

July 21, 2009

Pakistan Market**MCB: There is still gas left in the tank****MORNING BRIEFING**

KSE100 Index: Closing 7710.64 ↓ (-53.37)

We reiterate our liking for MCB bank given its superior asset quality, strong Net Interest Margin (NIMs), high capital adequacy and aggressive management focus. Though the scrip has performed admirably in 2009 (adjusted return of 48% to date), we believe there still remains a decent upside potential of 17% to our target price of Rs198.

Valuation: Deep discount to regional peers

Despite trading at PE multiple of 8.0x, (premium of 15% to local peers) and PBV of 1.7x, MCB remains our preferred pick in the banking sector. The valuation premium of MCB is premised on its expected out performance with a much superior 3 years (2009-11) average ROE of 21.5% versus local peers' average of 14%. The bank has historically traded at an average premium of 45% on PBV to its local peers. Moreover, it carries the lowest asset quality risk with NPL ratio of 8.1% versus peers' average of 10%. The valuation is even more compelling when compared with regional peers as MCB trades at a massive discount of 57% and 26%, respectively to peers one year forward PE and PBV. The most striking aspect is the fact that MCB has both a superior ROE (23% v/s peers' average 15%) and CAR (16% v/s peers' 14%).

Superior asset quality against local peers persists

While MCB's NPL to advances ratio has deteriorated to 8.0% in 1Q2009 as against 4.9% in Dec 2007, it still remains significantly superior to its peers' average of 10.1%. We believe NPLs would have risen sharply in 2Q2009 largely driven by dismal Large Scale manufacturing figures (contraction of 13% in 4M2009), however MCB would continue to be better positioned vis-à-vis peers. Our analysis is driven by the fact that its exposure is more diversified and less skewed towards the high risk textile and consumer segments. Moreover, reversals are expected with regards to its exposure in financial sector (particularly lending against shares to brokers) as equity market condition has improved substantially since hitting rock bottom in Jan 2009.

Higher NIMs provides room to absorb fall in KIBOR

MCB continues to enjoy higher spread and NIMs compared to peers with a record high NIM of 9.7% recorded in 1Q2009. This is significantly better than the peers and industry average of 6.3% and 6.1% respectively. We expect industry spreads to decline by 60-80bps from the current 7.47% (May 2009) by the end of the year, however, MCB's cost efficient position, would ensure it has more capacity to absorb the impact of this decline than peers.

RBS acquisition could spur growth in fee income

Being one of the late entrants in the consumer financing, MCB's fee income growth lagged that of its peers with lowest fee income in the Big 4 banks. This scenario could change if MCB is successful in its bid to acquire the RBS Pakistan operations, which has both a strong infrastructure and quality human resource. And even though consumer business is under pressure on account of higher NPLs at present, it does offer long term opportunity once economy starts picking up.

Pension fund advantage to remain intact

MCB bank's low cost to income ratio is primarily driven by continued surplus in its Pension Benefit Obligations (PBO) which allows reversal on the fund to be set off against admin cost. Resultantly, MCB's cost to income ratio has hovered around 25-30% versus an average 40% for peers. The bank currently carries more than Rs6bn of unrealised capital gains which are to be recognised over 3 years. However, since pension fund sold off most of its holding in MCB, the quantum of gains is expected to decline. That said, the cost ratio would still remain lowest amongst major peers.

Risks to our valuation

- Significant deterioration in asset quality
- Steeper than anticipated decline in spreads
- Slower than expected economic recovery

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For more details please refer to our short report titled "MCB: There is still gas left in the tank" released earlier today.

Also in focus**Change of Marketable lot size from today**

As per the exchange's notice issued on July 17th, marketable lot size of all entry listed securities for ready and square-up markets will be converted to one share from today. Furthermore, Odd lot market will cease to operate as a separate market. However, there are still limits on the order size in the pre-open session.

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