Foundation Securities
REP-095

Pakistan

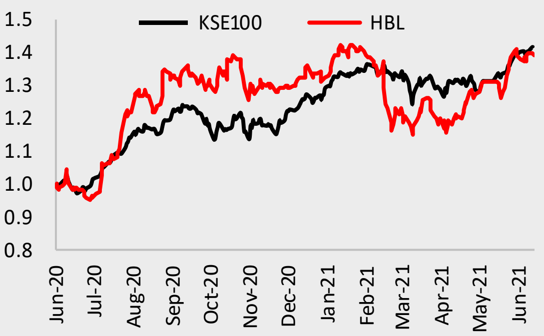
HBL PA — Outperform

Price (LDCP)	Rs	133.7
Jun-22 Target Price	Rs	174.0
Upside/Downside	%	30.2
12M Target Price	Rs	173.0
- 2-Stage Gordon growth model		
Sector		Banks
Market cap	Rs bn	196.1
30-day avg turnover	$ m	1.3
Market cap	$ m	1,256.9
Freet float	m	733.4
Shares issued	m	1,466.9

Investment fundamentals

Year end Dec		2020A	2021E	2022E	2023E
NII	mn	130,104	127,656	148,450	168,584
NFI	m	27,632	29,237	29,032	30,415
Fee Income	m	18,796	22,166	23,677	25,579
Total Income	m	160,699	156,893	177,482	198,999
Non Markup Exp.	%	95,449	99,714	109,342	120,731
A.Expenses	m	94,018	98,515	107,962	119,169
Provisions		12,220	6,280	5,390	6,044
PBT		53,031	50,899	62,750	72,223
PAT	Rs	30,913	30,657	38,278	44,056
EPS	Rs	21.1	20.9	26.1	30.0
DPS	Rs	4.25	7.00	8.00	10.00
EPS Growth	x	99.4	(0.8)	24.9	15.1
Payout Ratio	%	20.2	33.5	30.7	33.3
Div. Yield	%	3.2	5.2	6.0	7.5
NIMs	%	4.55	3.95	4.25	4.32
ADR	%	46.1	46.3	48.1	49.2
Infection Ratio	x	6.3	5.9	5.4	5.0
Coverage Ratio	x	99.7	100.0	102.0	105.0
IDR	x	68.8	61.6	61.6	61.6
Deposit growth	x	16.1	10.5	10.2	10.2

HBL KSE 100 Relative Performance



Source: Bloomberg, Foundation Research, June 2021
(all figures are in Rs unless noted)

Analysts

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Foundation Securities (Pvt) Ltd
Friday, June 18, 2021

Habib Bank Limited

Banking on Silk Route

Event

- Sharp economic recovery and probable reversal in interest rates would play in bank's favor, in our view. We foresee, NIMs accretion, robust fee income and lower provisioning expense amid operational efficiencies would help to boost bank's profitability. Moreover, HBL's global repositioning towards Chinese investment in the region is likely to unlock growth potential beyond Pakistan. Aforementioned factors would overshadow investor's concerns regarding asset quality and capital adequacy. Thus, we maintain our "Outperform" stance with a Jun-22 TP of Rs174/sh.

Impact

- **Rebound in profitability driven by improving fundamentals:** We expect HBL's profitability to grow with a 3yr CAGR of 13% on the back of reversal of interest rate cycle. This profitability is expected to be driven by NII expansion, upbeat fee income, normalized operating expense and lower provisioning expense. We expect interest rates to increase from 4QCY21 onwards.

- **Dynamic positioning to lower risk and promote growth:** Since New York incident, HBL has been repositioning its international portfolio towards Chinese investments and spending aggressively on compliance and Information Technology (IT). We expect this shift in focus to uplift its profitability in future. Furthermore, we expect HBL's global branches to turn profitable in the medium term due to global economic recovery. On the local front, in addition to opportunities of inorganic growth, exposure in Islamic banking and digital initiatives would provide further impetus to the growth.

- **Robust loan growth with improving asset quality:** As federal government is all set to shift gears from stabilization to growth, we expect overall credit demand in the economy to grow. In line with the overall industry credit demand, we expect HBL's gross advances to grow over 10% p.a. for next three years without any major deterioration in the asset quality with provision coverage of over 100%.

- **Well positioned investment book:** HBL's exposure in floating rate investment instruments currently stands slightly over 50% which we expect to further increase as management expects interest rates to increase from 2HCY21. We believe that HBL's investment portfolio is well positioned to play the upcoming interest rate cycle.

- **Sufficient capital buffers to dilute concerns:** Incorporating the additional requirement under D-SIB and implementation of IFRS9, we expect HBL to keep its payout ratio on the lower side and stay above the management's target of keeping minimum cushion of 2ppts over regulatory requirements. We expect this to address concerns over capital adequacy.

Earnings Revision

- We revise our CY21/22 EPS upward by 20/10% due to change in core assumptions.

Price Catalyst

- June- 22 TP: 174/sh based on 2-Stage Gordon growth model methodology
- Catalyst: (1) Improvement in asset quality and (2) earlier increase in interest rates.
- Risk: (1) Higher than expected increase in NPLs and 2) slower progress of Intl book.

Outlook

- We have an "Outperform" stance on the scrip with Jun-22 TP of Rs174/sh.

Rebound in profitability

We expect HBL's profitability to grow with a 3yr CAGR of 13% on the back of reversal of interest rate cycle. Profitability growth is expected to be driven by NII expansion, upbeat fee income and lower provisioning expense. We expect interest rates to increase from 4QCY21.

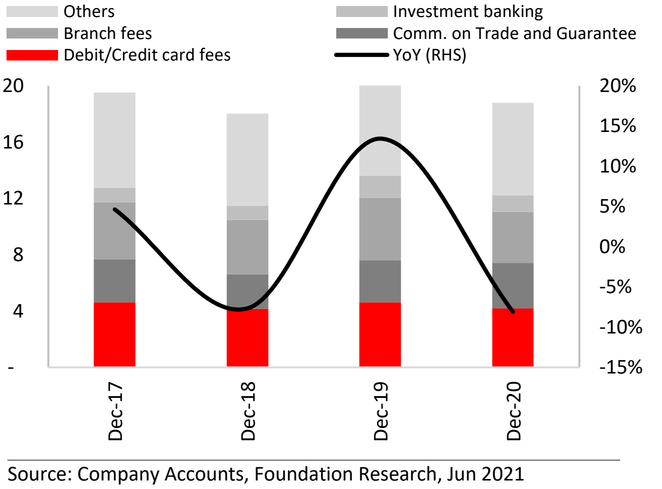
During CY20, the bank almost doubled its profitability to Rs30.9bn compared to Rs15.5bn in the previous year. Sharp decline in interest rates and outbreak of COVID-19 remained the key features which impacted profitability in CY20. To highlight, sharp decline in interest rates resulted in higher NIMs initially (as deposits re-price earlier than assets) and provided the opportunity for the bank to book hefty capital gains (Rs7.0bn) against the loss of Rs2.7bn during CY19. However, this surge in profitability was partially neutralized by negative implications of COVID-19 on the business as fee income declined by 8% YoY given a steep decline of 48% YoY and 18% YoY during CY20 in bancassurance and branch banking fee respectively. In addition to this, provision expenses also remained on the higher side as it surged 3.7x YoY to Rs12.2bn (highest in a decade). This substantial increase in the provisioning expense was primarily driven by uptick in general provision stock to Rs11bn (↑Rs7.3bn) to create room for potential increase in NPLs from COVID related financing facilities and probable implementation of IFRS9. Both of these concerns have now largely subsided as economy has found its way back to growth trajectory whereas implementation of IFRS9 is likely to get delayed to CY22.

Going forward, we expect expansion in Net Interest Income (NII), growth in fee income and increasing efficiency on the back of controlled operating expenses to drive the profitability for HBL. Gradual increase in interest rates from 4QCY21 is likely to lift NII in CY22 and beyond. In addition to this, improvement in international trade volume and normalization of public mobility post COVID is likely to translate into better fee income. Furthermore, normalization of operating expenses post NY branch closure has now started to ease profitability indicators. We believe this trend would continue as we don't foresee any significant surge in the operating expenses. Therefore, as a result of improved profitability and moderate payout policy, ROE/ROAs of the bank will improve and stay over 15% post CY23.

Fig 01: Reversal in interest rates to lift NIMs

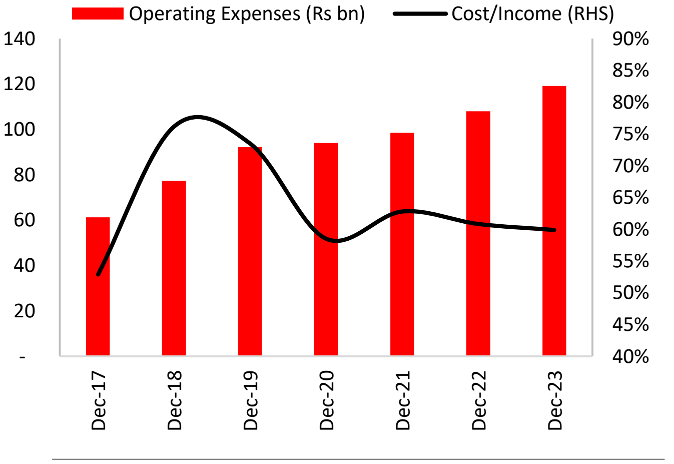
Source: Company Accounts, Foundation Research, Jun 2021

Fig 02: Fee income to remain robust



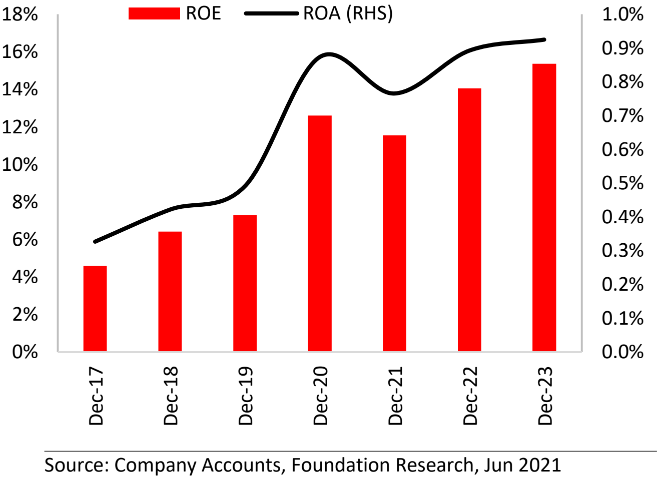
Source: Company Accounts, Foundation Research, Jun 2021

Fig 03: Operating efficiency to improve post NY



Source: Company Accounts, Foundation Research, Jun 2021

Fig 04: …which would improve ROE/ROA



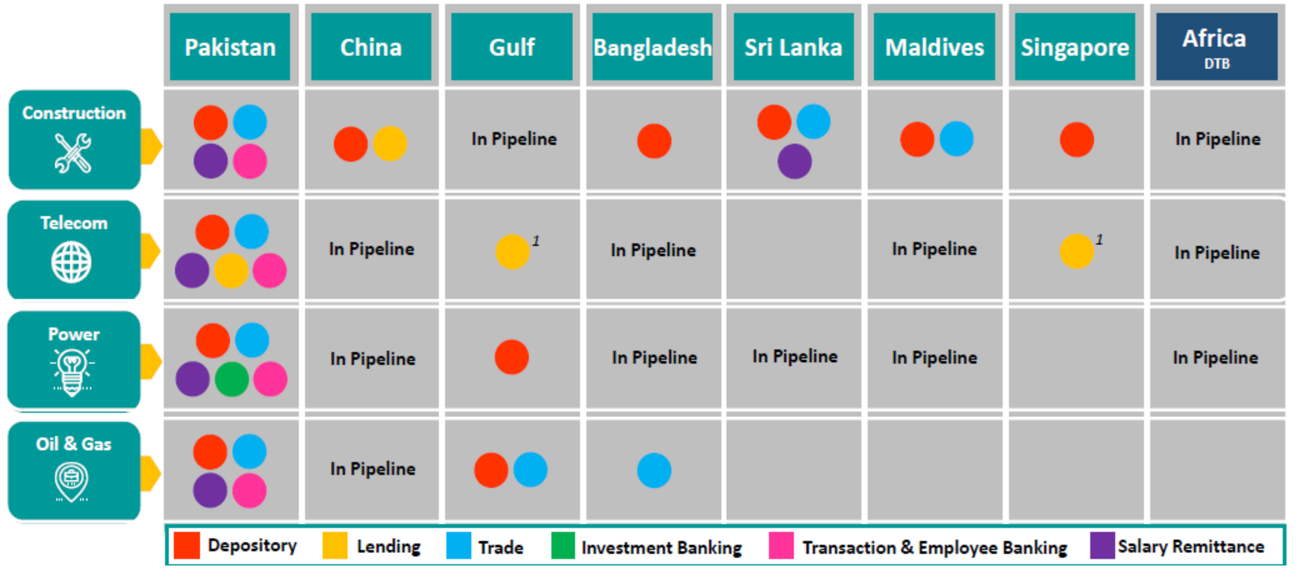
Source: Company Accounts, Foundation Research, Jun 2021

Dynamic positioning to lower risk and promote growth

Since the New York incident back in 2017, Habib Bank Limited (HBL) has been aggressively working to reposition itself to improve its brand image and make its foreign operations more relevant and profitable. The bank went through aggressive business transformation which kept its operating cost elevated (mainly due to higher consultancy, compliance and IT cost) for past few years. As part of its global repositioning plan, HBL has now planned to keep its focus around Chinese Belt and Road Initiative to cater to Chinese investment. Therefore, the bank is now focusing on countries of Chinese investment in the region along with catering to overseas Pakistanis. In addition to this, HBL also maintains its exposure in Kenya, Nepal and Kyrgyzstan via its investments in Diamond Trust Bank Kenya, Himalayan Bank Limited and Kyrgyzstan Investment and Credit Bank. So far, HBL has handled transactions of over US$6bn+ under CPEC in different roles. This optimistic vision of HBL to grow by capitalizing on the regional economic growth gives it edge over local peers. HBL was the first and the only Pakistani bank to commence operations in China with its Beijing and Urumqi Branches. Strategic positioning and partnership with major Chinese partners provides substantial potential for growth. However, most of HBL's overseas operations are currently in losses but with the renewed operational directional we expect these operations to become profitable in next few years.

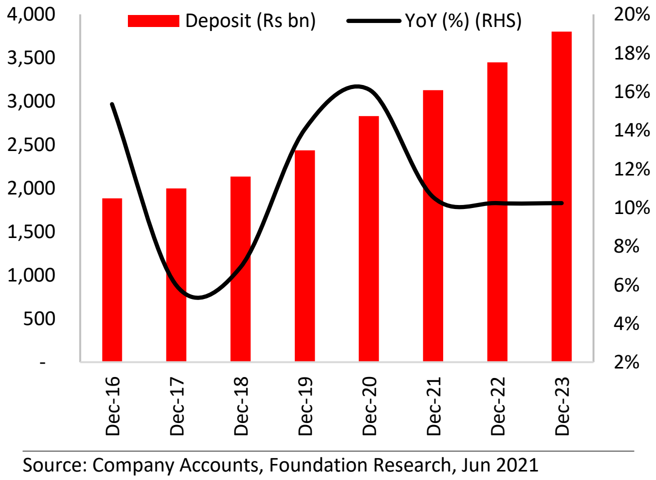
On the local front, we expect HBL to increase its focus on the Islamic front to build on the momentum of fast growing industry deposit base. The bank currently holds the 3rd largest market share of 22% in the Islamic industry deposits. So far HBL Islamic has been unable to capitalize on the momentum of rapid growth in the Islamic banking. In addition to this, HBL's continuous investment in technology is expected to generate value for the bank. Furthermore any potential opportunity of inorganic growth can't be ruled out as HBL is evaluating Silk Bank's retail business to acquire.

Fig 05: Changing its global positioning to facilitate Chinese investments



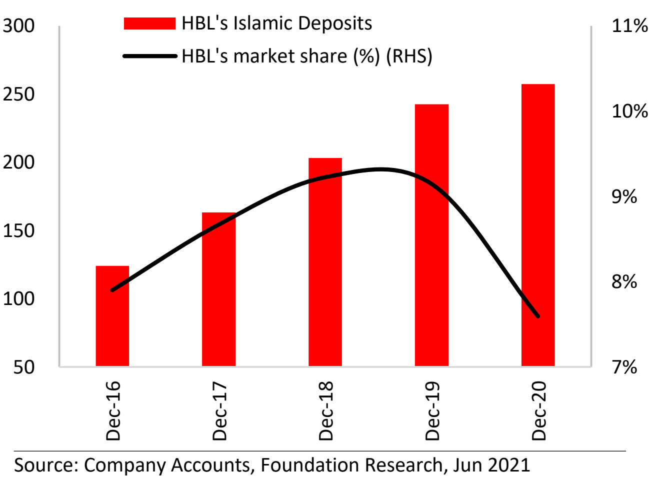
Source: Investor Presentation, Foundation Research, Jun 2021

Fig 06: Local deposit base to carry its momentum



Source: Company Accounts, Foundation Research, Jun 2021

Fig 07: Islamic franchise to improve its market share



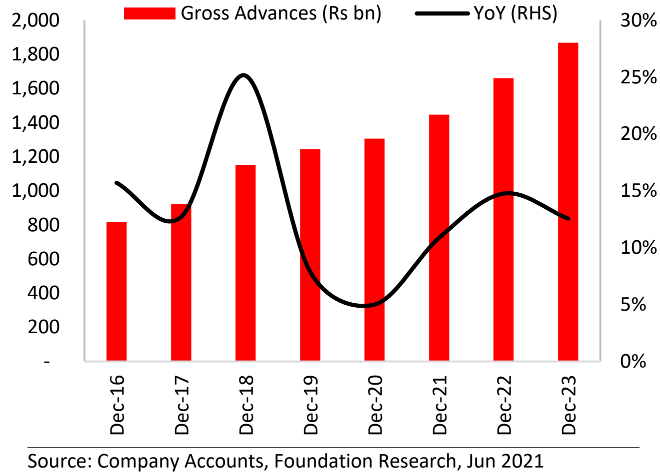
Source: Company Accounts, Foundation Research, Jun 2021

Robust loan growth with sound asset quality

As federal government is all set to shift gear from stabilization to growth, we expect overall credit demand in the economy to grow to achieve this goal. In line with the overall industry credit demand, we expect HBL's gross advances to grow over 10% p.a. for next three years without any major deterioration in the asset quality. Whereas provision coverage is estimated to stay over 100%, going forward.

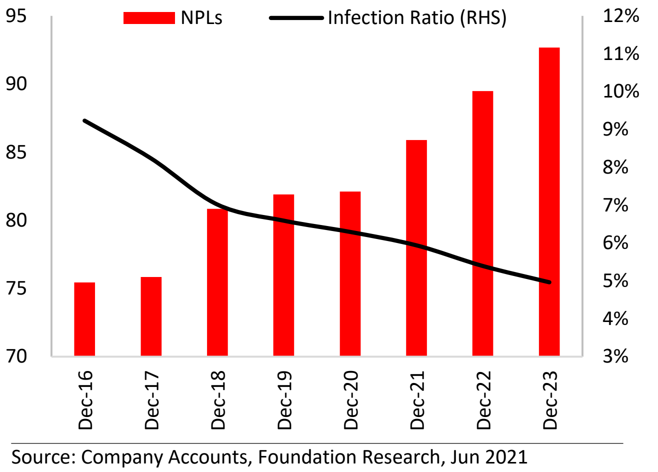
During CY20, HBL's gross advances grew by 5% YoY whereas gross advances of UBL and MCB recorded a decline of 13% and 5% YoY. This increase in the loan portfolio despite the economic pressure reflects the sound asset quality due to strong clientele of the bank. Although, HBL recorded some credit deterioration where more than half of the incremental Non-Performing Loans (NPLs) were generated from oil & gas sector that was concentrated around one company. In contrast to this, Textile and Agriculture witnessed some credit recovery as NPLs stock form these sectors recorded a YoY decline of 9% and 42% respectively. To counter any further credit deterioration that may arise in the medium term, HBL has significantly increased its general provision coverage (↑Rs7.3bn, ↑3.0x YoY) to stand at 13% compared to 5% in CY19. As a result of this, cost of credit for the bank spiked up to 95bps which is highest since Dec'12. Having said that, we believe that the significant buildup of provision coverage would be enough to absorb any further credit deterioration that may arise after the expiration of SBP's principal deferment schemes. Going forward, we have assumed gradual uptick in HBL's ADR of 3ppts over next three years. Whereas infection ratio is likely to come under 5% by CY23 with a coverage ratio of over 100%.

Fig 08: Credit offtake to ↑ with growing economy



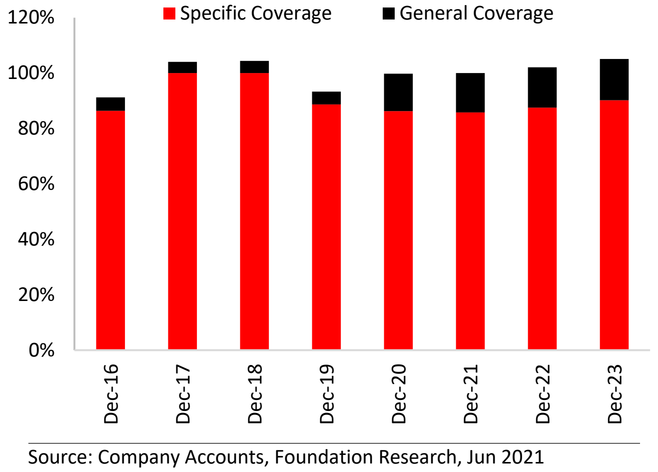
Source: Company Accounts, Foundation Research, Jun 2021

Fig 09: ..but asset quality is likely to remain robust



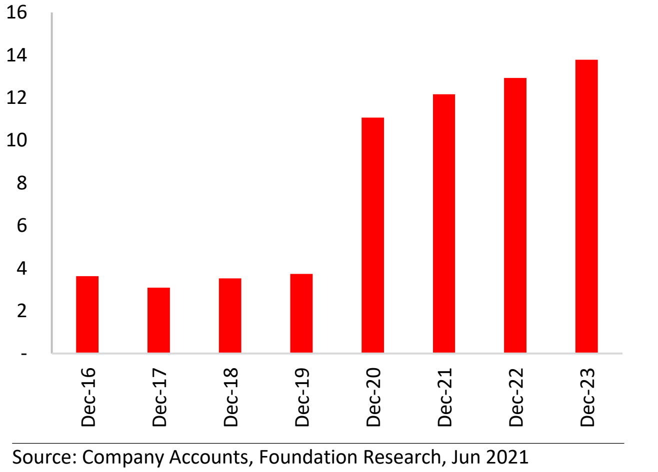
Source: Company Accounts, Foundation Research, Jun 2021

Fig 10: ..with adequate provision coverage



Source: Company Accounts, Foundation Research, Jun 2021

Fig 11: and sufficient general provisioning (Rs bn)



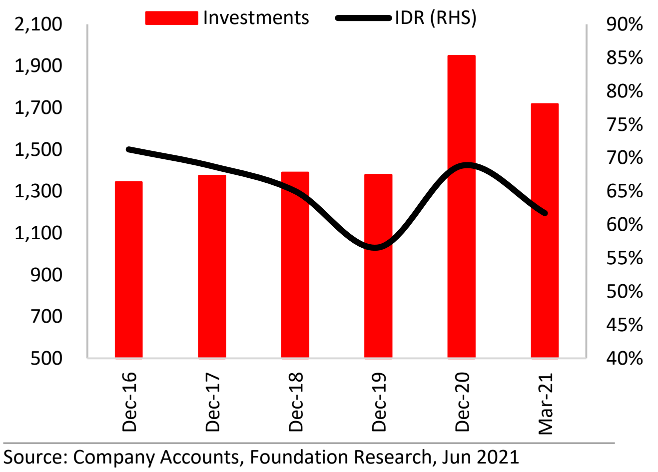
Source: Company Accounts, Foundation Research, Jun 2021

Well Positioned Investment Portfolio

As banks shied away from fresh lending due to uncertain economic environment on account of COVID outbreak, investments became the preferred avenue of asset deployment. As a result, investment portfolios of all the banks peaked translating into higher IDRs. Similar trend was observed for HBL, however, the extent of this diversion remained well below compared to peers. HBL's investment portfolio grew by 41% YoY during CY20 resulting in an increment of 12ppts in IDR to clock in at 69%. However, uptick in economic activity has now revived interest in lending. Therefore, investment portfolio in Mar'21 declined by 12% compared to Dec'20 yielding 12ppts retracement in IDR level. Going forward, we expect bank's IDR to remain lackluster to create room for potential credit growth in the system.

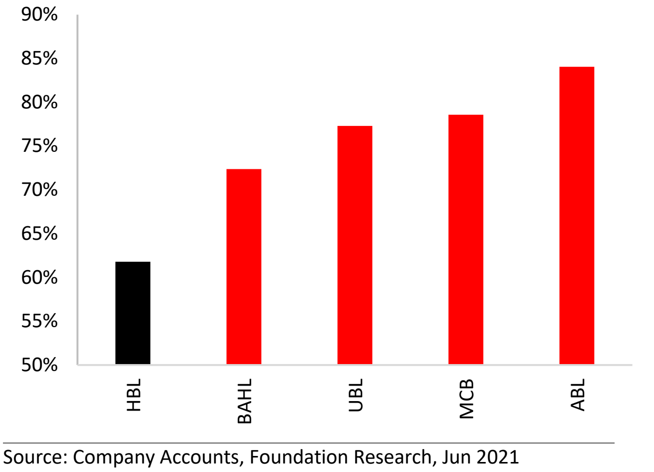
Security wise breakdown reveals that the bank has built up its PIB book during CY20 which increased share of PIBs in total investments by 8ppts to 53%. Share of T-bills declined during 1QCY21 by Rs274bn to account for 21% of the total investment portfolio. We believe that this dilution was a result of lower spread over borrowing which is evident by the almost similar amount of drop in borrowing. On the PIB front, management of the bank has shared that the floating rate PIBs accounts for 35% of the total PIB portfolio. Furthermore, it has also revealed that the investment portfolio will be having decent size of PIB maturities during CY21. To highlight, the industry is estimated to have PIB maturities worth Rs1.34tn with 69% concentration in Jul'21. Having said that, we expect HBL to increase its exposure in the Floating Rate Bonds (FRBs) as the management is expecting interest rates to increase from 2HCY21. This composition of the investment portfolio makes HBL well positioned to play the upcoming interest rate cycle.

Fig 12: Well managed investment book



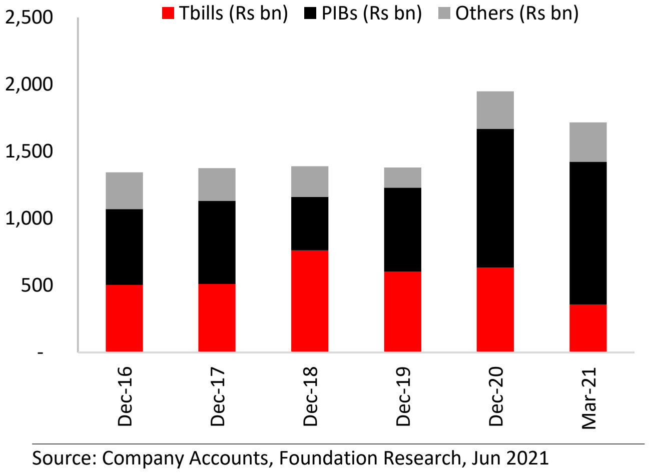
Source: Company Accounts, Foundation Research, Jun 2021

Fig 13: Lower IDR gives room for further accumulation



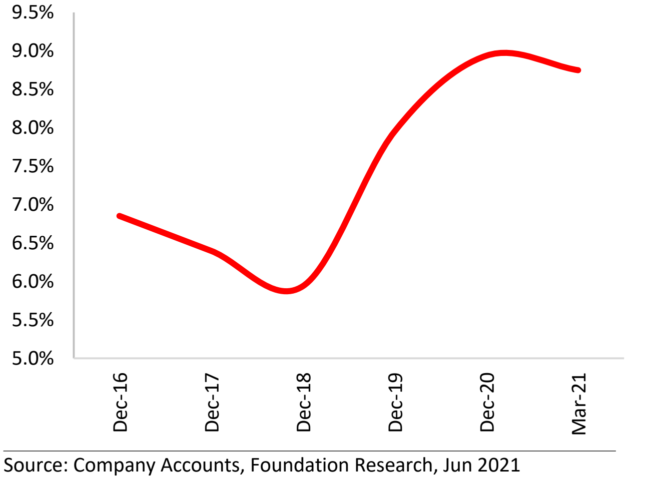
Source: Company Accounts, Foundation Research, Jun 2021

Fig 14: Exposure in shorter tenor/FRBs to increase



Source: Company Accounts, Foundation Research, Jun 2021

Fig 15: Investment Yield



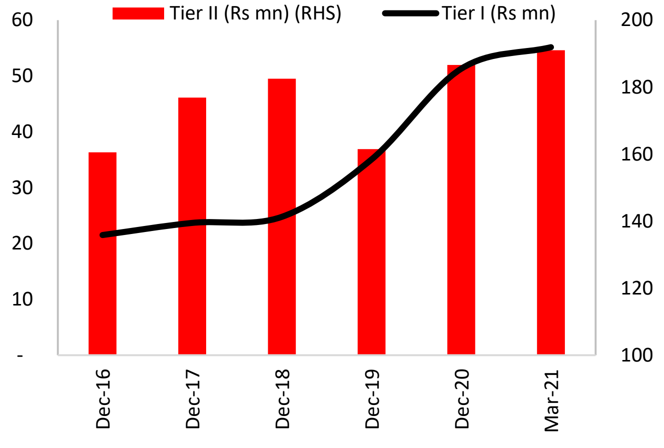
Source: Company Accounts, Foundation Research, Jun 2021

Sufficient capital buffers to keep concerns at bay

With the rebound in profitability and moderate payout ratio, HBL's capital buffer has significantly improved in past few years. In CY20, HBL's total capital grew by 22% compared to a 3yr CAGR of 4% with the growth in both Tier I and Tier II section. In addition to this, Risk Weighted Assets (RWA) as a percentage of total assets remained well contained bumping CET 1/Total CAR to 12.56/17.24% in CY20 and further bumped to 13.02/17.89% in 1QCY21.

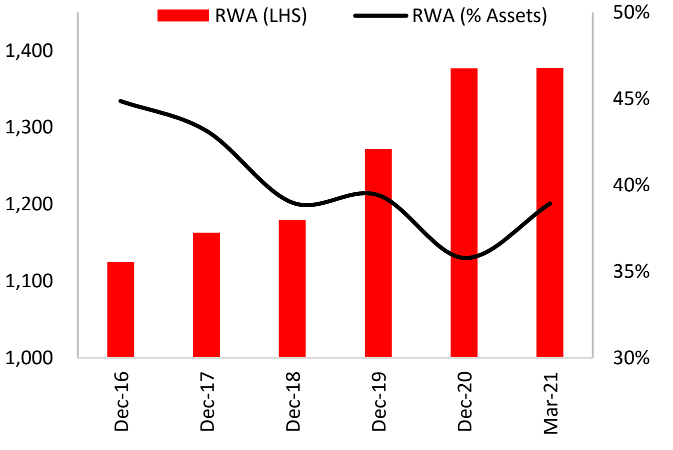
Going forward, we expect HBL's capital buffer to gradually increase at the cost of lower dividend stream compared to peers. To highlight, HBL is subjected to higher Capital Adequacy Ratio (CAR) requirement as it being classified as Domestic Systemically Important Bank (D-SIB). Another important reason for beefing up the CAR is the implementation of IFRS-9. Incorporating these two, management aims to maintain a buffer of minimum 200bps over the regulatory requirement. By 1QCY21, HBL's CET1/Total CAR was over 325/439bps over SBP requirement. We expect HBL to operate with a CAR of over 17% for next few years and maintain a lower payout ratio in the near term.

Fig 16: ↑ profitability has increased capital buffers



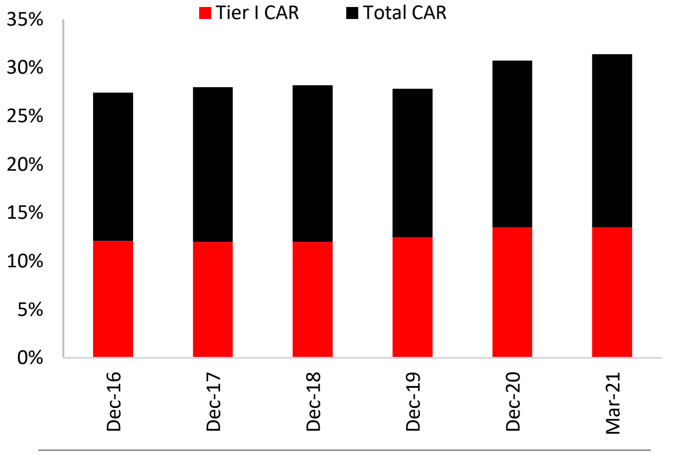
Source: Company Accounts, Foundation Research, Jun 2021

Fig 17: RWA (%Assets) has been optimized



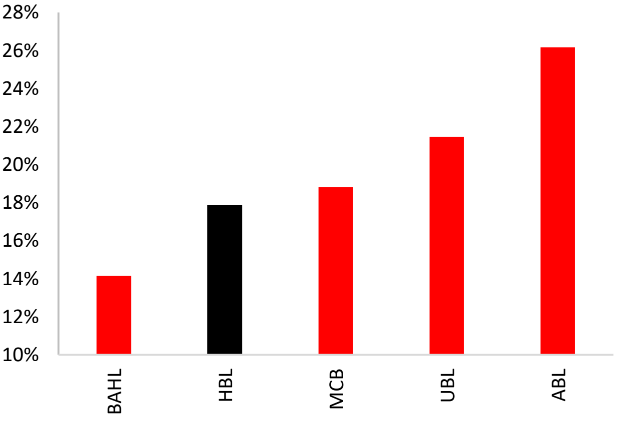
Source: Company Accounts, Foundation Research, Jun 2021

Fig 18: CAR to remain at comfortable levels



Source: Company Accounts, Foundation Research, Jun 2021

Fig 19: Lower CAR to restrict payouts



Source: Company Accounts, Foundation Research, Jun 2021

Table 01: Habib Bank Limited (HBL PA, Outperform, Target Price Rs174)

Balance Sheet		**CY20**	**CY21E**	**CY22E**	**CY23E**
Cash	m	375,280	324,769	358,015	394,663
Investments	m	1,948,577	1,928,037	2,125,404	2,342,975
Advances	m	1,223,510	1,361,304	1,569,408	1,771,793
Fixed Assets	m	89,190	93,736	95,598	96,360
Total Assets	m	3,849,063	3,950,730	4,403,337	4,873,965
Deposits	m	2,830,371	3,128,883	3,449,177	3,802,258
Borrowings	m	544,108	318,081	350,641	386,535
Other Liabilities	m	209,088	238,335	262,732	289,627
Total Liabilities	m	3,583,568	3,685,299	4,062,551	4,478,421
Net Assets	m	265,495	265,432	340,787	395,545
Share Capital	m	14,669	14,669	14,669	14,669
Unapp. Profits	m	138,208	147,625	161,798	176,097
Total Equity	m	265,495	265,450	279,548	293,865
Quarterly I/S		**CY21 Q1**	**CY21 Q2**	**CY21 Q3**	**CY21 Q4**
NII	m	32,469	31,684	31,722	31,780
NFI	m	7,963	9,894	6,104	6,111
Fee Income	m	5,904	4,169	4,484	5,412
Total Income	m	40,432	41,579	37,826	37,891
Opex Expenses	m	24,263	24,654	25,153	25,643
Admin Expenses	m	23,902	24,380	24,868	25,365
Provisions	m	1,920	1,360	1,500	1,500
PBT	m	14,508	18,697	17,074	10,127
PAT	m	8,560	7,765	7,412	7,179
EPS		5.68	5.16	4.92	4.77
DPS		1.75	1.75	1.75	1.75

Income Statement		**CY20**	**CY21E**	**CY22E**	**CY23E**
NII	m	130,104	127,656	148,450	168,584
NFI	m	27,632	29,237	29,032	30,415
Fee Income	m	18,796	22,166	23,677	25,579
Total Income	m	160,699	156,893	177,482	198,999
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PBT	m	53,031	50,899	62,750	72,223
PAT	m	30,913	30,657	38,278	44,056
EPS		21.1	20.5	25.4	29.2
DPS		4.3	7.0	8.0	10.0
EPS Growth	%	99.4	(0.8)	24.9	15.1
Payout	%	20.2	34.1	31.5	34.2
Key Ratios		**CY20**	**CY21E**	**CY22E**	**CY23E**
NIMs	%	4.6	4.0	4.3	4.3
ADR	%	46.1	46.3	48.1	49.2
Infection	%	6.3	5.9	5.4	5.0
Coverage	%	99.7	100.0	102.0	105.0
IDR	%	68.8	61.6	61.6	61.6
Deposit growth	%	16.1	10.5	10.2	10.2
CASA	%	83.1	84.0	84.8	86.0
Cost/Income	%	58.5	62.8	60.8	59.9
CAR	%	17.2	17.2	18.2	19.0
ROE	%	13.0	12.0	14.0	15.0
BV	x	181.0	181.0	190.6	200.3

All figures are in Rs unless noted
Source: Company Accounts, FSL Research, Jun 2021

About the Company

HBL is Pakistan's largest bank and was the first commercial bank to be established in Pakistan in 1947. Over the years, HBL has grown its branch network and maintained its position as the largest private sector bank in Pakistan with over 1,650+ branches and 2,100+ ATMs globally, serving 23 million+ customers worldwide. The Government of Pakistan (GoP) privatized HBL in 2004 through which Aga Khan Fund for Economic Development (AKFED) acquired 51% of the Bank's shareholding and the management control. The remaining 41.5% shareholding by the GoP was divested in April 2015. AKFED continues to retain 51% shareholding in HBL while the remaining shareholding is held by individuals, local and foreign institutions and International Finance Corporation.
The Bank is a leading full-service commercial bank. The key areas of operation are Branch Banking, Corporate & Investment Banking, Treasury, SME & Rural Banking, Financial Institutions & Global Trade Services, Transaction Banking and Islamic Banking. The Branch Banking business is the mainstay of the Bank, positioning HBL as the largest retail bank in Pakistan catering to all market segments. HBL Corporate & Investment Banking Group (CIBG) is a leading provider of financial services to multinational and local corporate clients across the country. The Bank also has the largest Treasury operations in Pakistan and plays a key role in Pakistan's domestic markets.
HBL enjoys a significant international footprint and is the largest domestic multinational. The Bank's international footprint is important as it provides opportunities to effectively serve its core customers across its network. China remains the lynchpin of HBL's international strategy and the Bank is the largest executor of CPEC related financing in Pakistan. In November 2019, HBL created history when the HBL Urumqi Branch formally commenced the RMB business by becoming the first and only bank from Pakistan and one of the three banks from the South Asia and MENA region to offer end-to-end RMB intermediation. In December 2019, HBL became the first Pakistani bank to be awarded the much coveted branch license to offer financial services to clients in Beijing.

Auditors: KPMG Taseer Hadi & Co. Chartered Accountants

Table 2: Habib Bank Limited Limited key personnel

Key Personnel	Name	Designation
	Mr. Sultan Ali Alana	Chairman
	Mr. Moez Ahamed Jamal	Director
	Mr. Shaffiq Dharamshi	Director
	Mr. Salim Raza	Director
Board of Directors	Dr. Najeeb Samie	Director
	Mr. Muhammad Aurangzeb	Director
	Ms. Saba Kamal	Director
	Mr. Khaleel Ahmed	Director
Management	Mr. Muhammad Aurangzeb	Chief Executive Officer
	Mr. Rayomond Kotwal	Chief Financial Officer
	Ms. Neelofar Hameed	Company Secretary

Source; Company Accounts, Foundation research, June 2021

Table 3: HBL pattern of shareholding and free float as at Dec 2020

Pattern of shareholders	Holding	Shares
Aga Khan Fund for Economic Develooment	748	51%
Foreign Companies	200	14%
Banks, DFIs and MFs	79	5%
CDC Group PLC	73	5%
Public Sector Companies and Corporations	45	3%
Others	321	22%
		0%
Free Float	733	50%

Source; Company Accounts, Foundation research, June 2021

Abbreviation

NII	Net Interest Income
NFI	Non-Funded Income
SBP	State Bank of Pakistan
D-SIB	Domestically-Systematically Important Bank
Opex	Operating Expenses
NPL	Non-Performing Loans
MCB	MCB Bank Limited
HBL	Habib Bank Limited
UBL	United Bank Limited
ECL	Expected Credit Loss
PD	Probability of Default
LGD	Loss Given Default
ROA	Return on Asset
ROE	Return on Equity
YoY	Year-on-Year
QoQ	Quarter-on-Quarter
BS	Balance Sheet
Bn	Billion
Mn	Million
Rs	Rupee
FRB	Floating Rate Bonds

Recommendations definitions

If

Expected return >+10%	Outperform.
Expected return from -10% to +10%	Neutral.
Expected return <-10%	Underperform.