Habib Bank Limited

Reinstate with "Overweight"; let the relief (rally) sink in

Friday, September 08, 2017

HBL - Overweight

Target Price: PKR 221.00

Current Price: PKR 152.94

HBL Performance

	3M	6M	12M
Absolute %	-40%	-41%	-24%
Relative to KSE %	-21%	-24%	-27%

Bloomberg	HBL PA
Reuters	HBL.KA
MCAP (USD mn)	2,247
12M ADT (USD mn)	3.2
Shares Outstanding (mn)	1,467

Source: PSX, BMA Research

HBL-Valuation Snapshot

(YE: Dec)	2016E	2017E	2018E
NII (PRsmn)	81,951	79,950	84,679
% Change	5%	-2%	6%
Non Int. Inc	31,062	31,557	32,873
% Change	-15%	2%	4%
PAT (PRs mn)	34,207	8,198	34,173
% Change	-3%	-76%	317%
EPS (PRs)	23.32	5.59	23.3
PER (x)	6.5	27.3	6.5
DPS (PRs)	13.05	7.04	7.04
P/BV (x)	1.1	1.2	1.1
ROE (x)	18.20%	4.30%	17.40%

Source: Company Accounts, BMA estimates

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REP-005

- **We reinstate coverage on Habib Bank Limited (HBL) with Overweight rating and new TP of PKR221/sh (PKR267 previously), implying 45% upside.**
- **In a latest twist on penalty saga, HBL has reached an out of court settlement with the US regulator and has agreed to pay USD225mn (73% of annual earnings or 12% of June'17 equity), thereby avoiding a worst-case scenario of paying maximum penalty of USD629mn and/or long-drawn legal battle.**
- **The stock price reaction is likely to be hugely positive post the announcement. A 30% correction in stock price since announcement of potential penalty on 25th Aug'17 reflects a worst-case scenario in valuation (CY17E P/BV of 1.27x, Tier II ROE of 18-19%)).**
- **The penalty will likely erode 195bps from HBL's Tier I capital bringing it down to 10.1% (CAR of 13.6%). Though revised Tier I ratio remains higher than central bank's benchmark (Tier I ratio of 7.5%, 128bps CETI buffer), the available cushion for growth will be significantly constrained, highlighting the need for beefing up capital via dividend cut and potential Tier I capital raising (6-8% right issue).**
- **We understand the bank is already in process of raising the required amount from international sources required for payment of penalty. The payment of penalty (likely by 21st Sep'17) will have minimal impact of country's reserves.**

Reinstate with "Overweight"; let the relief (rally) sink in: In a latest twist on supervisory action saga, HBL and the US regulator have reached an out of court settlement on the issue. As per the agreement, the New York Department of Financial Service (DFS) has imposed a fine of USD225mn on HBL due to alleged violation of relevant law and regulations on money laundering, terrorist financing and other illicit financial transaction. The penalty is merely 36% of maximum penalty of USD629mn which DFS had arrived at based on a total of 53 alleged violations. We reckon HBL has gotten a good deal. The management in its latest briefing with analysts had acknowledged the weakness in risk & compliance functions of the New York branch and as such were prepared to pay fine of significantly lower magnitude. We reinstate coverage on HBL with Overweight rating and new TP of PKR221/sh (PKR267 previously), implying 45% upside.

Key conditions: Key conditions in the Consent Order which stipulates the terms of the settlement agreement are summarized below;

- HBL will pay civil monetary penalty of USD225mn within fourteen days of execution of the Consent Agreement (21st of Sep'2017)
- The penalty is non-deductible for tax deduction in the US. Pakistan tax laws also stipulates similar conditions.
- HBL will complete orderly wind-up of its branch in New York while meeting all requirements to the satisfaction of the US regulator.
- HBL agreed to cooperate with the US regulator on various orders (Consent Agreement 2015, Surrender Order, Consent Order 2015 etc) issued in connection with bank's branch operations in New York.
- HBL agreed no provision of Consent Order is subject to review in any court or tribunal outside the department (DFS).
- DFS will not take any further actions against HBL unless breach of conditions set forth in the consent order.

Earnings estimates cut: We now estimate CY17E EPS of PKR5.56 (down 75%). The penalty will likely shave off PKR16/sh from CY17 earnings (assuming no tax deduction). Our future earnings estimates have also been adjusted down by 3-4% to reflect the impact of likely fund raising for payment of penalty and likely lower growth in RWA. We understand the bank is already in process of raising the required fund from external sources (if not already arranged) and the payment of penalty will have minimal impact on country's reserves.

Possibility of right issue is still high: HBL's revised Tier I ratio will likely be eroded by 195bps to 10.1% (CAR of 13.6%). Though revised Tier I ratio remains higher than central bank's benchmark (Tier I ratio of 7.5%, 128bps CETI buffer), the available cushion for growth will be significantly constrained, highlighting the need for beefing up capital. Secondly, the cushion will also shrink in future as higher Tier I ratio is phased in as per Basel III requirement (10% by 2019, with 2% additional buffer in the form of CET). HBL is likely to adopt a combination of dividend cut and potential Tier I capital raising (6-8% right issue @PKR160/sh). Given the size of the bank, the bank's need to maintain per party exposure limits for clients (linked to equity base of the bank) and HBL growth aspirations, merely withdrawal of cash dividend may prove insufficient. We see low possibility of central bank allowing HBL to amortize the penalty amount on its book, a relaxation that central bank has allowed other banks on loan provisioning, for two reasons, (1) size of the banks, (2) unlike loan classification which still carries possibility of future recovery by the bank, the penalty carries no such possibility of reduction.

Likely implications for HBL: Three key implications from HBL's strategy perspective are;

#1- The scale down of bank's operations outside Pakistan. HBL's international operations (branch +subsidiary) have earned negative ROE in the past few years.

#2- Reduction in bank's exposure to risky assets. This can potentially have long-lasting impact on bank's earnings capacity.

#3- Significant changes in senior management (risk, internal audit, international operations, can be primary targets). However, the changes are likely to be gradual.

Key risks to our investment thesis: (1) risk of non-compliance of Consent order and the possibility of further penalty, (2) the structure for funding raising for penalty is not clear at this stage, (3) higher than estimated dilution of ownership due to right issue, (4) other risks associated with economy (slow-down in demand, FX volatility) and operations of banks.

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Rating definitions	
Overweight	Total stock return > expected market return + 2%
Market-weight	Expected market return ± 2%
Underweight	Total stock return < expected market return - 2%

*Total stock return = capital gain + dividend yield

Old rating system (discarded effective Feb 29'16)

Buy	>20% upside potential
Accumulate	>=5% to <=20% upside potential
Hold	<5% to >5% potential
Reduce	<=-5% to >=-20% downside potential
Sell	<-20% downside potential

Valuation Methodology

To arrive at our period end target prices, BMA Capital uses different valuation methodologies including

- Discounted cash flow (DCF, DDM)
- Relative Valuation (P/E, P/B, P/S etc.)
- Equity & Asset return based methodologies (EVA, Residual Income etc.)