26 May 2021

Bank AL Habib Ltd.

Great at what it does!

- **We initiate coverage on Bank AL Habib Ltd. (BAHL) with a Buy rating and December 2021 TP of PKR89/sh. BAHL is the foremost trade finance bank in Pakistan, demonstrates best-in-class asset quality, and commands strong customer loyalty. It has successfully navigated tough economic conditions in the past, a track record that has endured during the coronavirus pandemic.**
- **Pakistani exporters have proven to be resilient and the outlook remains encouraging, particularly for the textile sector. This holds positives for BAHL's loan growth and asset quality. BAHL also appears to be more aggressively pushing its Islamic business, which can help it lift market share and margins. These positives can help offset a limited fee franchise, weak digital presence and modest capital buffer.**
- **BAHL trades at a CY21f P/B of 0.84x, which is at a 30% discount to the previous 5yr average. Valuations are cheap, even after accounting for flattish earnings across the next 2yrs and a lower sustainable ROE range of sub-18% vs. over 20% in the past. Upside to medium-term estimates can arise from higher-than-projected margins, if interest rates enter double digits, as well as from improved cost efficiency.**

Market leader in trade finance

BAHL is conservative and has a narrow focus, but it is great at what it does. It is the leading trade finance bank in Pakistan, with an estimated 14% market share. This results in almost a third of its loans being extended to the Textile sector while trade commission makes up more than half its fee income. Pakistani exporters have increased market share during the Covid-19 pandemic, benefitting from strong home textile demand, amid US-China trade tensions and regional competitors suffering a much worse outbreak – while most of the past impediments to the Textile sector's growth have been significantly allayed. BAHL's focus on exporters should enable it to grow loans quickly while maintaining asset quality. We see a 5yr loan CAGR of c.15% and a cost of risk limited to 20-30bps, with prospects for net provisioning reversals in some years.

Leveraging the brand

BAHL's brand commands strong customer loyalty. The bank generates almost two-thirds of its deposits from individuals, the second highest in our coverage after MEBL, which helps deliver a CASA approaching 80%. This partially offsets the relatively thinner yields on the loan book, which is focused on quality and has limited consumer exposure. We think BAHL's funding cost advantage can further improve in future. Having had a quick deposits CAGR of 16% over the past five years to become the 7th largest bank in Pakistan, BAHL can now focus on further improving its deposit mix. Also, its growing focus on Islamic business (now c.9% of its deposits vs. 7.5% a year ago), can also reduce funding costs as Islamic savings deposits are not subject to a rate floor; this can help with margins in the future.

BAHL has outperformed peers on NII growth in the previous decade (18% pa vs. 11% pa for our Universe) driven by strong asset growth, particularly investments. That said, BAHL is more exposed to reinvestment risk as PIBs are nearly two-thirds of investments – the bulk of which have fixed yields and are maturing in CY21. This may push down NIMs to 4.0% in CY21f from 5.2% in CY20. The SBP is likely to remain dovish in light of the ongoing third wave of Covid-19 where we see only a gradual increase in interest rates in the next 1-2 years. As a result, NIM expansion may be modest and NII growth may settle at sub-15% pa over the medium term.

Off-peak ROE but valuations are very attractive

We expect BAHL to post mid-cycle ROE of 17-18%, down from an average of 20% in the previous 5yrs. That said, given that the CY21f P/B of 0.84x is already at a c 30% discount to the previous 5yr average, we believe valuations are attractive. BAHL's fee franchise may remain limited, consumer lending is likely to be cautious, and the payout ratio may stay in the 25-30% range; but upside to our estimates can arise from higher than projected margins as well as improved cost efficiency (there is room for BAHL to reduce its staff per branch ratio). If this happens, it is possible that the Cost/Income is lower vs. c.60% that we have modelled. As a result, our projections for mid-cycle ROE may well prove to be conservative.

Buy

BAHL PA
Price: PKR68.68/sh
Target Price: PKR89/sh

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Initiation of coverage

Bank AL Habib Ltd

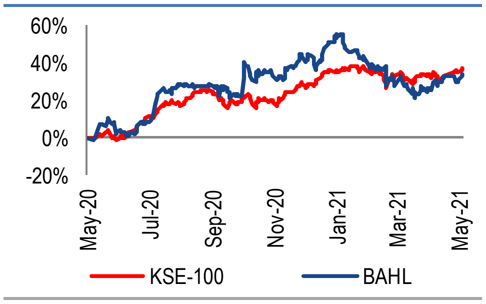
Bloomberg / Reuters	BAHL PA/BKEQ.KA
Mkt Cap (US$mn)	494
Upside (%)	29.6
Fwd D/Y (%)	5.8
Total Return (%)	35.4
12m Hi-Low (PKR/sh)	79.52/50.55
6m Avg. D. Vol ('000 shrs)	818
6m Avg. Td Val (US$mn)	0.37

BAHL - Valuation Snapshot

	CY20A	CY21F	CY22F	CY23F
EPS(PKR)	16.15	15.05	15.31	16.79
EPS Gth (%)	60%	-7%	2%	10%
PER (x)	4.25	4.56	4.49	4.09
P/B (x)	0.95	0.84	0.75	0.66
ROE (average)	25%	20%	18%	17%
DPS (PKR)	4.50	4.00	4.00	4.50
DY (%)	6.6%	5.8%	5.8%	6.6%

Source: IMS Research

BAHL vs. KSE100 Index



Source: IMS Research

Investment Thesis

We initiate coverage on Bank Al Habib (BAHL) with a Buy rating and a December 2021 target price of PKR89/sh. Our TP offers 30% potential upside (total return: 35%). BAHL's brand name is synonymous with superior service quality, leadership in trade finance, and best-in-class asset quality.

Pakistan's Textile exporters have gained market share during the Covid-19 pandemic, aided by a less severe outbreak in Pakistan and US-China trade tensions. Government's focus on facilitating exporters is expected to endure, which is positive for BAHL.

BAHL is far ahead of peers on asset quality and its NPL stock stands below pre-pandemic levels. The NPL ratio is just 1.2%, compared to 4.2% for BAFL and 2.7% for MEBL, while BAHL's coverage is also more than 180%. The bank is well placed to withstand any economic down-cycle and potentially record provisioning reversals as the economy continues to recover.

Capital retention is expected to push down ROE to 17-18% vs. over 20% across the past 5yrs. However, given that the CY21f P/B and P/E of 0.84x and 4.6x are already at a c.30% discount to the previous 5yr averages, we believe valuations are attractive.

Upside to estimates can arise from higher than expected interest rate increases going forward, which can enable BAHL to outperform. We also see room for BAHL to reduce its branch per staff ratio (19 vs. 15 for peers) – the bank may be persuaded to do so if branch footfall is sustainably lower post-pandemic, which can bring the Cost/Income below the c.60% that we have modelled.

Key Highlights

	CY20
3yr CAGR	
Deposits	16.6%
Advances	14.5%
NPBT	27.3%
CASA	76.6%
NPL Ratio	1.4%
Coverage	171.3%
Cost/Income	55.0%
NIMs	5.2%
CAR	15.2%
ROE	25.2%

Source: Company Accounts

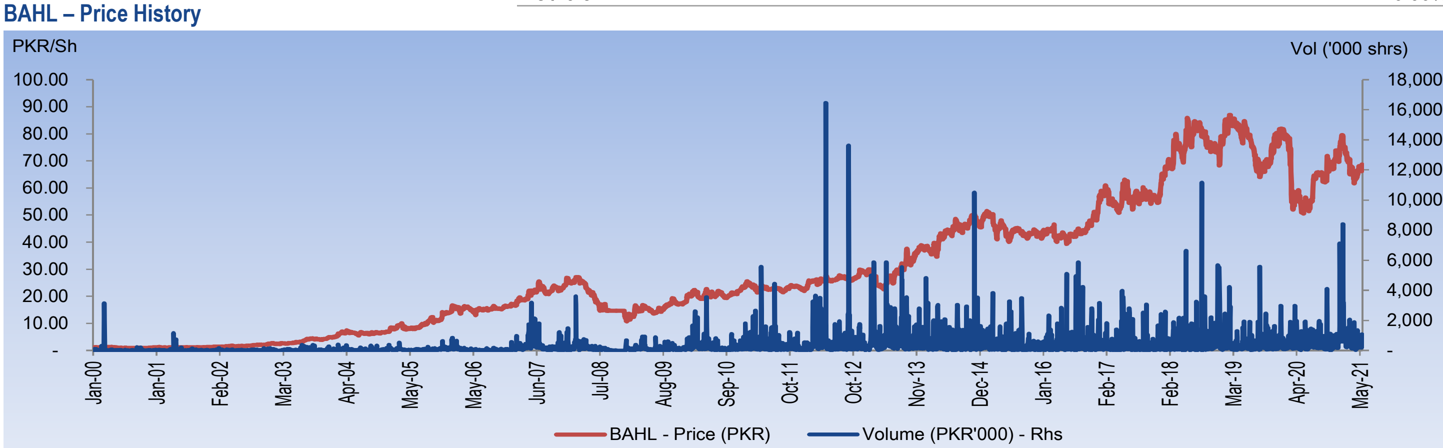
Company Profile

- Bank Al Habib Limited has a long banking pedigree. The group was among the founding members and sponsors of Habib Bank Limited (HBL), now owned by AKFED.
- Belonging to the Dawood Habib Group (which includes Habib Asset Management, Habib Insurance and Habib Sugar Mills under its umbrella), BAHL was incorporated in 1991 after the government allowed the private sector to establish commercial banks. The extended Habib family, including different branches, owns Habib Metropolitan Bank (HMB), Indus Motors (INDU) and Thall Ltd (THALL).
- BAHL operates with a network of more than 800 branches, concentrated primarily in Pakistan, with just three overseas branches. BAHL is ranked 7th on balance sheet size, with major concentration in the Textile and Trade sectors. It has a strong brand in Pakistan, backed by best-in-class asset quality and superior service quality in traditional banking.

Pattern of Shareholding

Directors, CEO, etc.	19.05%
Joint Stock Companies	12.36%
Banks & DFIs	8.07%
State Life Insurance	6.61%
Individuals	45.34%
Others	8.58%

BAHL – Price History



Source: IMS Research, Bloomberg

Valuations are attractive

We expect BAHL to post mid-cycle ROE in the 17-18% range, down from an average of c.20% in the previous five years. That said, given that the CY21f P/B of 0.84x is already at a c.30% discount to the previous 5yr average, we believe valuations are attractive. Although several other banks are also at a similar discount to their past 5yr valuation multiples, only BAHL has been able to match the earnings growth and, to an extent, the ROE expansion that MEBL has delivered.

Valuation Comparison

P/E (x)	MCB	UBL	ABL	HBL	BAFL	MEBL	BAHL	IMS Universe Banks
2021f	6.50	6.67	5.08	5.61	4.94	7.04	4.56	5.93
5yr average	9.73	9.85	7.18	16.59	6.41	7.45	6.31	9.21
(Disc)/premium to 5yr avg	-33%	-32%	-29%	-66%	-23%	-6%	-28%	-36%
P/B (x)	**MCB**	**UBL**	**ABL**	**HBL**	**BAFL**	**MEBL**	**BAHL**	**IMS Universe Banks**
2021f	1.06	0.79	0.64	0.68	0.57	1.81	0.84	0.85
5yr average	1.41	1.14	0.91	1.16	0.84	1.64	1.17	1.17
(Disc)/premium to 5yr avg	-25%	-31%	-30%	-42%	-33%	10%	-29%	-27%

Source: IMS Research

Target price sensitivity to RFr & g

Rf \ g	8.0%	9.0%	10.0%	11.0%
12.0%	72.0			
11.0%		82.0		
9.5%			110.0	
9.0%				132.0
8.0%				

Source: IMS Research

Valuation methodology

We have valued BAHL using Residual Income Methodology: BVPS(po)+[EPS-(BVPS*CoE)] for CY22-25f + [(ROE-CoE)/(CoE-g) x Terminal BVPS]. The formula is similar to dividend discount model (DDM) and Gordon Growth Model; but instead of dividends, the formula is looking at residual income. RI is the earnings left over after paying for the opportunity cost of capital (equity charge) which we then discount back. RI Model takes into account that portion of the stock's price which is above or below the book value. We use a risk-free rate of 10.5%, equity risk premium of 6%, beta of 1.0 and a sustainable growth rate of c.9% to arrive at a CoE of 16.5%. Our December 2021 TP of PKR89/sh implies a forward P/B of 1.1x.

Residual Income Calculation

Key Metrics		2021f	2022f	2023f	2024f	2025f
Long term ROA	0.92%					
Capital Leverage ratio	18.75					
Sustainable ROE	17.3%					
Sustainable Payout ratio	27%					
Sustainable growth rate	9%					
EPS (PKR)		15.05	15.31	16.79	19.68	22.52
BV / share		81.97	91.17	104.71	120.83	139.32
Cost of equity		13.5	15.0	17.3	19.9	23.0
RI		1.53	0.26	(0.49)	(0.26)	(0.46)
PVRI		1.53	0.23	(0.36)	(0.16)	(0.25)
Terminal Value						15.16
Breakup of RI valuation						
PV RI,2021-25	(0.55)					
PV Terminal Value	8.23					
Basic Value,BV0	81.97					
RI Valuation,12 month	**89.00**					

Source: IMS Research

Market leader in trade finance

BAHL is a strong brand name in the trade finance space

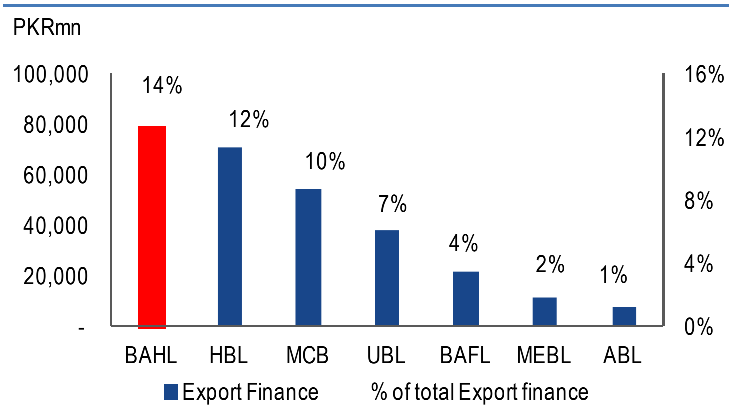
BAHL is conservative and has a narrow focus but it is great at what it does. It is the leading trade finance bank in Pakistan, with an estimated 14% market share. This results in almost a third of its loans being extended to the Textile sector while trade commission makes up more than half its fee income. Pakistani exporters have increased market share during the Covid-19 pandemic and are benefitting from high home textile demand, amid US-China trade tensions and regional competitors suffering a much worse outbreak. Improved energy conditions and quicker tax refunds have provided additional support to the Textile sector. The transition to a flexible exchange rate should also help going forward. BAHL's focus on exporters should enable it to grow loans quickly while maintaining asset quality. We see a 5yr loan CAGR of c.15% and a cost of risk limited to 20-30bps, with prospects for net provisioning reversals in some years.

Largest in the trade finance segment

BAHL is the largest bank in the trade finance segment, handling c.14% of Pakistan's export financing. This leads to a loan book tilted towards Textile and Wholesale & Retail trade sectors – c.30% of BAHL's loans are extended to the Textile sector vs. 18% for the banking industry, while 15% of loans are extended to the Trading segment vs. 8% for the industry. In this regard, the bank has made good use of the SBP's wide array of refinancing facilities (e.g. EFF, LTFF) which carry limited risk, but at the cost of thin margins. The bank has also participated in the SBP's Temporary Economic Refinance Facility (TERF), which provides concessionary loans for setting up of new industrial units. So far c.PKR460bn worth of credit has been extended under the TERF by Pakistani banks.

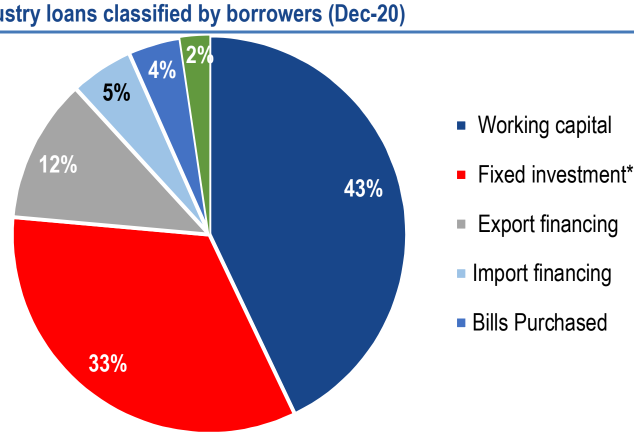
One possible risk for BAHL's business model could be the possible end to quasi-fiscal activities e.g. EFF, LTFF under the proposed new SBP Act, as has been speculated in the media. That said, we understand that such schemes are likely to continue, within the broader context of Pakistan's sustained push on exports together with measures such as a market-determined exchange rate, quicker release of tax refunds and improved energy conditions.

BAHL leads in trade finance (% of Export financing – Dec-20)



Source: IMS Research

Industry loans classified by borrowers (Dec-20)



*(incl. LTFF & TERF)
Source: SBP, Company Accounts and IMS Research

Textiles dominate Pakistan's export. A positive outlook for Textiles is a plus for BAHL.

Positive outlook for Textiles is a plus

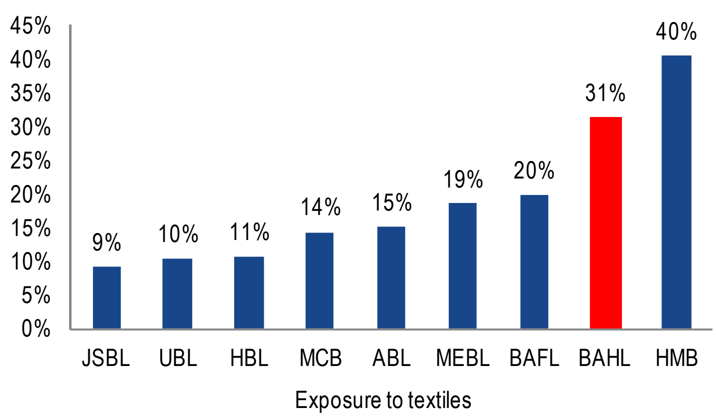
BAHL's trade positioning is partly a function of its high exposure to the Textile sector (c.30% of advances in CY20). In the past, the Textile sector had its share of rough patches, which resulted in a high infection ratio (greater than its share in total loans). However, BAHL has managed to maintain strong asset quality in this sector also; as per latest available data, 1% of BAHL's textile loans are non-performing vs. about 15% for overall loans to the textile sector.

The outlook for the Textile sector is much better than it has been in the past, when the operating environment was beset by security and energy challenges, as well as a managed exchange rate. The sector has bounced back swiftly after complete lockdowns were lifted in mid-2020, and has benefitted from strong Home textile demand amid US-China trade tensions and regional competitors suffering a much worse outbreak. In 10MFY20, textile exports were up 13% yoy to c.US$21bn, and we understand that order books are full until the end of 2021. This has been supplemented by Government relief, where the government is set to unveil an ambitious Textile & Apparel Policy 2020-25 laden with cash subsidies and lower rates on utilities worth PKR960bn (US$6.3bn) to boost production and exports of value-added textile products. This can extend the ongoing turnaround in the Textile sector.

Going forward, improved cash flows amid strong export orders can result in stronger loan growth to exporters, especially textiles, as well as NPL recoveries. This enthusiasm is reflecting in the sector embarking on an expansion phase. Reportedly the Textile sector has borrowed c.50% of the loans disbursed under the TERF, which provides financing for setting up new industrial units at a maximum rate of 5% pa.

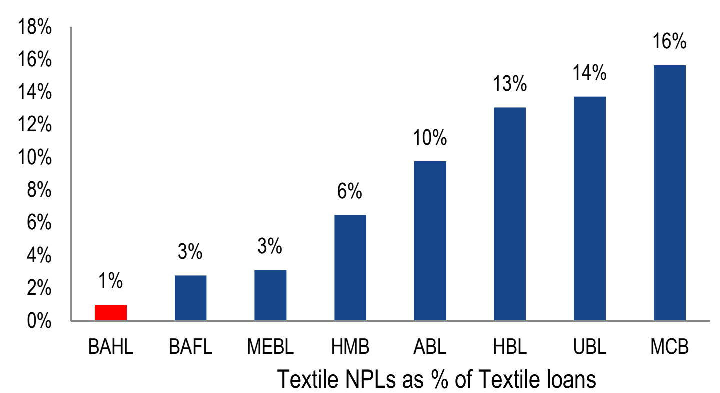
An improved outlook for Textiles (we are Overweight on the sector) is beneficial for BAHL's loan growth, asset quality and fee income. We see BAHL's loans and fee income growing at about 15% pa over the next five years, with the cost of risk not expected to exceed 20-30bps.

Textile exposure is the second highest in the loan book...



Source: IMS Research

...but BAHL's Textile loan book quality is far superior

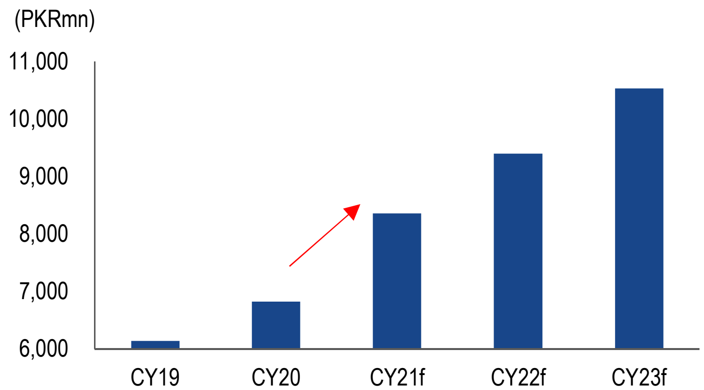


Source: IMS Research

Trade commission coming off a low base

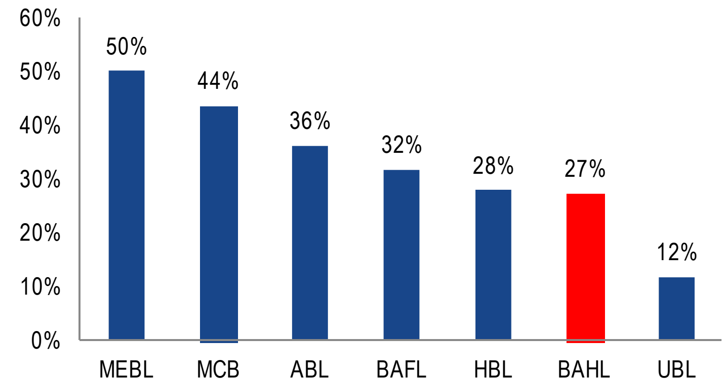
Trade commission forms c.60% of BAHL's fee income, aligned with its trade-focused business model. Despite a few months of low fee due to lockdowns, BAHL's fee income grew by 11% yoy in CY20, while trade commission rose by a strong 17% yoy. The ongoing third wave of Covid-19 continues to risk disruption for businesses, but we think any lockdowns will be transitory and should not derail the economic recovery that has taken place thus far, particularly as the vaccination drive picks pace. We expect fee income to grow by 23% yoy in CY21f before normalizing to deliver a 5yr CAGR of c.15%. Trade commission is expected to continue dominating the fee mix, in our view, particularly as the remaining unrealized capital gains are not particularly high.

Fee income on the rebound



Source: IMS Research, Company Reports

Unrealized capital gains as % of NFI (BAHL vs. peers)

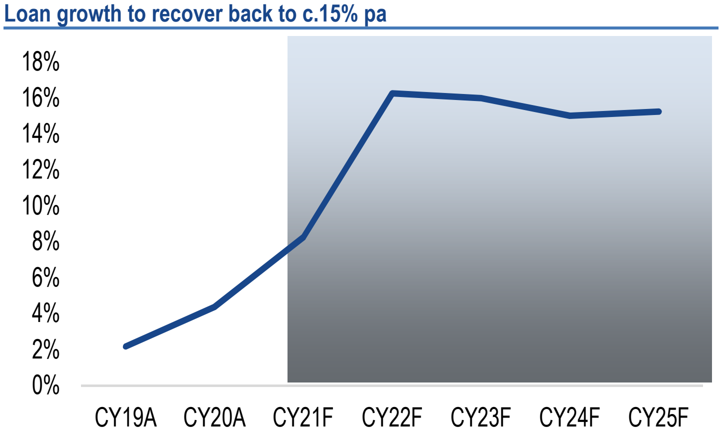


Source: Company Accounts and IMS Research

Loans to grow swiftly from here

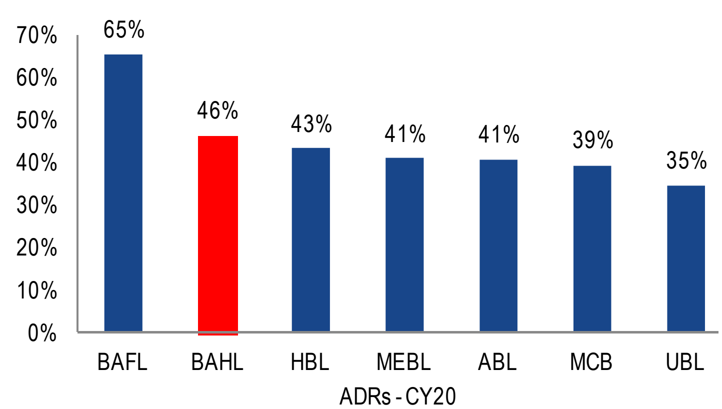
BAHL's loan growth remained subdued during CY19-20 at c.3%, due to a period of macroeconomic slowdown and disruptions following the Covid-19 pandemic. With economic recovery underway (the government is projecting FY21f GDP growth at c.4% after a 0.4% contraction in FY20), credit growth is also rebounding. This should bring BAHL back to a higher loan growth trajectory. BAHL grew its loan book at a 10yr CAGR of 15%, and we expect a similar pace across the next 5 years. The ADR should remain in the early to mid-40%, slightly lower than the previous 10yr average of 46%. Similar to the past, the focus is expected to remain on high quality corporate lending.

Loan growth to recover back to c.15% pa



Source: IMS Research, Company Reports

ADR is modest but still better than most peers



Source: IMS Research, Company Reports

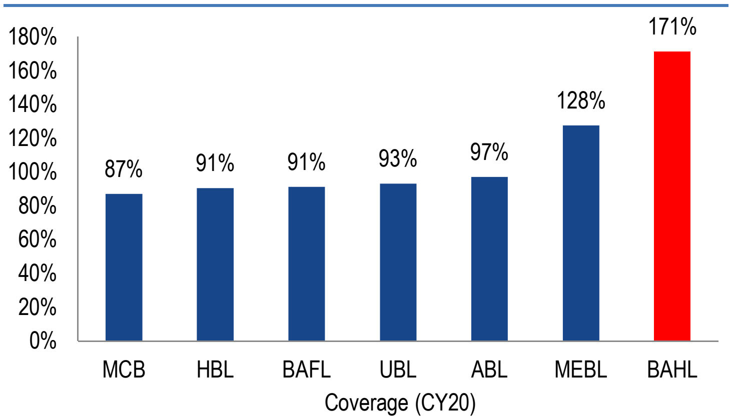
Loan book structure	CY20
Advances to deposits ratio	46%
Non-performing loans	1.41%
Specific coverage	88%
Total coverage	171%
Consumer & SME as % loans*	8%
Public sector loans as % of loans	11%
Last 3yr loan growth CAGR	14%

***Assumed**
Source: IMS Research

Asset quality is best in class

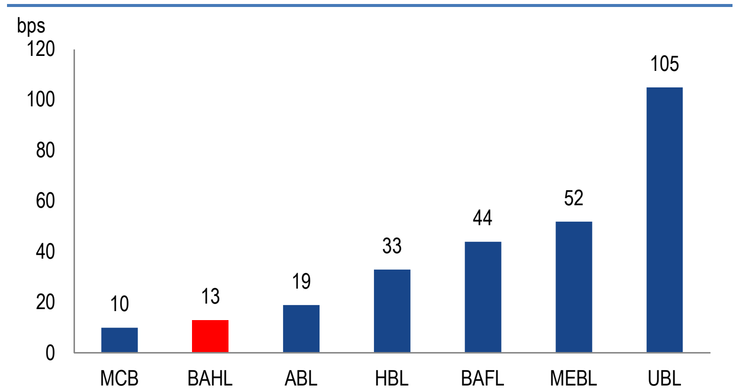
BAHL has maintained provisioning coverage of over 130% since the 2007-08 global financial crisis, by building a buffer of discretionary general provisions. This helped mitigate the need to build additional coverage during the Covid-19 pandemic. To illustrate, BAHL's cost of risk rose to c.60bps in CY20 vs. c.140bps for our Universe Banks. BAHL's NPL ratio is just 1.2% (vs. 5.2% median for our Universe Banks), with provisioning coverage of +180% as of March 2021 (vs. 92% for our Universe). Under the SBP's Loan Deferment facility, BAHL has so far restructured c.PKR38bn (or c.7.5% of total loans), in line with the industry average. We think the worst is behind us, where the ongoing third wave of Covid-19 is unlikely to derail the macro reforms process due to successful rollout of vaccination in Pakistan. We therefore expect credit costs to come off from 60bps in CY20 to about 10bps in CY21f, and to not exceed 20-30bps in subsequent years. Net provisioning reversals in some years are also possible, but we have not built this in in our model. In addition, BAHL also has adequate buffers in place against the impending implementation of IFRS-9.

BAHL has the highest provisioning coverage



Source: IMS Research, Company Reports

With a low cost of risk (5-yr average)



Source: IMS Research, Company Reports

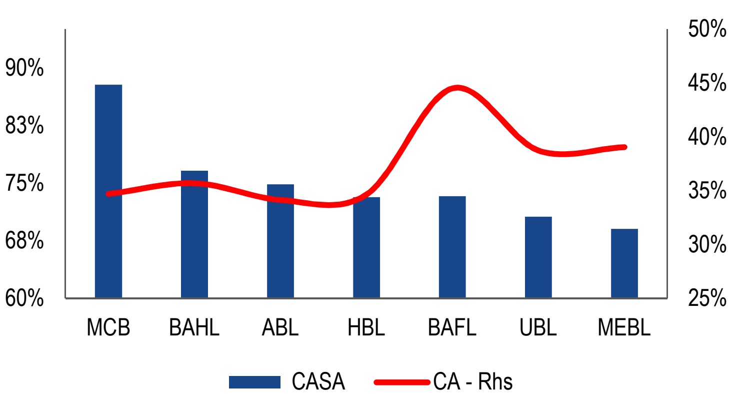
Leveraging the brand

BAHL's brand commands strong customer loyalty. The bank generates almost two-third of its deposits from individuals, the second highest in our coverage after MEBL, which helps deliver a CASA approaching 80%. This partially offsets the relatively thinner yields on the loan book, which is focused on quality and has limited consumer exposure. We think BAHL's funding cost advantage can further improve in the future. Having a quick deposits CAGR of c.16% over the past 5yrs to become the 7th largest bank in Pakistan, BAHL can now focus on further improving its deposit mix. In addition, BAHL's growing focus on its Islamic business (now almost 9% of its deposits vs. 7.5% a year ago), can also reduce funding costs as Islamic savings deposits are not subject to a rate floor.

Large individual depositor base provides funding cost advantage

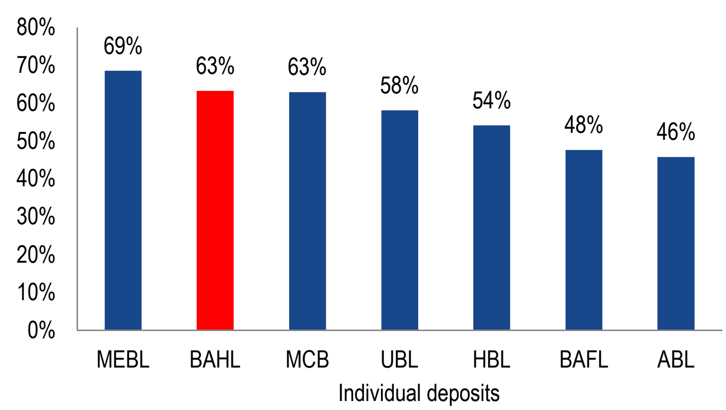
BAHL has a strong deposit franchise that results in a funding cost advantage and enables its loan book to focus on quality. While the bank's CASA is at par with peers, the true funding cost advantage arises from its large individual depositor base (63% of total deposits), second only to MEBL (69%) and an expanding Islamic business which should have a 10% share in its deposits in CY21. In contrast to corporate deposits, this provides a cushion during times of rising interest rates as individual customers tend to be more loyal and less sensitive to rate changes. For our Coverage Universe, the proportion of individual depositors in the mix is much lower (56% median).

BAHL has a relatively efficient deposit mix…



Source: IMS Research, Company Reports

…and a very high individual depositor base

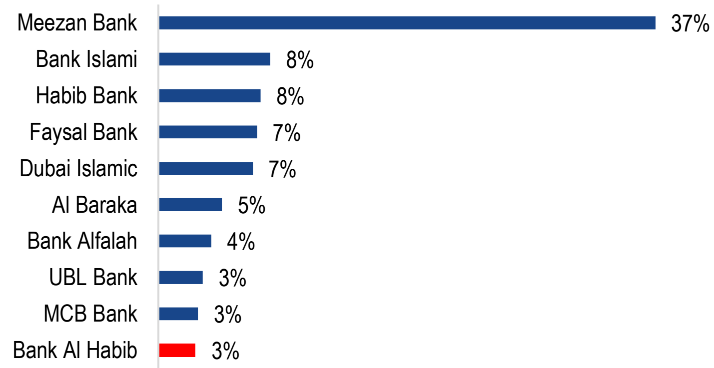


Source: Company Accounts and IMS Research

Islamic business is growing quickly

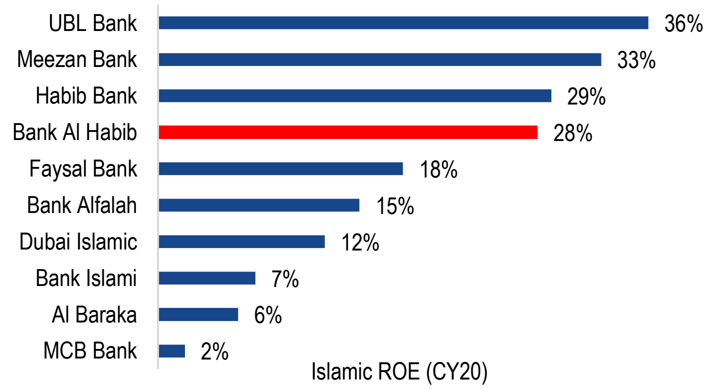
BAHL has grown its Islamic Banking branches with a 5yr CAGR of 30% to 106 at the end of March 2021 (vs. 29 branches in CY15). Islamic deposits now contribute more than 9% to BAHL's deposit base and 3% to the overall Islamic industry deposits. Although still relatively small, BAHL is clearly focusing on its Islamic franchise. The advantages here are two-fold – overall deposit growth can accelerate and the deposit cost may also come down further, as Islamic banks do not face a rate floor on their savings deposits. Importantly, BAHL's Islamic business maps well against peers with C/I at 45% vs. 52% median for the Islamic banking industry and superior ROE generation of nearly 30% (vs. 15% for Islamic peers, and more in line with MEBL).

Islamic Deposits market share



Source: IMS Research

BAHL's ROE is one of the highest within the Islamic space

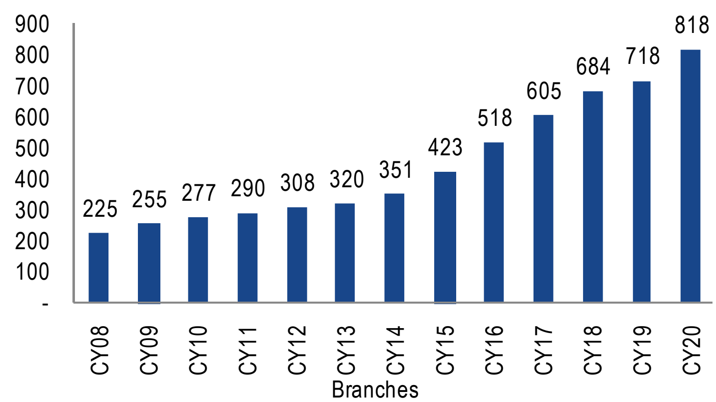


Source: Company Accounts and IMS Research

Balance sheet growth to help offset margin compression

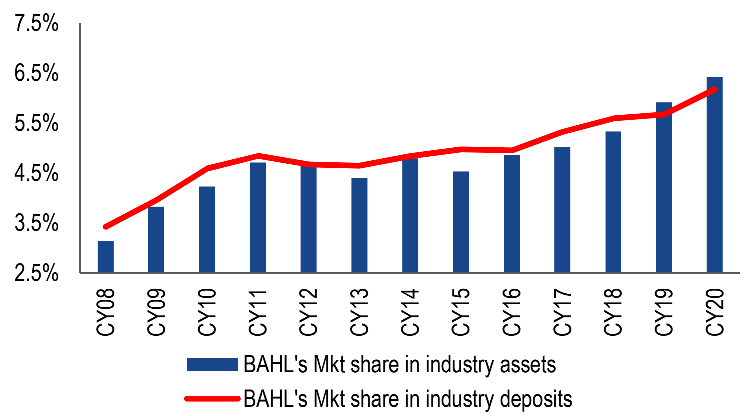
BAHL began its banking operations in 1992; since then, the bank has developed a very strong brand (7th largest bank in Pakistan) with a c. 6.2% share in the overall banking sector deposits, generated via 800 plus branches. BAHL has had an impressive 10yr CAGR for deposits of c.16% (vs. c.14% for our Banking Universe). This is second only to MEBL and has been achieved without compromising on the deposit mix (CASA: 78%, CA: 37%). With similar targets set for CY21f (100 additional branches) by the bank, we project a deposit growth of 18%/16% in CY21/22f, settling at c.15% on average over the medium term.

BAHL has undergone swift branch expansion…



Source: Company Accounts

…with market share rising to 6% of total industry deposits

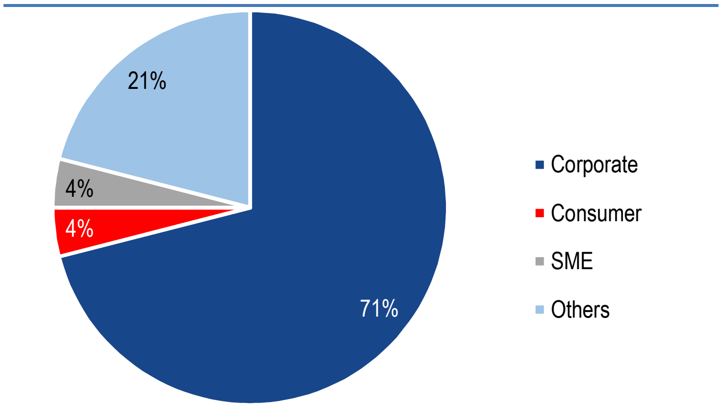


Source: IMS Research, Company Reports

NIMs will recover gradually as the rate cycle turns

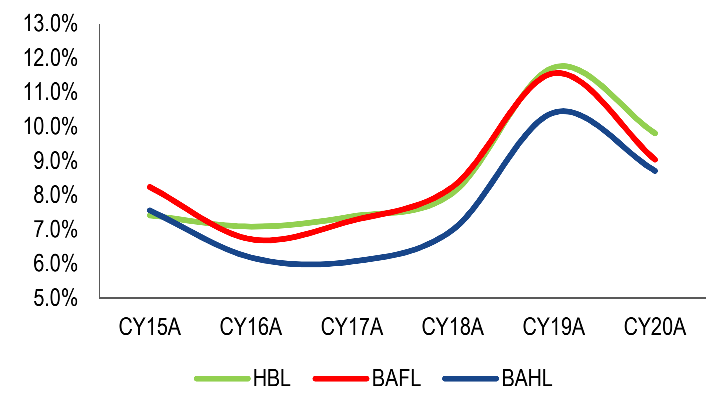
BAHL has maintained a conservatively structured loan book. While this has helped maintain sector-beating asset quality (NPL ratio: 1.2%), but has compromised yields. For instance BAHL has visibly lower yields vs. BAFL and HBL, which have higher consumer exposure (c. 8%). That said, BAHL has consistently outperformed the large private banks in terms of NII growth over the past decade (18% vs. 11% for our Universe Banks). This has been led by strong balance sheet growth – deployed mostly in its investment portfolio (5yr IDRs: 65%) due to relatively thinner yields on loans. With interest rates expected to remain lower for longer, BAHL stands relatively more exposed to reinvestment risk vs. peers given PIBs contribute nearly two third of the overall investment mix – bulk of which are fixed category and maturing this year. This is likely to push down on NIMs (to 4.0% from a high of 5.2% in CY20), where we project a modest 6%yoy decline in NII in CY21f. Subsequently, however, we expect a c.15% pa pace for NII growth.

BAHL has very little consumer exposure…



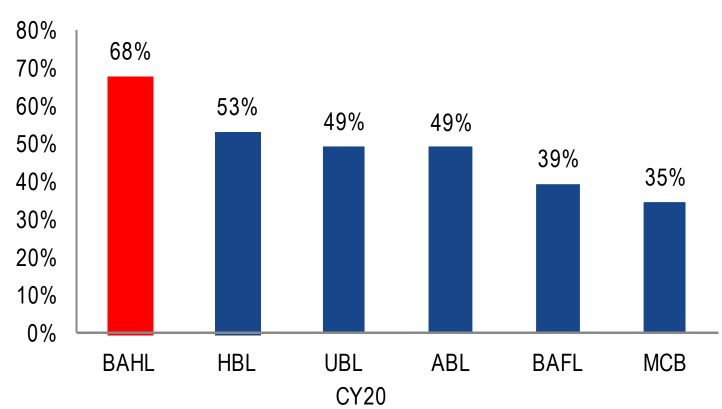
Source: IMS Research

…which leads to relatively lower advances yields



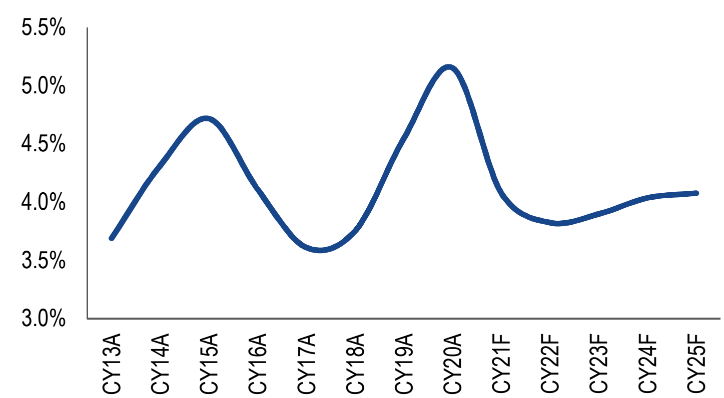
Source: IMS Research, Company Reports

PIBs as a share of Investments (CY20)



Source: IMS Research, Company Reports

NIMs will lift gradually CY21f onwards



Source: IMS Research, Company Reports

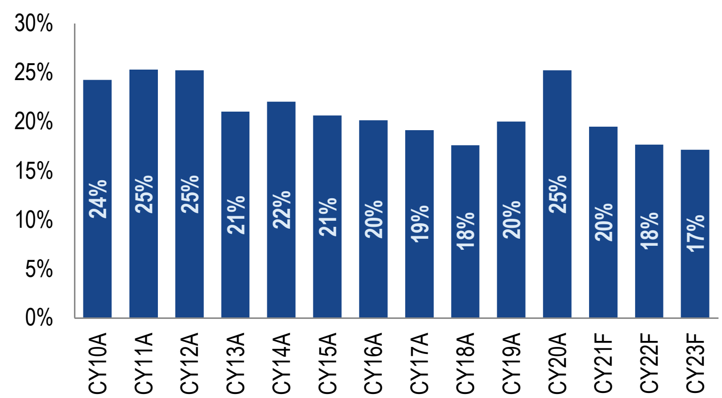
Off-peak ROE but valuations are very attractive

We expect BAHL to post mid-cycle ROE in the 17-18% range, down from an average of c.20% in the previous five years. That said, given that the CY21f P/B of 0.84x is already at a c.30% discount to the previous 5yr average, we believe valuations are attractive. BAHL's fee franchise may remain limited, consumer lending is likely to be cautious, and the payout ratio may stay in the 25-30% range, but upside to our estimates can arise from higher than projected margins as well as improved cost efficiency. The latter may dovetail with an increased focus on digitization, spurred by the coronavirus pandemic, and a consequent reduction in branch staff (BAHL has the highest staff per branch in our coverage). If this happens, it is possible that the Cost/Income will be sustainably lower vs. the 60% that we have modelled. As a result our projections for mid-cycle ROE may well prove to be conservative.

Over 20% ROEs may not sustain

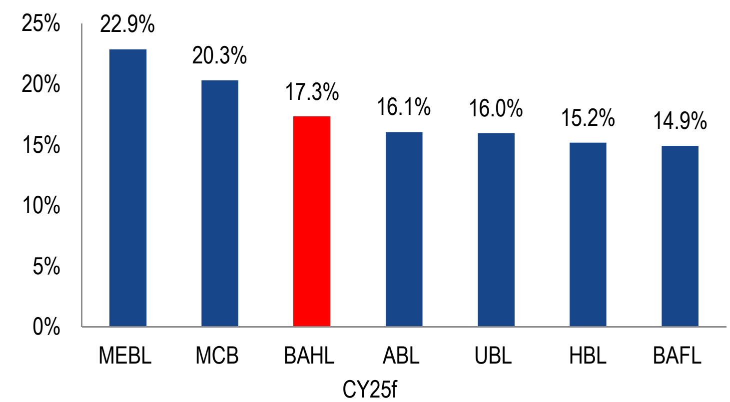
BAHL's ROE expanded from 17.6% in CY18 to 20.0% in CY19 and then to 25.3% in CY20. In the last 10 years, BAHL has delivered an average ROE of 21.6%. Going forward, however, we expect the bank's mid-cycle ROE to be in the 17-18% range with interest rate increases expected to be modest and gradual, and with thin capital buffers leading to a 25-30% cash payout ratio.

Mid-cycle ROE may drop to 17-18%...



Source: IMS Research, Company Reports

...but this is still better than most peers



Source: IMS Research

CAR is sufficient to accommodate growth plans for now

BAHL has grown its balance sheet aggressively to drive profitability (5-year deposit CAGR: 16%). While the bank has been able to maintain very strong asset quality. The a growth strategy has stressed CAR in the past where BAHL underwent capital raising in 2017 and 2018 (PKR7bn ADT-1 and PKR4bn T-2 instrument subsequently). This, together with windfall profits during CY19-20, helped raise CAR to 15.2% in CY20 vs. the SBP requirement of 12.5% (temporarily 11.5% under Covid-19 conditions). We believe BAHL's CAR can support c 15% pa asset growth over the medium term without the need to raise additional capital. In our view, the capacity for higher growth may be unlocked by quicker than expected interest rate increases and a reduction in BAHL's RWA density (42% vs. a median of 38% for our Universe Banks).

Capital Adequacy – Peer comparison (March 2021)

Capital adequacy	CAR (Required)*	Reported CAR	Buffer over req. CAR	Tier-1 (Required)	Reported Tier-1	RWA Density
ABL	12.50%	26.17%	13.67%	10.00%	20.33%	26%
UBL	14.00%	21.47%	7.47%	11.00%	16.25%	38%
MCB	12.50%	18.83%	6.33%	10.00%	15.33%	47%
MEBL	12.50%	18.37%	5.87%	10.00%	14.16%	33%
HBL	14.50%	17.89%	3.39%	12.00%	13.93%	39%
BAFL	12.50%	15.46%	2.96%	10.00%	12.29%	46%
BAHL	12.50%	14.15%	1.65%	10.00%	10.94%	42%

*Excluding interim SBP relief measures on HLA and CCB

Source: IMS Research

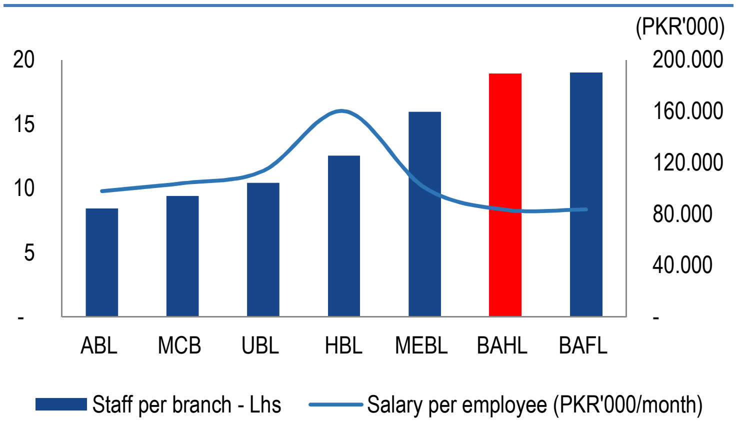
While we have not built it into our model, better cost efficiency is possible.

Better cost efficiency is possible

BAHL has had an impressive 10 year CAGR of c.16% for its deposits (vs. 14% for our Banking Universe), and has nearly doubled its branch network in the past five years – from 423 branches in CY15 to 818 branches in CY20. While this has allowed BAHL to achieve a deposit market share of over 6%, it has rapidly added to admin expenses with the result that Cost/Income averaged 57% in 2015-20 vs. 52% in 2010-2015.

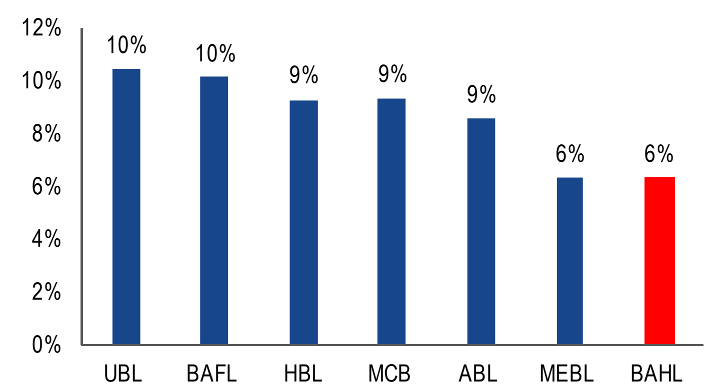
We expect the C/I to remain in the c.60% vicinity over the medium term but flag that there is potential for BAHL to realize cost efficiencies if it pushes digital banking and reduces its per branch headcount. BAHL has the highest staff per branch ratio in our coverage (18.9 vs. an average of 12.6) – this results in superior customer service but eats into profitability in our view even as BAHL's average employee costs lower than staff at peer banks (PKR83,000/month vs. PKR110,000/month for peers). Given that Covid-19 has affected branch footfall and pushed digitization, a greater push on alternative/digital channels by BAHL can help it improve its cost efficiency without compromising on its cherished emphasis on customer service. To be clear, the bank plans to continue growing its brick-and-mortar network with another 100 branches targeted in CY21f, and we have not built in a digital push (and accompanied C/I improvement) in our model. If it happens, however, it can help lift our estimates and further cement our liking for the stock.

BAHL has a high staff per branch



Source: Company Accounts and IMS Research

Lowest in terms of digital spending (IT expense as % of total) - CY20



Source: Company Accounts and IMS Research

Risks

A further decline in interest rates will elevate reinvestment risk

While SBP has indicated to keep interest rates unchanged at 7% till June 2021 , this is hinged on reigning in the spread of the Covid-19 virus, where Pakistan is presently undergoing a third wave. While our base case estimates incorporate a 100bps increase in interest rates at the end of CY21. A large chunk of BAHL's fixed rate PIBs are maturing within this year where a further decline in interest rates can elevate the reinvestment risk. We estimate that yields on these investments are north of 10%.

Covid-19 and asset quality downturn

Escalation in Covid-19 cases can lead to asset quality downturn in lockdown conditions. So far the government has refrained from shutting down businesses other than hospitality and transport. However, with Covid-19 cases climbing in Sindh (positivity ratio north of 10%), the possibility of further restrictions cannot be ruled out. While BAHL has adequately provided against any asset quality headwinds (over 180% coverage), it may look to further beef up general provisions ahead, which could increase credit costs vs. our estimated 11/-2bps in CY21/22f.

End to quasi-fiscal activities by the SBP

SBP offers refinancing facilities (concessionary loans for certain priority sectors) to incentivize exports and fixed asset investment by industries. Recently the IMF set targets for FBR tax collection of PKR6.0tn for FY22f, c.23% higher vs. in FY20 and restrictions on quasi-fiscal activities of SBP. While this does not affect SBP's ability to refinance, any reversal in this decision will directly affect BAHL which has a 14% share in export handling.

EU GSP+ status abruptly ends

The EU parliament passed a resolution for the immediate revision of Pakistan's GSP+ Status by the EEAS in April'21. The EU is the largest textile exports destination for Pakistan, contributing c. 30% of overall sales for our IMS Universe. Revocation of the GSP Plus status will lead to renegotiation of contract pricings resulting in margin attrition for the textile companies. BAHL's exposure to the textile sector is 30% of its total loans, however we flag that the NPL ratio for from textiles stand at just 1%. That said, a shock to textile company sales may result in sharp asset quality deterioration.

Low capital buffers prevent desired growth from materializing

BAHL's CAR stood at 14.15% (at end-March 2021) while T1 stood at 10.94%. While this is more than adequate to support BAHL's growth plans in the near term, capital raising may be required down the road in order to sustain expansion plans. However, there is also room to further de-risk where BAHL's RWA density stands at 42% (vs. 38% median for our Universe Banks).

BAHL - Financials

Income Statement (PKRmn)

Year end Dec 31	CY19A	CY20A	CY21f	CY22f	CY23f
Interest Income	105,617	125,292	111,915	133,737	160,441
Interest Expense	64,413	67,649	57,418	75,829	93,489
Net Interest Income	41,204	57,643	54,497	57,909	66,952
Total Provisions	3,399	4,547	708	20	1,412
Post Provisioning NII	37,805	53,096	53,789	57,888	65,540
Fee Income	6,135	6,820	8,354	9,398	10,526
Dividend Income	398	432	486	523	562
Capital Gains/Loss	(32)	182	1,092	1,092	710
Other Income	663	819	778	837	879
Total Non- Interest Income	9,469	10,396	12,907	14,101	14,872
Total Income	47,273	63,493	66,696	71,990	80,412
Non- Interest Expenses	28,328	34,897	39,389	44,248	49,976
NPBT	19,040	28,709	27,439	27,906	30,608
Total Tax	7,849	10,752	10,701	10,883	11,937
NPAT (Attributable)	11,188	17,948	16,728	17,013	18,661

Balance Sheet (PKRmn)

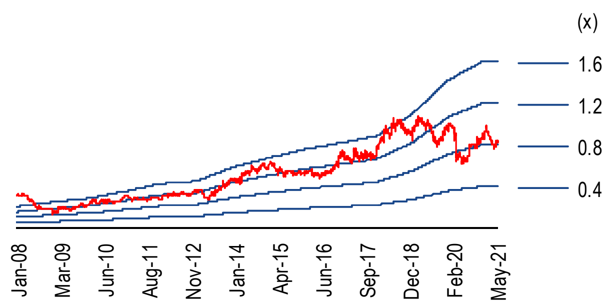
Year end Dec 31	CY19A	CY20A	CY21f	CY22f	CY23f
Assets					
Cash balances	113,839	105,936	116,825	134,810	157,326
Balances with other banks	9,526	19,681	15,640	16,776	17,952
Lending to Fin. Institutions	1,858	2,175	2,309	2,425	2,532
Investments	586,511	765,319	929,863	1,046,095	1,182,088
Advances	488,653	510,050	552,130	641,851	744,547
Balancing Assets	1,086,547	1,297,226	1,499,941	1,707,146	1,947,119
Operating Fixed Assets	36,572	43,977	46,051	49,340	52,734
Intangible assets	369	295	510	580	659
Deferred tax assets	-	-	-	-	-
Other assets	61,812	75,346	73,855	78,945	84,151
Total Assets	**1,299,139**	**1,522,779**	**1,737,181**	**1,970,821**	**2,241,989**
Liabilities					
Bills payable	20,132	31,013	29,463	30,936	32,482
Borrowings	228,745	211,627	227,499	244,562	262,904
Deposits & Other Acc.	903,630	1,099,223	1,297,084	1,498,132	1,730,342
Subordinated debt/loans	14,993	14,990	14,990	14,990	14,990
Deferred tax liabilities	1,378	140	112	89	72
Other liabilities	68,329	85,342	76,808	80,648	84,681
Total Liabilities	**1,237,206**	**1,442,336**	**1,645,955**	**1,869,357**	**2,125,471**
Net Assets	**61,933**	**80,444**	**91,226**	**101,464**	**116,518**
Share Capital	11,114	11,114	11,114	11,114	11,114
Reserves	16,467	18,431	20,105	21,807	23,674
Unappropriated Profit	28,164	40,417	50,552	60,944	73,375
Tier I Equity	**55,745**	**69,962**	**81,772**	**93,866**	**108,164**
Surplus on reval. of assets	6,082	10,367	9,330	7,464	8,210
Total Tier II Equity	6,187	10,481	9,455	7,598	8,354
Total SHEQ	**61,933**	**80,444**	**91,226**	**101,464**	**116,518**
Total SHEQ & Liabilities	**1,299,139**	**1,522,779**	**1,737,181**	**1,970,821**	**2,241,989**

Source: IMS Research

Key Ratios

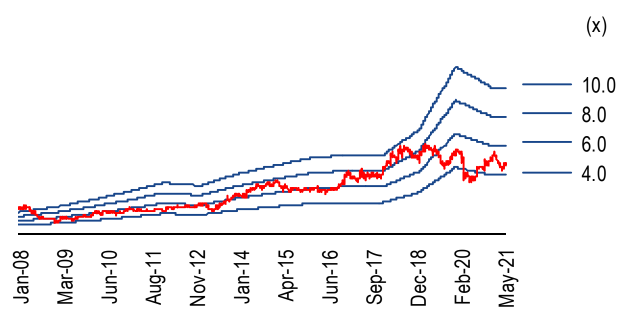
(PKRmn)	CY19A	CY20A	CY21f	CY22f	CY23f
EPS(PKR)	10.07	16.15	15.05	15.31	16.79
EPS Growth	32.3%	60.4%	-6.8%	1.7%	9.7%
P/B Tier I (x)	1.37	1.09	0.93	0.81	0.71
Total BVS (PKR)	55.63	72.28	81.97	91.17	104.71
P/B (x)	1.23	0.95	0.84	0.75	0.66
PER (x)	6.82	4.25	4.56	4.49	4.09
ADR	54.1%	46.4%	42.6%	42.8%	43.0%
Yield on earning assets	10.6%	10.5%	8.0%	8.3%	8.8%
Cost of Funds	6.1%	5.4%	3.9%	4.5%	4.9%
NIMs	4.5%	5.2%	4.1%	3.8%	3.9%
Cost of Risk (bps)	36.0	59.9	10.7	(1.8)	15.8
Growth in Loan Book	2.2%	4.4%	8.3%	16.3%	16.0%
Growth in Deposits	13.4%	21.6%	18.0%	15.5%	15.5%
Cost/Income	55.9%	51.3%	58.4%	61.4%	61.1%
ROE (average)	20.0%	25.3%	19.5%	17.7%	17.1%
ROA (average)	1.0%	1.3%	1.0%	0.9%	0.9%
DPS (PKR)	3.50	4.50	4.00	4.00	4.50
Dividend yield	5.1%	6.6%	5.8%	5.8%	6.6%
Payout Ratio	34.8%	27.9%	26.6%	26.1%	26.8%

BAHL – P/B (x) CY21f



Source: IMS Research

BAHL – P/E (x) CY21f



Source: IMS Research

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Buy	Total return expectation of ≥ 15% or expected to outperform the KSE-100 index
Neutral	Total return expectation of > -5% or expected to match the return of KSE-100 index
Sell	Expected downside of more than 5% or expected to underperform the KSE-100 index

*Based on 12 month horizon unless stated otherwise in the report.

Valuation Methodology: We use multiple valuation methodologies in arriving at a Target Price including, but not limited to, Discounted Cash Flow (DCF), Residual Income (RI), Dividend Discount Model (DDM) and relative multiples based valuations.

Risks: Please refer to page 13.

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