1Q CY09. However, this concerns us because spike achieved in recent quarters is unsustainable amidst stabilizing currency / interest rates volatility. The declining trend is visible in 2Q CY09 financials as FX income for our coverage banks declined 23% QoQ to PKR 1.75bn in Jun09. Secondly, SBP data regarding banks derivative positions in currency swaps, FRAs and options reveal a declining trend further reinforcing our stance that non-interest income will remain under pressure during 2H CY09.

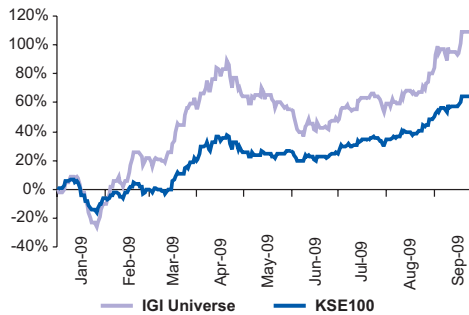


Source: SBP

Source: SBP

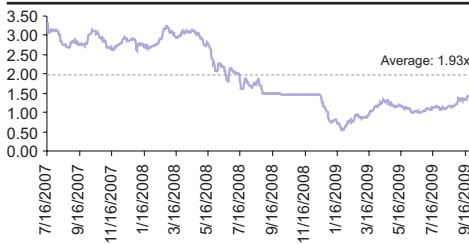
Price performance - Strongest rebound on record

Sector Price Performance



Source: Bloomberg

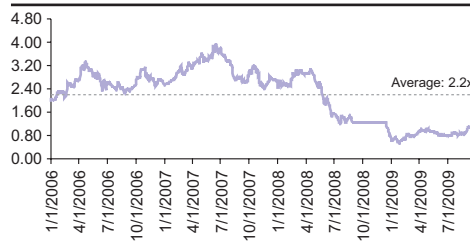
IGI Universe PB



Source: Bloomberg & IGI Research

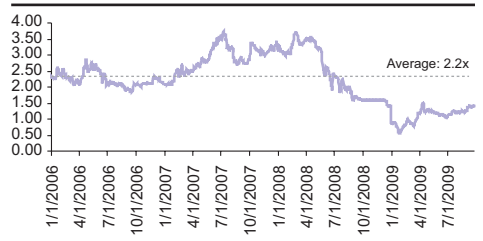
During 1H CY09, the banking sector roared back from trough valuations of Jan09 and have rallied YTD by 75-120% in absolute terms and have outperformed the benchmark KSE100 index by 25-55%. However, at current levels, we believe that most positives are priced in and banking sector stocks are trading at above our target price estimates. The banking sector is trading at PB of 1.4x below 3yr PB average of 1.9x for IGI Universe. Despite being below LTM average we feel that given weak earnings and low ROE the current valuations are above justified multiples and we maintain a neutral stance on the sector.

UBL - PB Band



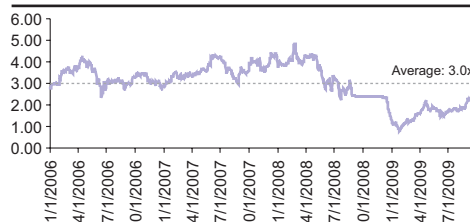
Source: Bloomberg & IGI Research

ABL - PB Band



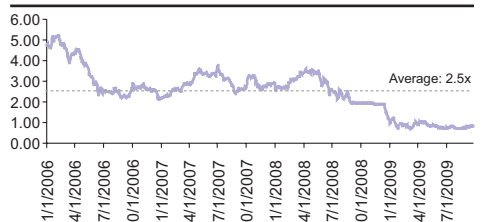
Source: Bloomberg & IGI Research

MCB - PB Band



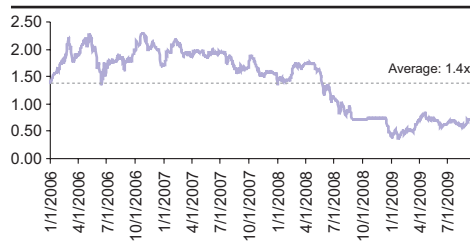
Source: Bloomberg & IGI Research

BAFL - PB Band



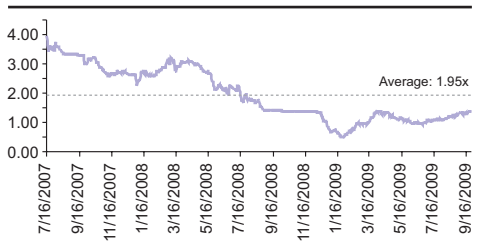
Source: Bloomberg & IGI Research

NBP - PB Band



Source: Bloomberg & IGI Research

HBL - PB Band



Source: Bloomberg & IGI Research

Valuations and Rating

We have revised our valuation assumptions and estimates in light of recent conditions. With prospects of earnings growth poor, we think the upside for banks is limited. Our Gordon Growth valuations cost of equity is 18% while sustainable ROE ranges from 13-20%. The implied 'Exit PB multiples' range from 0.8-1.8x. We think risk of deceleration has increased particularly by the fact that our coverage banks (NBP, HBL, UBL, MCB, ABL, BAFL) stock prices have peaked. We maintain a neutral stance on NBP, UBL and BAFL while an underweight stance on HBL, MCB and buy stance on ABL.

IGI Universe Banks

	CY07A	CY08A	CY09E	CY10E
Div Yield (%)	5.0%	4.8%	5.5%	6.3%
P/E (x)	8.2	8.0	8.2	7.3
P/B (x)	1.7	1.6	1.4	1.2
ROE (%)	23%	20%	17%	17%
ROA (%)	2.4%	2.1%	1.8%	1.8%
NIM	5.9%	6.0%	6.0%	5.1%

Source: Company Reports & IGI Research

UBL - Financial Highlights

(Fair Value : 55)

	CY07A	CY08A	CY09E	CY10E
EPS (PKR)	8.06	7.51	7.33	8.87
Div Yield (%)	3.8%	4.0%	4.2%	6.2%
BVPS (PKR)	41.13	42.55	49.97	55.34
P/E (x)	7.04	7.56	7.75	6.41
P/B (x)	1.38	1.33	1.14	1.03
ROE (%)	23%	17%	15%	17%
ROA (%)	1.8%	1.4%	1.3%	1.4%
NIM (%)	6.0%	5.8%	5.6%	4.9%

Source: Company Reports & IGI Research

NBP - Financial Highlights

(Fair Value : 80)

	CY07A	CY08A	CY09E	CY10E
EPS (PKR)	18.02	14.56	12.66	14.95
Div Yield (%)	6.7%	6.4%	6.5%	7.1%
BVPS (PKR)	109.43	96.78	112.63	124.76
P/E (x)	4.70	5.82	6.69	5.67
P/B (x)	0.77	0.88	0.75	0.68
ROE (%)	19%	14%	12%	13%
ROA (%)	2.8%	2.0%	1.6%	1.8%
NIM (%)	6.0%	5.9%	5.5%	4.8%

Source: Company Reports & IGI Research

ABL - Financial Highlights

(Fair Value : 55)

	CY07A	CY08A	CY09E	CY10E
EPS (PKR)	5.73	5.76	6.44	7.04
Div Yield (%)	4.7%	4.7%	5.9%	6.2%
BVPS (PKR)	27.91	31.29	38.76	42.81
P/E (x)	8.48	8.44	7.54	6.90
P/B (x)	1.74	1.55	1.25	1.14
ROE (%)	22%	19%	18%	17%
ROA (%)	1.4%	1.2%	1.2%	1.1%
NIM (%)	3.9%	4.1%	4.1%	3.5%

Source: Company Reports & IGI Research

MCB - Financial Highlights

(Fair Value : 190)

	CY07A	CY08A	CY09E	CY10E
EPS (PKR)	23.79	22.17	20.92	22.49
Div Yield (%)	7.1%	5.1%	6.9%	7.6%
BVPS (PKR)	83.27	87.01	97.53	108.11
P/E (x)	9.49	10.18	10.79	10.04
P/B (x)	2.71	2.59	2.31	2.09
ROE (%)	33%	26%	23%	22%
ROA (%)	4.3%	3.6%	3.0%	2.9%
NIM (%)	8.0%	8.1%	7.9%	6.6%

Source: Company Reports & IGI Research

HBL - Financial Highlights

(Fair Value : 105)

	CY07A	CY08A	CY09E	CY10E
EPS (PKR)	10.98	17.05	15.17	16.74
Div Yield (%)	2.4%	3.7%	4.0%	4.4%
BVPS (PKR)	68.37	81.58	95.06	105.07
P/E (x)	11.30	7.28	8.18	7.41
P/B (x)	1.82	1.52	1.31	1.18
ROE (%)	17%	22%	17%	17%
ROA (%)	1.6%	2.2%	1.8%	1.8%
NIM (%)	5.7%	6.0%	6.7%	5.9%

Source: Company Reports & IGI Research

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Analyst Certification

I, Ahmed Raza Khan, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject, securities and issuers. I also certify that no part of our compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

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