

## NBP: The Banking Giant

**PKR 64; Target PKR 97; Upside Potential 51.2%**

We initiate our "BUY" recommendation on NBP with a target price of PKR 97 using the DDDM with an upside potential of 51.2%. The stock trades at 3.7x 08 earnings and 0.5x P/BV 08 and 4.1x 09 earnings and 0.5x 09 P/BV which ranks it amongst the cheapest of the top 5 banks in its league. Although CY09 would remain testing for the entire sector as well as NBP, but the recent decline has already priced in those factors. Cheap valuations and a low LDR with potential to take advantage of any spike witnessed in loan growth are key opportunities. Downward adjustment in interest rates is the key determinant in the sensitivity of the valuations metric for NBP.

### Background

NBP stands as the largest commercial bank in the country by assets and ranks second to Habib Bank in Branch network. The bank gains its advantage by its broad based branch penetration comprising of 1,232 nationwide domestic and 18 international corresponding branches allowing the bank leverage to earn higher spreads due to its above average sticky deposit mobilization from rural areas of the country where 44% of its branches operate.

### Risk Aversion in Consumer Portfolio

NBP's reluctance to enter the consumer financing market was a blessing in disguise as the deterioration of macro-economic fundamentals throughout CY08 had a devastating impact on defaults of credit cards and auto loans. However, NBP does have a consumer product by the name of "Advance Salary" which offers upfront future salaries to GoP employees with an arrangement with the public sector entity thus, mitigating the credit risk and immunizing the bank from consumer defaults.

### GoP Support & Ownership

As the GoP's treasurer the bank is well positioned to take advantage of fee based income on Pakistan's trade volume especially with its presence in Pakistan's key trading partners and also in the collection of government taxes and challans. With its sheer balance sheet size and highest per party limit, NBP is well positioned to be the most valued commercial bank in the country but due to its public sector ownership certain associated risks are built into the valuation, such as loose controls and lack of technological initiatives that may impact on asset quality in a high interest rate scenario.

### Regulatory Changes

The Pakistani banking environment is currently going through a phase of consolidation whereby Banks have to meet the PKR23bn capital requirement by 2013, this and other Tier I and Tier II capital changes are likely to reduce the number of banks in operation. Another regulatory change that would directly impact on valuations of banks is the increase in CAR ratio to 10% from 8% to enhance the risk management and solvency of banks. This change has resulted in permanently declining the component of future earnings paid out to shareholders by 2%. In the case of NBP it has maintained a prudent policy of maintaining a CAR ratio in excess of 2% above the required ratio.

SAAO Weightage OW  
SAAO Target Price (PKR) 97.0

Current Price (PKR) 64.5  
52 week high (PKR) 241.3  
52 week low (PKR) 46.1  
Exchange Rate (US \$) 79.5  
Index Weightage (%) 3.87

Average Turnover(mn) 5.08

Mkt Cap (PKR) (bn) 57.8  
Mkt Cap (US \$) (mn) 727  
Issued Shares (mn) 897

Free Float (%) 20

KSE Ticker NBP  
Reuters Code NBPKKA  
Bloomberg Code NBP PA

Majority Shareholding Sector GOP  
Comm Banks

**Lowest LDR**

NBP has been conservative in advancing in the preceding years a policy likely to generate dividends as rising NPL's and the latest credit crisis that asserted its pressure on the banking sector due to restricted access to cash by smaller commercial banks. Currently NBP has a LDR of 0.63 which remains much lower than its industry peers of 0.71. Over the past decade NBP has maintained an LDR in the range of 0.55 to 0.65 signaling its conservative stance on loan growth. Under the prevailing circumstances the bank is likely to maintain this ratio but moving forward the excess liquidity is likely to emerge as an opportunity in a declining interest rate scenario. Deposits from state owned institutions coupled with the ability to mobilize low cost sticky deposits will keep the banks deposit stream running, advances growth is likely to remain under the noose, but infrastructural projects such as dams, power plants and national and international corridors will serve as opportunities.

**Textile Sector & Asset Quality**

According to SBP data released approximately 29% of commercial banks advances are to the textile and associated sector. This sector has seen some rapid deterioration on the back of increases in utility prices (gas and fuel), high cost of borrowing as lending rates have shot up, falling exports in a global recessionary environment and high input cost due to higher inflation and devaluation of the Pak Rupee.

NBP ranks amongst top advancer to the Textile sector, as per CY07 accounts the bank had a PKR 61bn exposure to the textile sector which is second only to HBL. The NPL's arising from textile companies defaulting on their loans has risen and remains a key downside risk to the banks future profitability.

**Banks Textile Loans**

Bank	PKR
NBP	61bn
HBL	83bn
UBL	60bn
ABL	34bn
MCB	35bn

Source: SAAO Estimates & Financial Accounts

**Investments**

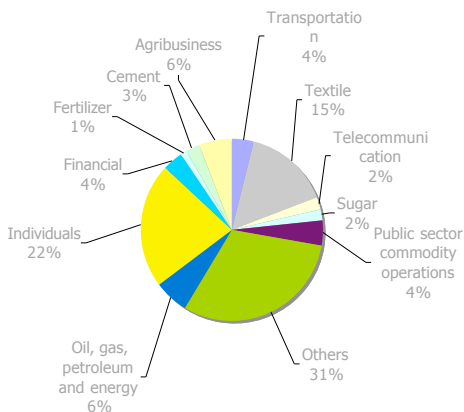
NBP's investments portfolio of PKR154bn mainly comprises of PIB's, Treasury bills and other corporate bonds. The investments portfolio has witnessed a decline of PKR56bn as of Sep 08 accounts primarily due to the its investment in NIT units(PKR5.7bn, Sep, 08) and a 5.83% stake (17,500,000) shares in Bank Al Jazira. This investment is marked to market as per SBP regulation as of 17, Feb, 2006. Stock markets around the world have witnessed one of the worst years in history plunging this investments stake of the bank. NBP's AFS portfolio comprises of PKR2.58bn of listed securities as of Sep, 08 and a provision of PKR1.8bn for the Market opportunity Fund.

The market lost a further 35% of its value upon removal of the floor, its reflection on NBP's portfolio and its investments in mutual funds and NIT units would be seen further denting the investments holding of the bank, although we remain optimistic about the pull back of the equity markets in CY09 from the lows tested during December upon removal of the floor.

**Advances Concentration**

As per CY07 final accounts, the bank has a diversified advances portfolio with textiles and individuals standing out as key loan book categories. Most of the loans in the individuals category comprise of the advance salary product, which remain a cash cow for NBP with a low risk profile. NBP's textile exposure's asset quality is experiencing an incline in NPL's to the extent of 12% of all loans to the textile sector.

NBP's Advances Composition



Source: SAAO Estimates & Financial Accounts

**BULL TRIGGERS**

Privatization: Although bleak prospects exist of any privatization of this banking giant in the ongoing worldwide financial turmoil but any news on strategic public-private partnership or further divestment may see significant price appreciation.

Interest Rates: Downward adjustment in the key policy Discount rate is likely to have a significant uptick in profitability due to lower NPL's and advances growth coupled with low cost of equity enhancing valuations.

**BEAR TRIGGERS**

- ↘ Asset quality concerns due to financing GoP projects and populist micro financing schemes which generally carry a lower lending rate and a higher default ratio.
- ↘ Lack of technological advancements leading to poor controls and inadequate infrastructure to tap into the consumer financing segment
- ↘ Sub standard performance as a result of HR policy changes on political grounds.
- ↘ Diversion of low cost deposits to longer term deposits with higher interest returned.

**RECOMMENDATION**

Although, we remain cautious on the banking sector over the deteriorating prospects of the domestic economy, foreign inflows into the banking system, rising NPL's and tougher regulatory requirements as key downside risks. But the post-floor scenario where the KSE100 index nosedived by 35% we see valuations becoming too attractive to ignore.

Key indicators throughout CY09 that would elaborate upon the fate of the banking environment are interest rates and NPL's.

NBP remains the strongest gainer in any credit off-take due to its highest per party limits and low consumer debt. Components driving future profitability will be the generation of low cost deposits and entry into less riskier assets.

Using a DDDM (Distributable dividend Discount Model) we arrive at a fair value of PKR 97 for NBP. This key determinants are the inflated cost of equity due to a higher yield on the 10 year note and the downward revision of economic growth. Any downward revision in interest rates is likely to be a key short term trigger for price appreciation.

**NBP Financials**

<b>INCOME STATEMENT</b>	CY07	CY08E	CY09E	CY10E	CY11E
(PKR millions)					
Interest earned	50569	61188	67307	72355	74526
Interest expensed	16940	27104	32525	35777	37566
Net interest income	33629	34084	34783	36578	36960
Total provisions	4723	9682	10554	6860	5831
NIM after provisions	28907	24402	24229	29718	31129
Non-interest income	13545	16254	16091	18505	21281
Non-interest expenses	14391	16550	18536	20760	23251
Profit before tax	28061	24107	21785	27464	29159
Taxation	9027	7714	6971	8788	9331
Profit After Tax	19034	16393	14814	18675	19828
EPS (Adjusted) @ 897mn shares	21.22	18.27	16.51	20.82	22.1

<b>BALANCE SHEET</b>	CY07	CY08E	CY09E	CY10E	CY11E
(PKR millions)					
Cash and Balances with treasury banks	94873	103049	106140	110916	116462
Balances with other banks	37473	43597	44905	46926	49272
Lending to financial institutions	21465	24573	32658	27302	26876
Investments	210788	166463	163292	179173	197090
Net Advances	340677	388414	400066	418069	430014
Other assets	30995	34085	31842	29862	37626
Operating fixed assets	25923	32500	37557	40954	38522
<b>Total</b>	<b>762194</b>	<b>792682</b>	<b>816462</b>	<b>853203</b>	<b>895863</b>
Bills payable	7062	7134	7848	8632	9496
Borrowings from financial institutions	10886	11335	13308	12798	14334
Deposits and other accounts	591907	618292	628676	656966	679960
Other liabilities	30869	39634	40823	38394	44793
Deferred tax liabilities	5098	5100	5132	5132	5132
Equity	116338	111186	120675	131280	142149
<b>Total</b>	<b>762194</b>	<b>792682</b>	<b>816462</b>	<b>853203</b>	<b>895863</b>

<b>KEY INDICATORS</b>	CY07	CY08E	CY09E	CY10E	CY11E
EPS	21.22	18.27	16.51	20.82	22.1
EPS Growth YoY	12.20%	-16.10%	-8.50%	20.80%	13%
BVPS	129.7	123.95	134.53	146.35	158.47
P/E (x)	3.2	3.72	4.11	3.26	3.07
P/BV (x)	0.52	0.55	0.5	0.46	0.43
DPS	6.8	8	8	10	11
Dividend yield	10%	11.80%	11.80%	14.70%	16.20%
ROE	16.40%	14.70%	12.30%	14.20%	13.90%
ROA	2.50%	2.07%	1.81%	2.19%	2.21%
Market Cap to Deposits	10.30%	9.90%	9.70%	9.30%	9%
Loans to Deposit	0.58	0.63	0.64	0.64	0.63

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