

WEDNESDAY, 16 JANUARY 2013

Sector Review

Banking Sector Review

Attractive fundamentals already priced in

Although banks face risks in 2013, particularly with expectations of lower trading gains and with Basel III approaching, we retain our positive outlook on banks' fundamentals given 1) the expected bottoming of margins, 2) the continued strength of loans and fee-based income, and 3) the consolidation of the industry. Nevertheless, the strong performance of banking stocks in 2012 limits the upside potential upside of most banks in our coverage list. BDO and MBT remain our top picks for 2013.

Margins expected to be flat; loan growth to remain strong. While bulk of the positive earnings surprise over the recent periods came from strong trading gains, we believe that the banks' earnings are now poised to benefit from higher net interest income. This should come as margins are expected to be flat while lending growth is expected to remain at a double-digit pace. As we have noted in our previous reports, the narrowing of margins has shown signs of slowing down, with quarter-on-quarter figures already flattish since 4Q11. Although we are not expecting a significant increase over the short term because of the intense competition, we believe that a sustained demand for loans should eventually drive lending rates higher. The shift towards higher yielding middle market and consumer segments should also help banks improve their spreads. In addition, banks are already starting to adopt a strategy of benchmarking lending rates against the SDA rate, which are less volatile than the usual PDST-F rates.

Loan growth is also expected to remain strong for 2013 amidst rising investor sentiment and improving economic conditions (better-than-expected 3Q12 GDP growth and stronger government finances). Other tailwinds for the year include the possible upgrade of the country's credit rating to investment grade, the expected rollout of PPP projects, and the mid-term elections in June.

In our forecast, we assumed that lending would grow by an average of 16.5% in 2013. We forecast net interest income to increase by an average of 15.9%, driven by lending growth and as net interest margins flatten.

Higher fee-based income to offset expected decline in trading gains. One of the top concerns for banks in 2013 is the expected decline in trading gains, coming from a very high base. Nevertheless, we believe that banks' profits will continue to grow in 2013 as higher net interest and fee based income offset the drop in trading gains. Indeed, while the trading income of all seven banks in our coverage list are forecasted to fall by at least 13% (average of 31%), total revenues are still expected to climb by an average of 8%, with only SECB (-6%) registering a decline in revenues. Likewise, excluding SECB we expect all banks to grow their earnings in 2013.

Exhibit 1: 2013 Growth Forecasts

	Trading Gains	Non-Interest Income	Total Revenues	Net Income
BDO	-13%	9%	15%	21%
BPI	-37%	0%	9%	11%
CHIB	-18%	4%	10%	12%
EW	-46%	3%	18%	20%
MBT	-23%	-5%	6%	10%
PNB	-21%	-5%	7%	1%
SECB	-57%	-32%	-6%	-12%
Average	-31%	-4%	8%	9%

Source: COL estimates

APRIL LYNN TAN, CFA
april.tan@colfinancial.com

CHARLES WILLIAM ANG
charles.ang@colfinancial.com

Basel III concerns overblown. With Basel III set to be implemented in January 2014 locally, speculations about potential capital raising activities among banks have persisted. However, we believe that such concerns are generally overblown. All banks in our coverage list already have capital levels which are above the proposed minimum of 10% for Tier 1 and 12.5% for total CAR. Even considering a possible reduction in capital levels brought about by a more conservative definition of capital, we believe that most, if not all banks will still comply with the minimum requirement based on the newer rules. While some banks may still decide to raise capital to provide a larger buffer, any sell down caused by these developments should be viewed as opportunities to accumulate shares. Based on their current capital adequacy ratios, PNB and BPI (assuming PNB-Allied Bank merger) have the lowest Tier 1 levels.

Exhibit 2: Capital Adequacy Ratios

	Tier 1 CAR	Total CAR	
BDO	15.2	20.3	
BPI	13.7	15.2	
CHIB	14.8	15.7	
EW	15.4	19.3	
MBT	15.3	19.3	*estimated following sale of Toyota
PNB	12.3	18.0	*estimated assuming PNB-ABC merger
SECB	16.1	18.2	

Source: Banks, COL estimates

Consolidation theme to support higher valuation for potential target banks. Towards the end of 2012, we saw banking stocks rally sharply following reports that BPI and PNB were in discussions for a potential merger. Potential target banks (such as RCB, EW, PNB, which have low valuations and relatively smaller market capitalizations) outperformed due to speculation that the move by BPI would increase the pressure for the other big banks (BDO and Metrobank) to also go through mergers and acquisitions. While no deal between BPI and PNB has been completed (with many speculating that the talks are off after the exclusivity period between the two banks expired), we believe that speculation of merger and acquisition activities will continue, especially given the existing moratorium on branch expansion for big banks, and the adoption of Basel III by 2014. This could mean that valuation for potential target banks would remain elevated.

Top picks are BDO and MBT. Our top picks for 2013 are BDO and MBT. We like both BDO and MBT because of the advantages brought about by their size and liquid balance sheet. These should improve their ability to grow their lending portfolio and their low cost funding. The two banks are also less vulnerable to a slow down in their trading operations as fee-based income comprises a larger percentage of their total revenues. In addition, both banks' capital adequacy ratios are at comfortable levels following BDO's US\$1Bil share offering and MBT's sale of its stake in Toyota Motor Philippines for Php9Bil. Lastly, valuations are attractive, with the two offering a 24% and 21% upside respectively.

While our favorable outlook on the sector should also benefit the other banks, the upside on these banks is currently limited following the sharp rally in 2012. Nevertheless, pullbacks to more reasonable valuations should still be viewed as opportunities to BUY the stock.

Investment Rating Definitions

BUY	HOLD	SELL
<p>Stocks that have a BUY rating have attractive fundamentals and valuations, based on our analysis. We expect the share price to outperform the market in the next six to twelve months.</p>	<p>Stocks that have a HOLD rating have either 1.) attractive fundamentals but expensive valuations; 2.) attractive valuations but near term earnings outlook might be poor or vulnerable to numerous risks. Given the said factors, the share price of the stock may perform merely inline or underperform the market in the next six to twelve months.</p>	<p>We dislike both the valuations and fundamentals of stocks with a SELL rating. We expect the share price to underperform in the next six to twelve months.</p>

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