



Habib Bank (HBL)

Earnings revised down, Downgraded to “Hold”

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Habib Bank (HBL): Downgraded to “Hold”

- **Investment Thesis:** Post announcement of HBL’s 2Q2018 financial results, we revise down our earnings estimate for HBL by ~20% for 2018-20 as bank is incurring additional cost on improving its local & international compliance. We also downgrade the stock to ‘Hold’ given lack of clear visibility on the continuity of this cost, which is estimated to continue at least till 2019. Furthermore, additional cost on account of deposit protection mechanism, FX losses and implementation of IFRS 9 could further restrict earnings growth going ahead. The stock currently trades at a 2018 PE of 8.7x and PBV of 1.1x with ROE of 14%.
- **Earnings revised down post 2Q2018 financial results:** HBL posted earnings of Rs2.3/share in 1Q2018, down 48% YoY taking 1H2018 EPS to Rs5.4/share, down 49%. Sharp deterioration in earnings during 1H2018 was due to 1) Rs1.9bn (Rs0.85/share) of pension charge, 2) bank business & compliance transformation project costing Rs2.5bn (Rs1.1/share) & 3) higher consultancy cost pertaining to NY operations. Along with higher costs, non-markup income of the bank was also down 35% YoY to Rs10.7bn primarily due to FX losses on borrowings and lower capital gains, which will likely prevail given expectations of currency devaluation & lower expected gains on bonds/equities. Accounting for the same, we revise down our earnings estimate by ~20% to Rs14/19/21 for 2018/2019/2020.
- **Cost related to NY operation to remain inflated:** HBL registered strong increase in admin costs during 1H2018, +27% YoY amid higher cost related to consultancy & other legal fees in connection to its U.S operations. This fees is related to legal consultation carried out by the bank for compliance of Anti-Money Laundering (AML) rules & regulation & other costs relating to closure of its NY branch. The bank incurred loss of Rs4.9bn during 1H2018 on its international business versus loss of Rs0.5bn in same period last year. To recall, New York Department of Financial Services (DFS) imposed a penalty in Sep 2018 of US\$225mn (revised down from US\$630mn) on non-compliance of its AML laws. Due to this, the bank has not only paid the penalty amount (paid in 2017) but has also been paying the increased legal cost. The increased legal cost is expected to continue till 2019 at least.

Habib Bank (HBL): NY Ops & FX Losses Increasing Costs

- **FX losses on foreign currency borrowings to continue:** The bank borrowed an amount of ~US\$200mn in order to pay the fine on its overseas operations, which was subject to FX losses during 1H2018 of Rs2.5bn as Pak rupee lost 10% against the USD in 1H2018. Given Pakistan's weak external account situation, we expect further currency devaluation in 2019 & 2020, which will likely result in further FX losses.
- **Bank to bear additional cost on deposit protection:** SBP has recently setup a Deposit Protection Corporation (DPC) to ensure deposit protection of small depositors by providing guarantee of Rs250k to the depositor in case of a default. Banking companies being member of the DPC will have to comply to the above regulation and will have to pay insurance premium of 0.16% of their respective eligible deposits. Eligible deposits would include all deposits excluding i) deposits that have been reported as unclaimed deposits, & ii) such deposits that are maintained at branches and subsidiaries of Pakistani bank operating outside Pakistan & branches located in export processing zone. The first premium was payable in July 2018 and is expected to have an annualized impact of Rs1-1.5bn (Rs0.5-Rs0.7/share) for the bank.
- **Rising interest rates to offer some support:** In a tough operating environment, the bank is likely to get some relief from rising interest rates. SBP has already raised policy rates by 175bps to 7.5% in 8M2018, which we expect to go further up to 9.75% by 2020. This is likely to support NII growth of the bank going forward on its domestic operations. We expect NII to grow by 8% on average during 2018-20. Higher NII will support earnings and ROE (excluding surplus) of the bank, which is expected to improve from 2019, however, it will still be lower than the average of 21% seen pre 2017 level when fine was imposed.

Habib Bank (HBL): NY Ops & FX Losses Increasing Costs

- Pension charge:** Supreme Court (SC) of Pakistan had ordered banks to increase minimum pension to Rs8,000/month to bank's pensioners with an annual increase of 5%. The bank booked Rs1.9bn (Rs0.85/share) of pension charge in 1H2018 which was revised down from Rs2.1bn charged during 1Q2018. The bank so far has provided for the pension charge as per the requirement of SC. However, any future adjustment to pension charge can not be ruled out.
- Implementation of IFRS9:** IAS39 is expected to be replaced by IFRS9 in 2019, which alters the mechanism of booking and measurement of financial instrument. It is likely to change the recognition of Non performing loans will change. Currently, banks follow objective classification criteria for recognition of NPLs as highlighted in SBP's Prudential regulations, which require provisioning of 25%, 50% & 100% for substandard, doubtful & loss categories. The new IFRS9 rule will require banks to classify NPLs based on subjective criteria, which will require banks to subjectively classify loans as NPLs that may not be recovered eventually from borrowers which could result in higher provisioning.
- Key Risks:** Key risks for the bank include 1) further increase in cost relating to NY operations, 2) increase in NPLs, 3) further increase in pension charge, & 4) imposition of further penalty.

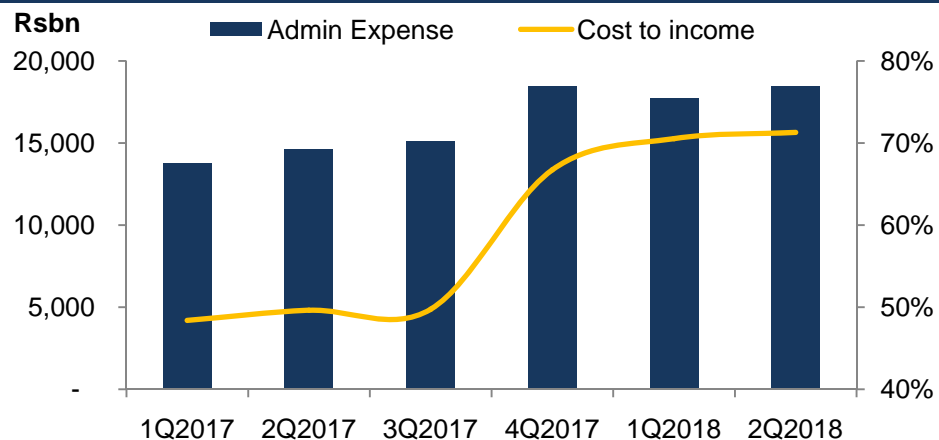
HBL: Key Numbers

	2016A	2017A	2018E	2019F	2020F
EPS	23.2	5.3	14.2	18.5	21
Earnings Growth	-3%	-77%	166%	30%	14%
PE at Rs161.6	7	30.3	11.4	8.7	7.7
Dividend Yield	9%	5%	4%	5%	5%
ROE	20%	5%	11%	13%	14%
PBV	1.2	1.2	1.1	1.1	1

Source: Company Accounts, Topline Research

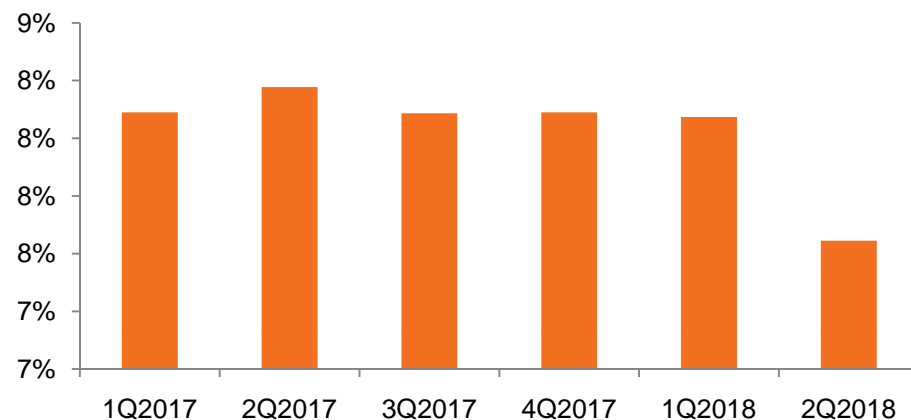
HBL: Key Ratios

Rising cost to income ratio



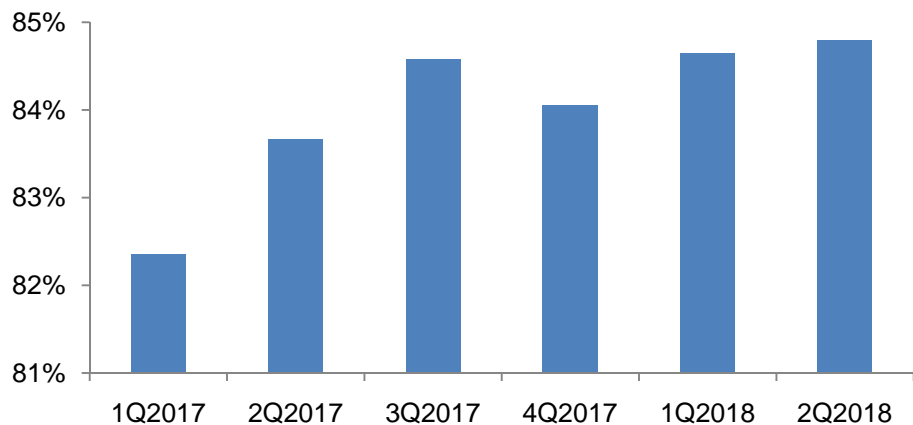
Source: Company Accounts, Topline Research

NPL ratio under control



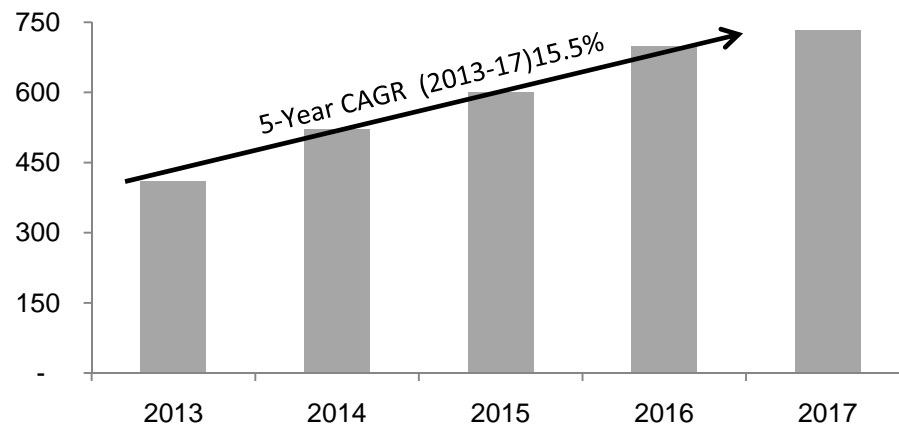
Source: Company Accounts, Topline Research

CASA consistently over 80%



Source: Company Accounts, Topline Research

Strong current account growth



Source: Company Accounts, Topline Research

Habib Bank (HBL): Financial Snapshot

Consolidated Income Statement

Rsmn	2016A	2017A	2018E	2019F	2020F
Mark-up / Interest earned	141,089	148,010	175,989	225,625	238,517
Mark-up / Interest expense	59,138	64,943	91,919	129,261	136,122
Net Mark-up / Interest income	81,951	83,067	84,069	96,364	102,396
Non-Interest Income	31,435	32,889	26,603	28,036	34,328
Operating expenses	55,771	63,541	74,124	78,091	84,764
Provisions/Reversals	718	(115)	300	2,444	2,962
Profit before taxation	56,898	52,531	36,248	43,866	48,998
Profit after taxation	34,070	7,829	20,850	27,143	30,807
EPS (Rs)	23.2	5.3	14.2	18.5	21.0

Source: Company Accounts, Topline Research

Consolidated Balance Sheet

Rsmn	2016A	2017A	2018E	2019F	2020F
Paid-up capital	14,669	14,669	14,669	14,669	14,669
Shareholders' equity	168,769	164,041	188,046	204,332	222,816
Total equity	196,269	188,815	207,925	220,932	236,794
Deposits	1,885,959	1,998,935	2,138,861	2,267,192	2,403,224
Total liabilities	2,310,926	2,495,286	2,622,404	2,773,835	2,934,352
Net advances	748,466	851,502	927,672	988,261	1,053,566
Net investments	1,344,405	1,374,808	1,425,074	1,505,650	1,589,980
Total assets	2,507,182	2,684,102	2,830,329	2,994,768	3,171,146

Source: Company Accounts, Topline Research

Key Ratios

	2016A	2017A	2018E	2019F	2020F
Earnings Growth	-3%	-77%	NM	30%	14%
PE at Rs161.60	7.0	30.3	11.4	8.7	7.7
Dividend Yield	8.7%	5.0%	4.3%	5.0%	5.0%
PBV	1.2	1.3	1.1	1.1	1.0
Return on performing loans	7.3%	7.6%	8.4%	10.1%	10.0%
Cost of deposits	3.7%	3.7%	5.2%	7.5%	7.5%
Net interest margin (NIM)	4.1%	3.8%	3.7%	4.0%	4.1%
NII/ Gross Income	72.3%	71.6%	76.0%	77.5%	74.9%
Cost / Income ratio	48.0%	53.4%	66.0%	61.7%	60.9%
Deposit growth	15.4%	6.0%	7.0%	6.0%	6.0%
Credit growth	17.4%	13.8%	8.9%	6.5%	6.6%
Investment growth	8.0%	2.3%	3.7%	5.7%	6.0%
Return on equity (ROE)	20.5%	4.6%	11.6%	13.6%	14.2%
Return on assets (ROA)	1.4%	0.3%	0.8%	0.9%	1.0%
Advances-to-deposit (ADR)	39.7%	42.6%	43.4%	43.6%	43.8%
Investment-to-deposit (IDR)	71.3%	68.8%	66.6%	66.4%	66.2%
CASA	82.6%	83.5%	84.1%	84.0%	84.0%
Gross infection ratio (%)	9.6%	8.2%	8.2%	9.0%	9.7%
Net infection ratio (%)	0.9%	1.1%	1.1%	1.2%	1.3%
Coverage ratio (%)	91.2%	87.6%	87.6%	87.6%	87.6%
Number of Branches	1,731	1,751	1,760	1,770	1,780

Source: Company Accounts, Topline Research

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Neutral	Stock will perform in line with the average total return of stocks in universe
Sell	Stock will underperform the average total return of stocks in universe

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