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KSE-100 Index

11,162.39

KSE Market Cap

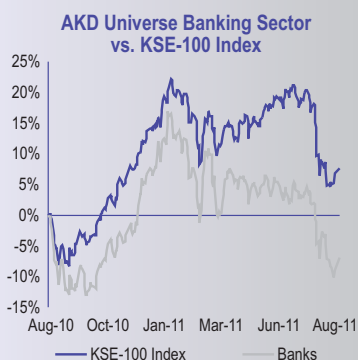
PkR2,956bn (US\$33,916mn)

Banking Sector Market Cap.

PkR604,628mn (US\$6,936mn)

AKD Universe Banking Universe

Symbol	Price (PkR)	TP (PkR)	Upside (%)	Stance
NBP	38.76	51.01	31.6	Buy
MEBL	18.75	23.97	27.8	Buy
MCB	174.16	219.82	26.2	Buy
BAFL	9.74	12.00	23.2	Buy
ABL	61.00	74.98	22.9	Buy
HMB	16.42	20.00	21.8	Buy
UBL	57.21	69.01	20.6	Buy
HBL	117.59	129.96	10.5	Accumulate



Lower interest rates; Rerating multiples

Although risks remain, we believe the recent 50bps cut in the Discount Rate is the start of a sustained interest rate downcycle. We take the previous monetary easing cycle (Apr'09-Nov'09) as a benchmark and believe that, for domestic banks, 2HCY11F/CY12F will likely closely resemble the classic interest rate downcycle of CY09/CY10. While NIM compression should be compensated by a decline in credit costs, banking sector scrips should also experience multiples' rerating in a lower interest rate environment. Considering that AKD Universe Banks have shed 19%CYTD (underperformance of 11%) even as Pakistan's macroeconomic landscape remains unaltered, we believe present valuations are compelling. We urge investors to ignore near-term bouts of volatility and formulate a longer-term investment horizon. We are Overweight banks where our top picks are the Big-5 Banks.

Status quo on Pakistan macros: Despite expectations of improved GDP growth, a stable PkR/US\$ parity, commencement of monetary easing and very strong corporate earnings momentum, the KSE-100 Index has slipped by 13% from its CYTD peak. While equity market valuations seem to have lost traction with fundamentals, we believe broader macroeconomic stability should revert investor focus to corporate earnings and valuations sooner rather than later. In this regard, although risks remain (particularly on fiscal deficit and its financing), we believe likely lower inflation should support continued monetary easing across the next year which, in turn, should provide rerating impetus to stock prices, including banking stocks.

2HCY11F like CY09; CY12F like CY10: Pakistan was last in the monetary easing cycle across Apr'09-Nov'09 where the Discount Rate eased from 15% to 12.5%. While this led to margin compression (aggregate NIMs for the Big-5 banks contracted from 6.9% to 6.4%), earnings growth did not stall due to 1) higher average interest rates in CY09 vs. CY08 and 2) declining credit costs in CY10. On aggregate the Big-5 banks should close out CY11F with 15%+YoY growth driven by robust NIMs while even a marginal reduction in credit costs (sector NPLs were flat QoQ in 2QCY11) should drive double-digit growth in CY12F. We believe this a realistic assessment considering that broader macroeconomic dynamics are expected to play out similar to CY09/CY10 (IMF program the common denominator).

Multiples' Rerating: The Big-5 banks traded at an average P/B of 1.14x across the last rate downcycle while, post the recent selloff, these banks trade at an average P/B of 0.9x i.e. a discount of 21%. While the earnings growth of CY11F will likely be tough to replicate (growth should decelerate a bit in CY12F), we believe a lower interest rate environment should lead to multiples' rerating (Big-5 average P/B expanded from 0.92x to 1.37x in the last interest rate downcycle). From this vantage, we upgrade Pakistan Banks to Overweight where we prefer the Big-5 Banks (less reliant on the FSV benefit which is poised to expire from CY12F). Note that our financial models already incorporate steady monetary easing across the medium term.

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Last rate downcycle (Big-5)

(Pkrbn)	1QCY09	2QCY09	3QCY09	4QCY09
Interest Earned	77.16	75.57	75.24	80.31
Interest Expensed	35.39	34.10	33.07	36.92
Net Interest Income	41.77	41.46	42.17	43.40
Loan Provisions	8.18	12.79	8.79	9.24
Total Provisions	8.88	14.57	9.24	12.78
Post Prov NII	32.88	26.89	32.94	30.62
Yield on EA	12.3%	11.4%	11.5%	11.5%
Cost of Funds	5.5%	4.9%	5.0%	5.1%
NIMs	6.9%	6.5%	6.5%	6.4%

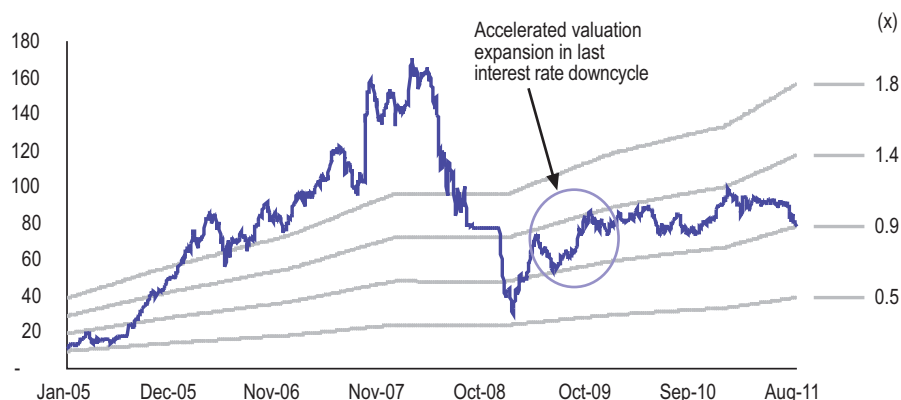
Valuation multiples' rerating should compensate for any deceleration in earnings growth. The Big-5 Banks traded at an average P/B of 1.14x in the last interest rate downcycle vs. an average P/B of 0.90x at present.

Classic interest rate downcycle with a twist: The SBP has reduced DR by 50bps to 13.5% in the last monetary policy statement (Jul'11). Accordingly, weighted average spread of 7.88% in Jul'11 likely represents a peak with balance sheet rerating poised to take spreads lower going forward. At the same time, NPLs for commercial banks appear to have flattened (up just 0.3%QoQ to Pkr544bn in 2QCY11). We believe recent data heralds the beginning of a classic interest rate downcycle similar to Apr'09-Nov'09 when contracting spreads were compensated by improving asset quality. In this regard, we believe the Big-5 Banks should be the major beneficiaries over the medium-term; although their margin-led business models should face some NII attrition, the same should be countered by declining credit costs particularly as the larger banks are less reliant on the FSV benefit. Note that the FSV benefit expires in 4 years (from 2008) which would mean that even if NPL formation decelerates, provisioning/credit costs for some banks could continue to be elevated in CY12F and beyond.

CY11F like CY09; CY12F like CY10: Headline CPI inflation in Pakistan has averaged 14.6% across the last four years. Event-risk aside, we believe domestic inflation should be lower across the next 2-3 years, leading to continued monetary easing. Considering that Pakistan will likely continue to remain within the IMF ambit - thereby leading to comparable macroeconomics - we believe banking sector dynamics across the last interest rate downcycle (CY09/CY10) will repeat across the next year or so. Key takeaways from the last rate downcycle are as follows:

- SBP reduced the DR from 15% to 12.5% across Apr'09-Nov'09. Although the Big-5 experienced margin compression (avg NIMs declined from 6.9% to 6.4%), earnings momentum did not stall due to reduction in credit costs. We believe similar dynamics will unfold across 2HCY11/CY12F. On aggregate, we expect the Big-5 Banks to post 15%+YoY growth in full-year CY11F and 10%YoY-15%YoY growth in CY12F.
- Despite monetary easing in 2009, banks continued to retain a cautious stance with preference for government securities at the expense of private sector credit growth. Going forward, we fail to see banks abandoning their risk-averse stance unless interest rates head into single digits (unlikely before the next 2-3 years, in our view). This should support asset quality improvement, leading to lower credit costs.
- KSE PER expanded from 5.59x to 7.74x across Apr'09-Nov'09. Similarly, the average P/B multiple for the Big-5 Banks expanded from 0.92x to 1.37x in this timeframe. While this was partly due to a low base (normalization post the late CY08 market meltdown), we believe multiples' rerating rather than earnings growth alone will drive banking stocks over CY12F. Post the recent selloff, the combined P/B multiple for the Big-5 Banks has contracted to 0.90x from 1.33x at its CYTD peak.

Big-5 Banks Price to Book Band 2012



Source: AKD Research

Recent Regulatory Changes

- SBP reduced Discount Rate by 50bps to 13.50% on Jul 30'11. Accordingly, the interest rate corridor for the Repo/Reverse Repo changed to 10.50%-13.50%.
- Rate of refinance for power plants (using renewable) energy increased by 20bps to 10.10% for up to 5yrs and to 9.70% for over 5yrs & up to 10yrs. Bank spread maintained at 2.50% for the former tenor and 3.00% for the latter.
- Refinance rates for Long Term Financing Facility (LTFF) raised by 150bps. Bank spread remains 1.50%-3.00% across the different maturities.
- Changes to Export Finance Scheme (EFS) whereby exporter may avail EFS if overdue export bill < 5% of previous year's export performance
- Shariah Advisors' approval obtained to allow Islamic banks to accept payment of utility bills after due date.

Recent Bank Notices

- **Aug 30'11:** MCB notifies that it has initiated the process of getting its shares enrolled for Sponsored Level I American Depository Receipts (ADRs). Level I ADRs are traded Over The Counter (OTC) i.e. they are not listed securities.
- **Aug 30'11:** NIB announces that it has requested its sponsor shareholder to subscribe to the unsubscribed portion of the Rights Issue i.e. 1,499,990,908 shares
- **Aug 18'11:** Dr. Muhammad Yaqub (ex-SBP Governor) resigns from MCB's Board of Directors. Mr. Ahmad Alman Aslam has been coopted as Director, subject to SBP approval, until the next election of Directors scheduled for Mar'12.
- **Aug 18'11:** BoK notifies the exchange that in respect of the 64.41% rights issue, an amount of PkR1.64bn was received during the acceptance and payment period.
- **Aug 10'11:** SILK conducts EGM for Board elections. Elected persons are 1) Mr. Munawwar Hamid (OBE), 2) Mr. Humayun Bashir, 3) Mr. Tariq Iqbal Khan, 4) Mr. Arshad Ghafur, 5) Mr. Sadiq Sayeed, 6) Mr. Javed Hamid, 7) Mr. Burhanuddin Khan, 8) Mr. M.A.Mannan and 9) Mr. Azmat Tarin.
- **Aug 5'11:** SBP grants approval for extension in Mr. Muhammad Usman Ali Usmani's term as CEO for one year until Sep 24'12.
- **Aug 4'11:** SECP extends time for issuance of rights shares (KASBB) till Sep 30'11.
- **Aug 1'11:** NIB notifies the exchange that its sponsor has fully subscribed the allotted portion of 4,636,993,265 rights shares on Jul 28'11.
- **Jul 28'11:** SNBL informs that its rights issue (200.272mn shares @ PkR5/share) has been fully subscribed. Paid up capital of the bank has risen to PkR8.025bn, in satisfaction of 2011 MCR requirements.
- **Jul 26'11:** KASBB notifies financial projections for 2011-2016. Management envisages capital injection of PkR4.5bn in CY11 and PkR2.5bn in CY12 and projects NPAT CAGR of 62% across 2011 (projected NPAT: PkR453mn) and 2016 (projected NPAT: PkR5,097mn). Considering advances and deposit growth CAGR is projected at 13% and 11%, respectively, the profit growth projections appear slightly optimistic, in our view. To recall, KASBB has recently issued 105.16% rights at PkR3/share.

- **Jul 1'11:** BOK notifies financial projections for 2011-2013. Management projects 17% p.a. deposit growth and 21% p.a. loan growth over the next two years. Profit is projected to more than double from PKR639mn in CY11F to PKR1,424mn in CY13F with management looking at a higher ADR and NIM expansion to drive the bottomline.
- **Jul 1'11:** SBP announces Jun 30'11 as the effective date of the scheme of amalgamation of MYBL with and into SMBL.

Valuation Multiples & Key Ratios

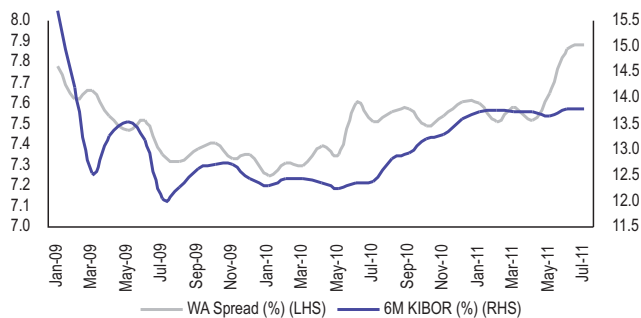
Symbol	Bank	Price	BVS	EPS	Mkt Cap/	ROE (%)	P/BVS	PER	ROE/PB
		05-Sep-11	Jun-11	1HCY11	Deposits	4Qs Avg	Mar-11	4Qs Avg	4Qs Avg
		PkR			(%)			(x)	
BOK	Bank Of Khyber	3.92	19.81	0.92	4.3%	12.1%	0.20	1.73	0.61
JSBL	JS Bank Limited	1.80	7.27	0.12	4.4%	0.3%	0.25	48.96	0.01
SBL	Samba Bank Limited	1.50	5.55	0.03	13.9%	0.2%	0.27	124.24	0.01
KASBB	KASB Bank Limited	1.17	3.55	(2.40)	2.3%	n.m	0.33	n.m	n.m
SNBL	Soneri Bank Limited	4.35	12.86	0.59	3.8%	4.2%	0.34	4.44	0.12
BIPL*	Bankislami Pakistan Limited	3.31	9.12	0.10	4.4%	1.8%	0.36	19.35	0.05
AKBL	Askari Bank Limited	9.07	23.82	1.03	2.3%	5.6%	0.38	6.95	0.15
FABL	Faysal Bank Limited	9.15	23.16	1.08	3.3%	1.7%	0.40	24.74	0.04
NIB	NIB Bank Limited	1.45	3.10	(0.31)	6.5%	n.m	0.47	n.m	n.m
NBP	National Bank of Pakistan	38.76	77.02	4.84	7.8%	14.1%	0.50	3.62	0.28
BAFL	Bank Al Falah	9.74	17.40	1.37	3.6%	10.4%	0.56	5.56	0.19
SCBPL	Standard Chartered Bank	7.56	13.34	0.46	12.4%	8.0%	0.57	7.07	0.14
HMB	Habib Metropolitan Bank	16.42	20.86	1.37	9.4%	13.3%	0.79	6.21	0.17
SMBL*	Summit Bank Limited	2.67	3.27	(0.56)	3.4%	n.m	0.82	n.m	n.m
UBL	United Bank Limited	57.21	63.69	5.24	11.5%	16.5%	0.90	5.69	0.18
MEBL	Meezan Bank Limited	18.75	17.54	1.88	10.2%	19.5%	1.07	5.95	0.18
SILK	Silkbank Limited	2.11	1.85	0.06	8.9%	-22.9%	1.14	n.m	n.m
HBL	Habib Bank Limited	117.59	90.63	9.08	14.8%	20.0%	1.30	6.76	0.15
ABL	Allied Bank Limited	61.00	46.91	5.90	12.9%	26.3%	1.30	5.41	0.20
BAHL	Bank AL-Habib Limited	28.00	19.45	2.37	8.8%	25.0%	1.44	6.10	0.17
MCB	MCB Bank Limited	174.16	105.54	12.71	29.4%	23.3%	1.65	7.48	0.14

*1QCY11 Results

Source: AKD Research

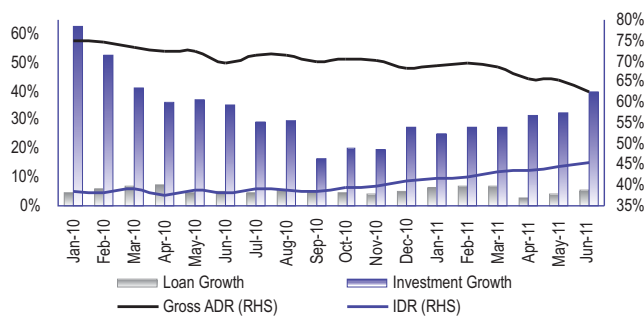
Banking Sector Recent Trends

Margins have likely peaked



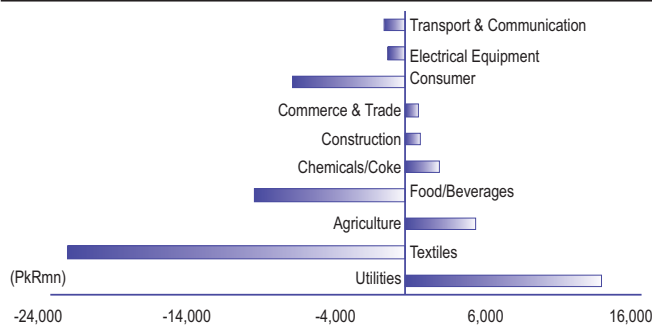
Source: SBP & AKD Research

Risk-averse stance to aid asset quality



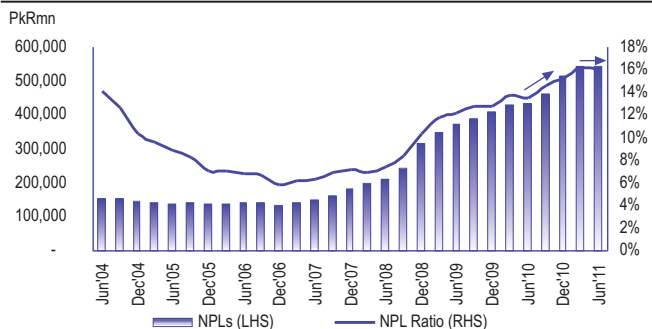
Source: SBP & AKD Research

Loan Book Trends (Jul'11)



Source: SBP & AKD Research

NPLs for Commercial Banks appear to have stabilized



Source: SBP & AKD Research

Banking sector earnings over the last year have largely been driven by higher margins inline with a higher interest rate environment. In this regard, the SBP has recently reduced the Discount Rate by 50bps to 13.5%. In our view, likely lower inflation going forward should facilitate continued monetary easing, leading to margin compression. Note that when the Discount Rate reduced from 15% to 12.5% in CY09, average NIMs for the Big-5 Banks contracted from 6.9% to 6.4%. As such, Jul'11 weighted average industry spreads of 7.88% likely represent a peak.

Banks have maintained an extremely risk-averse stance over the last two years where growth in investments (primarily T-bills) has outpaced loan growth by some distance. While the SBP has reinitiated monetary easing, we fail to see banks abandoning their risk averse stance, at least in the next 2-3 years. This is in keeping with expected double digit interest rates and heavy GoP borrowing requirements. In our view, a shift in asset mix towards advances is unlikely outside of a single digit interest rate environment. As such, we expect declining credit costs to compensate for margin compression.

While banks' preference is highly skewed towards risk-free investments, they have not shied away from opportunistic working capital lending. In Jul'11, the Textile sector has retired > PkR20bn which is inline with seasonal dynamics (cotton procurement from next quarter). While consumer financing continues to contract, it is interesting to note that Food/Beverages have also retired loans on a net basis. Kharif sowing season explains the increase in Agriculture lending while piled up circular debt has led to continued increase in lending to utility companies (primarily power).

NPLs for commercial banks registered at PkR544bn on Jun 30'11, up 26%YoY and 0.3%QoQ. Although risks to credit costs remain (provisioning coverage is below-average at 68% and hefty FSV benefits may come in for reversals from CY12F), we believe recent deceleration in NPL formation is prescient. Note that NPL formation flattened out last year before the floods/interest rate increases that led to another round of fresh NPL slippage. While risks remain (particularly on circular debt related exposure and potential expiry of FSV benefit), we believe the Big-5 banks as a group should post lower credit costs going forward which should counter tighter NIMs and provide impetus to the bottomline.

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Buy	≥ 20% upside potential
Accumulate	> 5% to < 20% upside potential
Neutral	≤ 5% to ≥ -5% potential
Reduce	≤ -5% to > -20% downside potential
Sell	< -20% downside potential

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