

January 28, 2009

Pakistan Market**Banks: FSV benefit, 2008 earnings revised up 20%**

KSE100 Index Closing 4972.55 ↑ (+157.21)

MORNING BRIEFING

State Bank of Pakistan yesterday issued a circular with respect to amendments in prudential regulations relating to provisions for loans and advance. According to the circular, banks would be allowed to take 30% benefit of forced sale value (FSV) for pledged stocks and mortgaged properties on non-performing loans (NPLs) effective Dec 31, 2008, a partial reversal of the previous FSV regulation in Oct 2007. At a time when banks profits are facing pressures from rising NPLs, the availability of FSV benefit would help improve 2008 earnings by around 18-20% from our earlier estimates and would trigger short term rally in banking stocks.

Earnings revised upwards by 18–20% for 2008

Earlier we were expecting banks profit to decline by 4% and after this we expect it to post 16% growth. According to latest numbers, the size of total NPLs as of Sep 30, 2008 stands at Rs278bn with a coverage ratio of 79%, while we estimate NPLs to rise to Rs302bn by Dec 2008. Our assumption is based on the average quarterly increase in NPL during 2008 of Rs21bn accounting for the fact NPLs generally increase at a faster pace in the last quarter of the year.

While banks have been allowed FSV benefit up to 30% on all NPLs in the doubtful and substandard category, benefit on FSV would be limited to a maximum of 3 years from the date of classification in the loss category. This means that as of end Dec 2008, NPLs classified prior to Jan 1, 2006 would not be allowed to avail the new FSV benefit. The total NPLs of the sector as of Dec 31, 2005 stood at Rs192bn, and based on our discussion with various banking experts nearly 50% of those are no longer outstanding NPLs as of Dec 2008.

Assuming FSV to NPL ratio of 16% (based on Dec 2007 actual numbers), the total pre tax benefit of FSV amounts to Rs20bn with an after tax benefit of Rs13-14bn translating into average earnings impact of 18-20% based on 2008 expected sector earnings.

Post 2008 FSV benefit on incremental NPLs

While 2008 earnings would achieve a major one time boost, the impact on earnings in 2009 and onwards would be largely confined to incremental NPLs for the year. As per estimates, 2009 earnings could receive a boost of around 5-7% depending on the incremental NPLs during the year and the valuation of FSV as determined by approved valuers. While short term earnings would get a boost, there are no changes in the banking sector dynamics. Moreover, there remains a risk regarding the new measure's impact on risk management and whether this move could ease the current stringent risk management procedures.

Bank	FSV gain after tax (Rs mn)	Impact/sh (Rs)	Prev EPS (Rs)	New EPS (Rs)	□ ↕
ABL	394	0.61	7.01	7.62	9%
BOP	1,405	2.66	(11.09)	(8.43)	NM
FABL	896	1.69	3.51	5.20	48%
HBL	1,047	1.38	15.50	16.88	9%
MCB	674	1.07	23.41	24.48	5%
NBP	1,056	1.18	16.30	17.48	7%
UBL	1,120	1.11	10.40	11.51	11%

Source: JS Research

Recommendation: 'Market-weight' maintained

We maintain a 'Market-weight' stance on the banking sector as we believe that there are no significant changes in the sector dynamics including risks that the sector currently faces. While short term earnings would get a boost, there would be no major change in the cash flow position while the risk of rising NPLs and slowdown in deposits and advances growth would remain intact. UBL and NBP remain our top picks for the sector.

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Also in focus**6-month KIBOR marching downward**

Amid liquidity improvement in the inter-bank market, 6-month KIBOR has started to decline. So far in 2009, the benchmark lending rate is down 39bps to 15.31%.

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