JS Research

JS Global Capital Limited

July 2009

Pakistan

Buy Rs168.77

MCB Bank Limited

Company Update

Target Price: Rs198

There is still gas left in the tank

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. Trading at 2009E PE and PBV of 8.0 and 1.7x, respectively MCB may seem expensive to local peers average PE and PBV of 6.9x and 1.0x. However its attractive 3 year (2009-11) average ROE of 21.5% justifies the premium. MCB has also historically traded at an average PBV premium of 45% to peers. Moreover, valuation is extremely compelling on a regional basis with a massive discount of 57% on PE and 26% on PBV. The key risks to our thesis are: (1) significant deterioration in asset quality (2) steeper than anticipated decline in spreads & (3) slower than expected economic recovery.

KATS Code: MCB

Bloomberg Code: MCB PA

Reuters Code: MCB.KA

Market Price:
Rs168.77

Market Cap:
Rs116.6bn
US$1.4bn

1-yr Avg. Daily Volume:
2.8mn shares
Rs471.6mn
US$5.8mn

1-yr High/Low:
Rs316.50/77.76

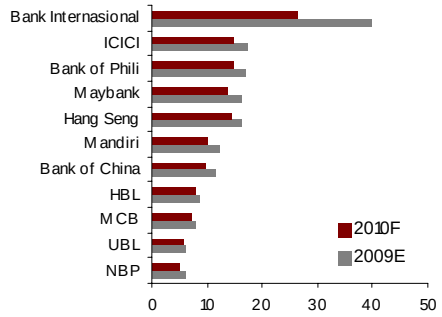
Estimated free float:
311mn shares (45.0%)

Valuation: Cheap v/s regional peers despite higher ROE & CAR

While MCB bank has been one of the top performers in 2009 outperforming the market by 16% (YTD return of 48%), we believe it still offers a decent upside of 17% at our target price of Rs198. Our valuation is based on a justified P/B multiple of 2.0x with a required return of 17.6%. Our preference for this methodology is premised on the fact that it rewards banks with high ROEs, resulting in a higher justified P/B multiple. Hence, despite trading at PE multiple of 8.0x, (premium of 15% to local peers such as NBP, UBL and HBL), 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%, while it has a superior balance sheet strength compared to both HBL and UBL as reflected by Capital Adequacy Ratio (CAR) of 16%.

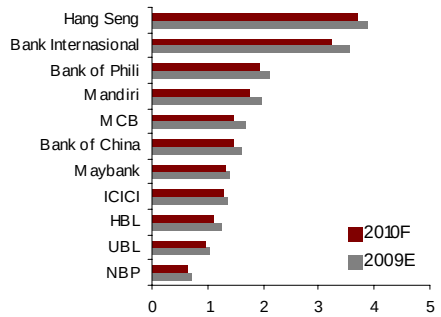
The valuation is even more compelling when compared with regional peers as MCB trades at a massive discount of 57% and 26%, respectively to peers one year forward PE and PBV. The most striking aspect is the fact that MCB has both a superior ROE (23% v/s peers' average 15%) and CAR (16% v/s peers' 14%).

Graph 1: PE (x)



Source: Reuters, JS Research

Graph 2: P/BV (x)



Source: Reuters, JS Research

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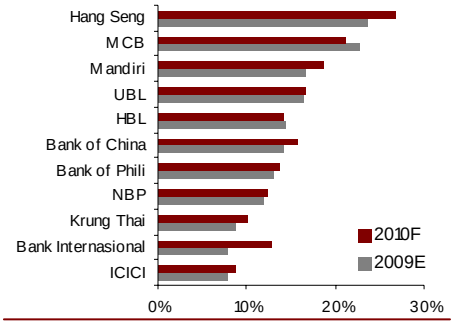
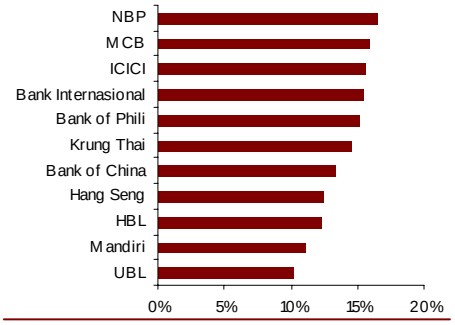
Graph 3: ROE



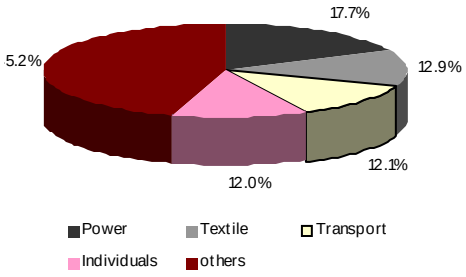
Source: Reuters, JS Research

Graph 4: CAR



Source: Reuters, JS Research

Graph 5: Lending portfolio mix

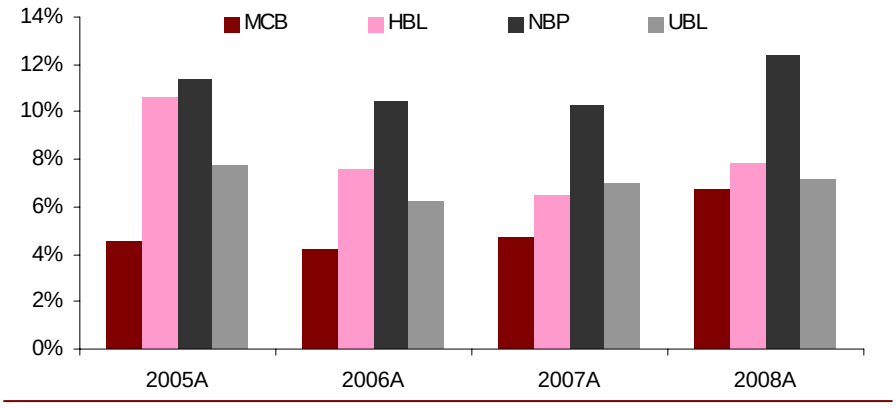


Source: Annual report 2008

Superior asset quality against local peers persists

A major concern facing the banking sector over the last few years has been the sharp surge in Non Performing Loans (NPLs) which has ultimately affected profitability via higher provisions charge. Since the beginning of 2008, NPLs have risen by a massive Rs181bn or 84% until Mar 2009, while provisions for NPLs have been recorded at Rs92bn (until June 09). MCB's NPL to advance ratio has also deteriorated to 8.0% in 1Q2009 as against 4.9% in Dec 2007, however it still remains significantly superior to its peers' average of 10.1%. We believe NPLs would have risen sharply in 2Q2009 largely driven dismal Large Scale manufacturing figures (contraction of 13% in 4M2009), however MCB would continue to be better positioned vis–a-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.

Graph 6: Comparison of Gross NPL ratio



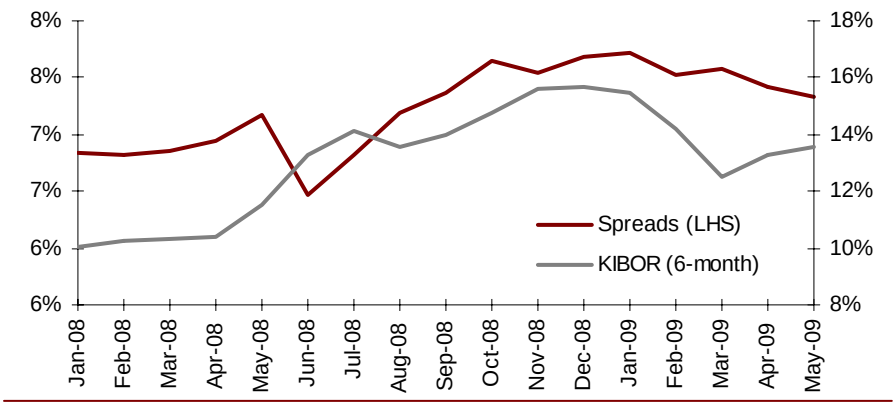
Source: Company Accounts

Higher NIMs enhances capacity to absorb decline 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. While spreads have already started to depict a declining trend amid sharp fall in KIBOR (6M KIBOR down 377bps since Dec 08), MCB's lowest cost of funds, provides it with a clear edge over peers.

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.

Graph 7: Trend of spreads vs 6-month KIBOR

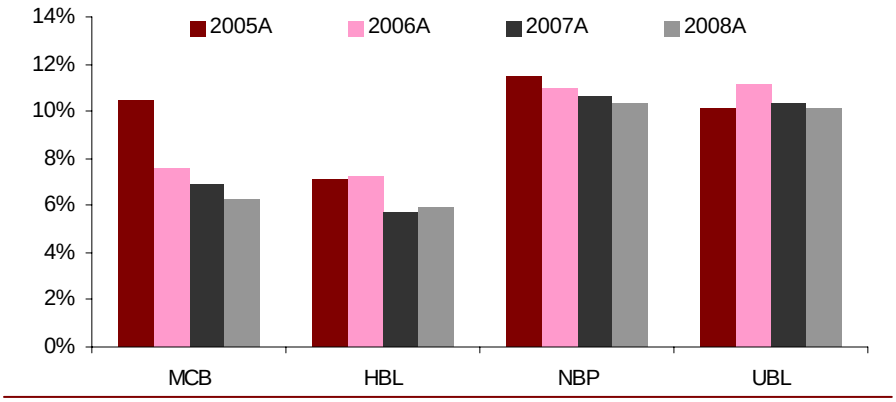


Source: SBP

RBS acquisition could spur growth in fee income

Being one of the late entrants in the consumer financing segment along with lack of international exposure, 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. RBS has a well established consumer banking business (30% exposure to consumer segment) supported by 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 again. Moreover, MCB could gain access to top quality multinational clients of RBS which could also contribute immensely towards growth in fee income.

Graph 8: Fee income as % of Total income



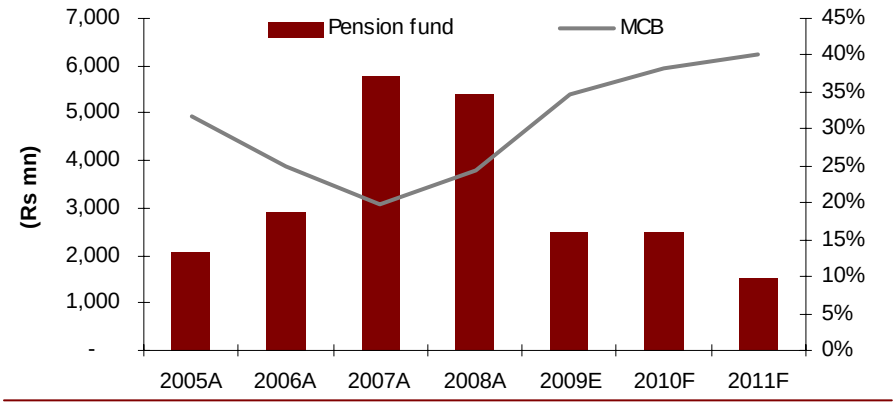
Source: JS Research

Pension fund reversals to slow, but competitive advantage 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. Hence, we expect admin expense to rise to Rs11.2bn (Cost to income ratio 32%) in 2009 from Rs7.5bn (Cost to income ratio 25%) in 2008. That said, the cost ratio would still remain lowest amongst major peers.

Graph 9: Pension fund and Cost to income ratio



Source: JS Research

Risks

Substantial deterioration in asset quality

A key downside risk to our estimates is more than anticipated deterioration in asset quality. We have assumed a sharp increase in NPLs during 2009 with a Gross NPL ratio 8.1% (2008: 6.7%) and average infection ratio of 6.8% over the next 5 years. However, slower than expected economic recovery could affect the quantum of NPLs which would ultimately hit profits of the sector via higher provisions. We have resorted to sensitivity analysis on the likely impact of incremental provisions on earnings in 2009.

Table: Sensitivity of NPL provisions on 2009E EPS

	Provision for NPLs (Rsmn)	2009E EPS (Rs)	Change in earnings
20% lower	3,440	21.7	3.9%
Base case	4,300	20.9	0.0%
20% higher	5,160	20.1	-3.9%
40% higher	6,020	19.3	-7.7%

Source: JS Research

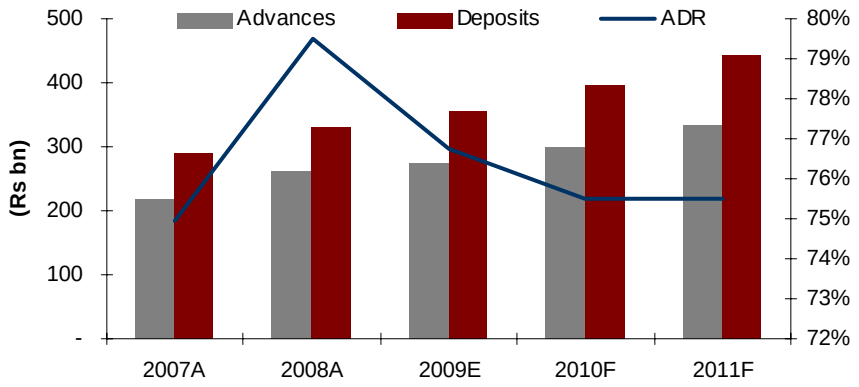
Steeper than anticipated decline in spreads

We expect pressure on spreads to intensify in 2H 2009 as KIBOR has fallen by a massive 377bps from a peak of 15.7% in Dec 2009. Moreover, cost of funds are likely to remain rather stable as the bank would only be able to reassess its term deposit (15% share in total), while 5% minimum rate on savings (50% of total deposits) is likely to stay intact. As a result, we expect spreads to average 7.3% in the next 5 years, while NIMs would fall from a peak of 9.7% in 1Q2009 to 7.7% by 2010. We have assumed average KIBOR of 12.5% and 11%, respectively for 2009 and 2010. However, higher than anticipated decline in KIBOR would affect the bank's spread and push profitability on the lower side, though there would some degree of set off through improve offtake numbers.

Slower pick up in credit offtake due to prolonged slowdown

Apart from rising NPLs, another factor affecting earnings of the banking sector has been the rather dismal credit offtake amid deteriorating economic fundamentals. After posting an average growth of 21% during 5 years (2004-08), banking sector advances growth is expected to slowdown to around 4% in 2009. Similarly for MCB, we expect advances growth of 4.5% in 2009 while we have assumed an average growth of 10% over the next 4 years in line with our assumptions of economic recovery. Slower than anticipated economic recovery, due to political/security situation or delays in external flows can lower our assumptions of credit offtake.

Graph 10: Advances, Deposits & ADR



Source: Company Accounts, JS Research

MCB Bank Limited

(Rs mn)	2007A	2008A	2009E	2010F	2011F
Income Statement					
Interest Income	31,787	40,044	47,372	48,857	51,533
Interest Expense	7,866	11,561	14,982	15,296	15,629
Net Interest Income	**23,921**	**28,483**	**32,389**	**33,561**	**35,904**
Fee Income	2,635	2,867	3,039	3,343	3,744
Other Non Interest Income	3,815	2,925	2,787	3,136	3,469
Operating Income	**30,370**	**34,275**	**38,215**	**40,040**	**43,117**
Operating expense	5,996	8,388	12,071	13,391	15,698
Profit before provision	**24,374**	**25,887**	**26,144**	**26,649**	**27,419**
Provision and other expenses	3,065	4,019	4,836	3,629	2,817
PBT	**21,309**	**21,867**	**21,308**	**23,020**	**24,601**
PAT	**15,267**	**15,374**	**14,420**	**15,720**	**17,065**
Balance Sheet					
Paid up capital	6,283	6,283	6,911	6,911	6,911
Reserves and Surplus	48,837	52,153	61,667	71,678	82,577
Total Equity	**55,120**	**58,436**	**68,578**	**78,589**	**89,488**
Deposits	292,098	330,274	357,338	396,646	442,822
Borrowing From Financial institutions	39,407	22,664	23,797	24,987	26,236
Other liabilities	23,861	32,242	33,832	35,502	37,256
Total Liabilities	**355,366**	**385,180**	**414,968**	**457,134**	**506,314**
Advances	218,961	262,510	274,257	299,468	334,330
Investments	113,089	96,257	119,661	134,985	148,469
Other Earning Assets	60,567	65,038	67,836	78,826	88,762
Other Assets	17,869	19,810	21,792	22,445	24,241
Total Assets	**410,486**	**443,616**	**483,546**	**535,724**	**595,802**
Ratio Analysis					
Valuation					
Earning Per Share	22.1	22.2	20.9	22.7	24.7
Book value per share	87.7	93.0	99.2	113.7	129.5
Price to earning ratio (x)	7.6	7.5	8.0	7.3	6.8
Dividend yield	7.5%	6.6%	6.0%	5.7%	5.7%
Price to book value (x)	1.9	1.8	1.7	1.5	1.3
Return on assets	3.7%	3.5%	3.0%	2.9%	2.9%
Return on equity	31.8%	27.1%	22.7%	21.4%	20.3%
Gross NPL Ratio	4.7%	6.7%	8.1%	7.6%	7.0%
Advances / Deposits	75.0%	79.5%	76.8%	75.5%	75.5%
Interest exp / Interest income	24.7%	28.9%	31.6%	31.3%	30.3%
Non Interest Income / Total Income	16.9%	12.6%	11.0%	11.7%	12.3%
Cost / Income	19.7%	24.5%	31.6%	33.9%	36.4%
Net Interest Margin	7.6%	8.1%	8.3%	7.8%	7.5%

Source: JS Research & Company Accounts

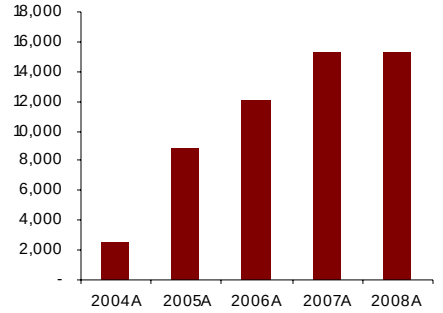
Company background

MCB is currently one of the leading banks of Pakistan with a total deposit base of approx. Rs.380 billion and total assets worth more than Rs.450 billion. Soon after being incorporated in 1947, MCB earned the status of a conventional financial institution managed by expatriate executives. In 1974, MCB was nationalized along with all other private sector banks.

MCB has a customer base of approximately 4 million and a nationwide distribution network of 1,060 branches and over 380 ATMs, in a market with a population of more than 60 million.

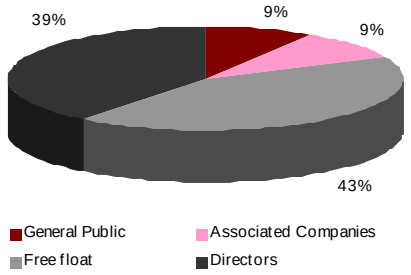
During the last fifteen years, MCB has concentrated on growth through improving service quality, investment in technology and people, utilizing its extensive branch network and developing a large and stable deposit base.

Graph 11: PAT trend (Rs mn)



Source: Company Accounts

Graph 12: Shareholding Pattern



Source: Company Annoucement
As of June 30,2009

Table: Key Events

1947	Incorporated in 1947 by Adamjee Group, MCB soon earned the reputation of a solid and conservative financial institution
1974	MCB was nationalized along with all other private sector banks.
1991	Acquired by a consortium of Pakistani corporates led by Nishat Group
Jan-03	Islamic Banking Division was formed with effect from 1st January 2003
May-05	The Best Domestic Commercial Bank Award 2005
Oct-06	Formal Market Opening for MCB Bank Limited Global Depositary Receipts (GDRs) at the London Stock Exchange
May-07	Atif Aslam Bajwa appointed as the President of MCB Bank Ltd.
May-08	Malaysia's Maybank acquires strategic stake in MCB
Jul-08	Best Bank in Asia Award 2008 – Euromoney Award
Apr-09	Express Interest to acquire Royal Bank of Scotland Limited (formerly ABN AMRO Bank (Pakistan) Limited

Source: Company Website/Reports

Key Management Personnel

Mr. Mian Mohammad Mansha – Chairman

Mian Mohammad Mansha is on the board of numerous companies in Pakistan and is one of the most powerful and influential persons in the country. He is the Chairman of the Nishat Group and was awarded the Sitara-e-Imtiaz civil award by President Musharraf in 2004.

Under Mr Mansha's guidance, MCB has demonstrated sound execution, stupendous growth and has turned into one of the premier financial institutions of Pakistan.

Mr. Atif Bajwa – CEO/President

Mr. Bajwa started his career in Citibank Pakistan as a corporate banker in 1982 and handled different relationship and unit head roles in Pakistan before moving to assignments in New York and Bahrain as senior member of the Corporate Banking and Corporate Finance Unit for the Gulf Markets.

He joined ABN AMRO Bank in 1993 and was appointed Country Manager of Pakistan in 1995. In 1998, he moved to Singapore as the Consumer Banking Head for Asia Pacific covering operations in 9 countries. In mid 2001, he returned to Citibank as the Regional Head for Central and Eastern Europe. In early 2005, he moved to Dubai with Mashreqbank to manage the Retail and Small Business Group, which has presence across the Middle East. In May 2007, he became CEO of MCB Bank.

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