BANKING SECTOR

HOLD

CAPITAL BASE ON TEST; LOWER VALUATIONS PROVIDE LIMITED UPSIDE

Banking Favourites: COMB, HNB

First Capital expects Banking Sector to experience tough conditions similar to 2018 amidst the BASEL III requirements and the IFRS 9 impairment, demands stronger balance sheets for most banks. The newly implemented Debt Repayment Levy of 7% is an additional burden for the banks. However, with most banks having already raised capital on the above expectations, implementation of cost management strategies via process digitalization and innovative fintech solutions to bridge market gaps may provide the competitive edge among its peers. Despite the shocks, the heavy dip in market price provides a limited upside potential while First Capital Research favours the larger banks with a strong capital base and high ROEs.

Figure 1: Banking Sector vs. ASPI

Source: CSE

Stock	Stock Code	Recommendation	Mkt. Cap (LKR mn)	Price	Target Price	Upside (%)	PER (x) 2019E	PER (x) 2020E	PBV (x) 2019E	PBV (x) 2020E	DPS in 2019E	DY 2019E	Total Return
Commercial Bank - Voting	COMB.N	***BUY***	93,654	99.0	147.0	*48%*	4.9x	4.3x	0.8x	0.7x	4.2	*4%*	***52%***
Hatton National Bank - Voting	HNB.N	***BUY***	69,402	175.0	270.0	*54%*	4.3x	3.5x	0.6x	0.6x	10.3	*6%*	***60%***
Sampath Bank	SAMP.N	***HOLD***	52,529	187.0	210.0	*12%*	4.5x	4.2x	0.6x	0.5x	0.0	*0%*	***12%***
National Development Bank	NDB.N	***HOLD***	21,515	97.0	120.0	*24%*	3.7x	3.4x	0.4x	0.4x	0.0	*0%*	***24%***
Seylan Bank - Voting	SEYB.N	***HOLD***	11,046	60.0	70.0	*17%*	5.6x	4.9x	0.5x	0.4x	0.0	*0%*	***17%***
Nations Trust Bank - Voting	NTB.N	***BUY***	21,954	90.0	110.0	*22%*	5.4x	4.6x	0.8x	0.7x	3.0	*3%*	***26%***
Banking Sector Universe						30%						2%	32%
Non-Voting Shares													
Commercial Bank - Non-Voting	COMB.X	***BUY***	5,598	86.1	118.0	*37%*	4.3x	3.7x	0.7x	0.6x	4.2	*5%*	***42%***
Hatton National Bank - Non Voting	HNB.X	***BUY***	14,415	148.3	216.0	*46%*	3.6x	3.0x	0.5x	0.5x	10.3	*7%*	***53%***
Seylan Bank - Non-Voting	SEYB.X	***HOLD***	6,770	37.7	40.0	*6%*	3.5x	3.1x	0.3x	0.3x	0.0	*0%*	***6%***
Nations Trust Bank - Non-Voting	NTB.X	***BUY***	3,201	80.0	100.0	*25%*	4.8x	4.1x	0.7x	0.6x	3.0	*4%*	***29%***

BASEL III and IFRS 9 to moderate credit growth at 14%

We expect private sector credit growth to be at modest level of 14% for 2019E and 2020E primarily due to requirements related to BASEL III and IFRS 9. Credit growth in 2019E is likely to be highly biased towards banks with strong Capital Adequacy Ratios. Tight monetary conditions and rising NPLs are also having a knock-on effect on the implementation of IFRS 9 depleting the existing capital base. Amidst capital requirements in state backs and selected small to mid-sized banks, we estimate that the sector is required raise LKR 24Bn of equity capital to achieve a credit growth of 14%. With increased Tier 1 and 2 capital requirements for all banks and a further increase in capital requirements for banks with over LKR 500Bn assets (identified as systematically important banks), is limiting capacity for banks to grow at a faster pace despite most banks having already raised capital in 2017 and 2018.

Digitalization & Fintech – "The Game Changer"

With the prevailing tough market conditions, growth in profitability would heavily depend on each bank's ability to embrace technology and improve its C/I ratio using technology. Process digitalization and re-engineering, front office automation and innovative fintech solutions to bridge the existing gaps in the market are the key game changers for the banks to compete with peers. The measures successfully implemented and embraced by customers may increase productivity and efficiency of the bank and improve ROEs.

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Debt Repayment Levy dims sector performance

The newly passed debt repayment levy was implemented on 1st Oct 2018 for a period of 3 years, further diminishing the prospects for the sector. The debt repayment levy amounts to 7% and is charged similar to the Financial VAT with minor changes.

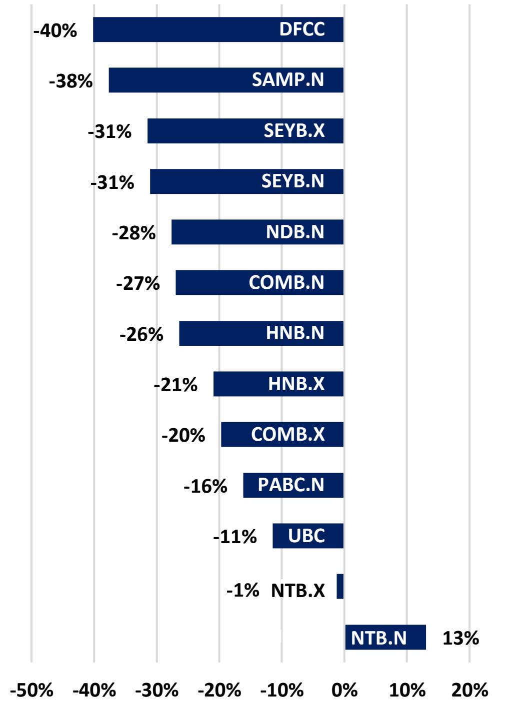
Banking Sector Recommendation on HOLD;

We expect our Banking Sector Universe (6 listed banks) earnings to grow by 15% for 2019E. The overall sector is likely to have a potential market return of 32% considering the total expected return of the voting shares including dividends amidst the depressed market prices. However, few banks are likely to require raising additional capital in spite of the challenging environment of the capital market. On the back of the challenging capital markets environment and the challenging operating environment for banks, we downgrade Banking Sector to **HOLD**

Individual Stock Recommendation is highly biased towards Banks with Strong Capital Adequacy Ratios and high ROEs

Considering the risks in the sector of 1) higher capital adequacy ratios, 2) rising NPLs amidst weak economic conditions and 3) capital erosion with IFRS 9 implementation, existing capital base would be key for the individual banks and its ability and pace to grow their asset base. We recommend banks with strong capital base to withstand the risks in the sector and growth at reasonable pace. In growing earnings with the challenging environment, we believe the driving force behind the above average growth would be driven by the healthy improvement in the bank's Cost to Income ratio boosting ROEs which would further strengthen the bank's capital base to grow in future years. Thereby, we recommend COMB and HNB as are our top picks in the banking sector.

Figure 2: 12 Month Price Change (upto 19th Mar)



Source: CSE

Banking Stocks Recommendation Summary

Commercial Bank Voting (Target Price: 147.0, Total Return: +52%): BUY

Commercial Bank, the market leader in listed space in terms of assets and market cap, captures a target price of LKR 147.0 with an earnings CAGR of c.15.2% over 2019E-21E. COMB's loan book is expected to grow by a CAGR c.15.7% over 2019E-21E to reach 1.3Tn by 2021E supported by its high ended corporate customers with strong asset quality in Sri Lanka and Bangladesh. COMB's island wide branch network provides a competitive advantage to strengthen NIMs. We expect COMB share to register a total return of 52% with 48% capital gain and dividend yield of 4% over 1-year period. **MAINTAIN BUY**

Hatton National Bank (Target Price: LKR 270, Total Return: +60%): BUY

HNB maintains cost leadership within the sector with a C/I ratio of 36.4% on the back of lean initiatives enhancing our internal processes. With the early transition to BASEL III requirements, HNB is above the minimum Tier 1 and total capital ratios recording the latest as at Dec 2018 at 12.80% and 15.22% respectively. Thereby, improving liquidity and capital adequacy within the bank entails growth while many players in the sector may take more stringent and conservative measures. The bank is the leading retail bank with an asset base of LKR 1,149Bn while holding the largest leasing portfolio amongst private commercial banks enabling the bank to grow its loan book at a CAGR of 15% for the period 2019-21E. First Capital Research expects a total return of 60% with a capital gain of 54% and a dividend yield of 6%. The counter captures a target price of LKR 270.0 for 2019E with an earnings CAGR of 22% over 2019-21E. **BUY**

Sampath Bank (Target Price: LKR 210, Total Return: +12%): HOLD

SAMP, 3rd largest privately-owned bank, is shifting its focus to corporate lending from SME and retail, considering the higher growth trajectory experienced in the past with a view to improve the portfolio quality. Its earnings stagnated at LKR 12.6Bn (-1%YoY) in 2018 while growing by a modest CAGR of 15% over 2016-18 signalling the moderation of the bank's growth amidst challenging environment coupled with the sizeable asset base. Recently announced Rights Issue proposes to raise LKR 12.1Bn further cementing the change in funding and lending strategies while significantly diluting the shareholding with ordinary shares increasing by 32% with funds being raised at a 58% discount to its book value. An expected moderate credit growth of 14% coupled with continuous investments into digitalisation and fintech are likely to support a modest growth in earnings, at a CAGR of +15% over 2019-21E while diluted TP for SAMP for 2019E is estimated to be LKR 210.0, providing an annualized return of 15%. **HOLD**

National Development Bank (Target Price: LKR 120, Total Return: +12%): HOLD

NDB, a mid-sized bank, shifts focus towards Retail and SME segment, but growth may trim with capital constraints as the bank approaches DSIB status during 2019E. The Bank which was incorporated as a development bank had its strong hold in project financing with diversifications stepping in over the last decade. In 2018, NDB recorded a loan book growth of 26%YoY well above its industry average of ~20% amidst the targeted emphasis in Retail and SME verticals. Nevertheless, we estimate a moderation in the loan portfolio to a CAGR of 9% for 2019E-21E substantially below the expected industry average growth of 13%, due to the capital constraints stemming from its failed Rights Issue. As the bank considers strategies to address its capital constraints on its path to DSIB status, we recommend a HOLD on a conservative note with a fair value of LKR 120.0, despite NDB's growth potential in the mid to long term. Our conservative recommendation on NDB would be reviewed if capital raising efforts are successful. **HOLD**

Seylan Bank (Target Price: LKR 70, Total Return: +14%): HOLD

With a total asset base of LKR 470Bn as of 2018, SEYB is at the verge of moving into D-SIB category in 2019E which is expected to increase the Tier I and Total capital requirement to 10% and 14%. We believe that this would result in restriction on credit disbursements until SEYB comply with BASEL III thus impacting the core business of the bank while IFRS 9 results in higher impairment provisioning as well as deteriorating the existing capital base over the next 3 years to 2021E. With earnings forecast of LKR 3.6Bn in 2019E (incorporating the effect of DRL of appr. LKR 924Mn) coupled with a loan portfolio growth of 12% and a TP of LKR 70.0, SEYB provides a total return of 14%. **HOLD**

National Trust Bank (Target Price: LKR 110, Total Return: +25%): BUY

Nations Trust Bank, one of the fastest growing commercial bank, captures a target price of LKR 110.0 with an earnings CAGR of c.14% over 2019-21E. NTB's credit card portfolio which achieved the No.1 status in lending volumes is expected drive fees & commission income with a CAGR of c.17% over 2019E-21E. NTB's loan book is expected to grow by a of CAGR c.18% over 2019-21E to reach LKR 357Bn by 2021E supported by its focused niche SME clientele. We expect NTB share to register a total return of 25% with 23% capital gain and dividend yield of 2% over 1-year period. **BUY**

Figure 3: Peer Comparison – Global

Company	Country	Mkt Cap (USD)	P/E	P/B	ROE*	ROA*	Div Yield	Total Assets (USD)
Malayan Banking BHD	Malaysia	25.45Bn	13.1	1.4	10.7%	1.0%	6.0%	190.84Bn
Hong Leong Financial Group	Malaysia	5.40Bn	11.4	1.2	11.1%	0.9%	2.1%	56.85Bn
Bank Rakyat Indo Agroniaga	Indonesia	508.89Mn	30.8	1.7	5.5%	1.2%	0.9%	1.40Bn
Bpd Jawa Timur Tbk Pt	Indonesia	760.26Mn	9.0	1.3	15.3%	2.1%	6.1%	4.25Bn
Asia United Bank	Philipines	538.56Mn	9.8	1.1	11.6%	1.5%	2.7%	3.92Bn
East West Banking Corp	Philipines	529.30Mn	5.9	0.5	11.6%	1.4%	0.0%	6.25Bn
Vietnam International JSB	Vietnam	580.10Mn	12.6	1.6	12.8%	1.0%	2.0%	5.42Bn
Vietnam Export-Import Commer	Vietnam	858.85Mn	14.7	1.3	9.3%	1.0%	2.9%	6.30Bn

Source: Bloomberg

Figure 4: Peer Comparison – Asia Pacific (Emerging) Countries

Company	Country	Mkt Cap (USD)	P/E	P/B	ROE*	ROA*	Div Yield	Total Assets (USD)
Federal Bank Ltd	India	2.48Bn	18.1	1.4	8.8%	0.7%	1.1%	21.37Bn
Indusind Bank Ltd	India	12.68Bn	24.9	3.8	16.2%	1.8%	0.5%	34.02Bn
Bank Al Habib Ltd	Pakistan	632.24Mn	10.7	1.8	17.6%	0.9%	3.8%	7.56Bn
United Bank Ltd	Pakistan	1.29Bn	10.8	1.1	11.3%	0.8%	8.2%	15.94Bn
Brac Bank Ltd	Bangladesh	1.06 Bn	15.6	2.2	18.6%	1.7%	0.0%	3.96Bn
Islami Bank Bangladesh Ltd	Bangladesh	535.83Mn	9.1	0.9	9.7%	0.6%	3.6%	11.38Bn

Source: Bloomberg

Figure 5: Peer Comparison – Sri Lanka

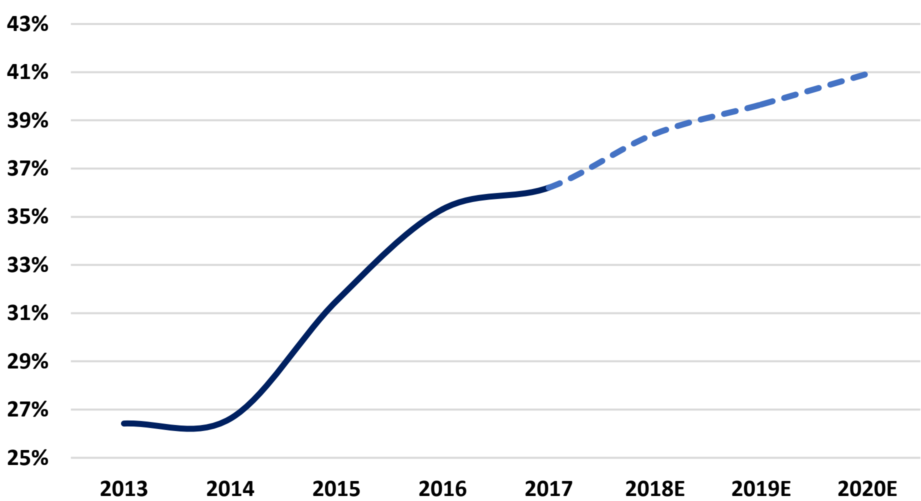
Company	Country	Mkt Cap (USD)	P/E	P/B	ROE*	ROA*	Div Yield	Total Assets (USD)
Commercial Bank	Sri Lanka	587.69Mn	7.8	0.9	16.2%	1.5%	5.8%	6.9Bn
Hatton National Bank	Sri Lanka	447.6Mn	5.9	0.6	14.6%	1.7%	4.1%	5.9Bn
Sampath Bank	Sri Lanka	349Mn	4.6	0.7	17.5%	1.5%	7.6%	5.1Bn
National Development Bank	Sri Lanka	119Mn	4.5	0.6	13.8%	1.0%	8.7%	2.5Bn
Nations Trust Bank	Sri Lanka	115.44Mn	5.5	0.8	15.7%	1.2%	2.4%	1.8Bn
Seylan Bank	Sri Lanka	75.56Mn	3.0	0.4	12.4%	1.0%	4.7%	2.4Bn

Source: Bloomberg

1.0 BASEL III and IFRS 9 to moderate credit growth at 14%

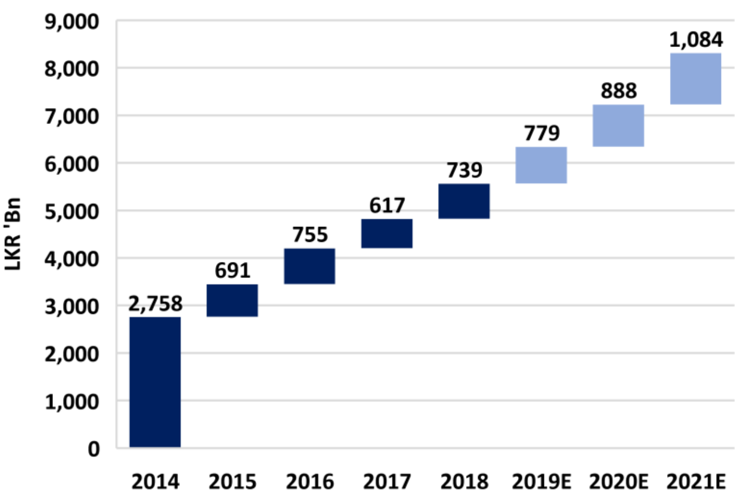
Credit growth at 14% broadly delivered by capital rich banks: The overall credit growth in the banking sector is expected to reach a modest 14%, to be hampered, as the implementation of BASEL III, requires a substantial increase in capital base, while the adoption of IFRS 9, is likely to impair the capital. For the banking sector to maintain a moderate credit growth of 14% in 2019E, the sector is required to increase the capital base by appr. LKR 24Bn to satisfy the BASEL III capital adequacy requirement. Additionally, the adoption of IFRS 9 is expected to deteriorate the total capital by appr. LKR 16Bn over a period of three years commencing from 2018 to 2021 adding pressure on credit growth.

Figure 6: Private Sector Credit as % of GDP



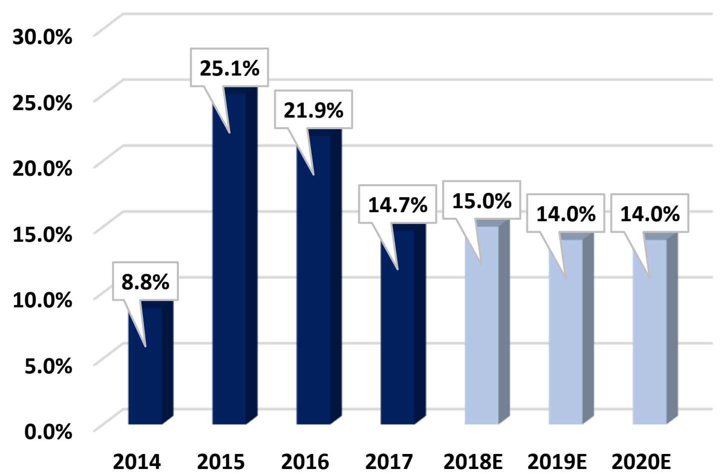
Source: CBSL & First Capital Research Estimates

Figure 7: Private Sector Credit Annual Increase

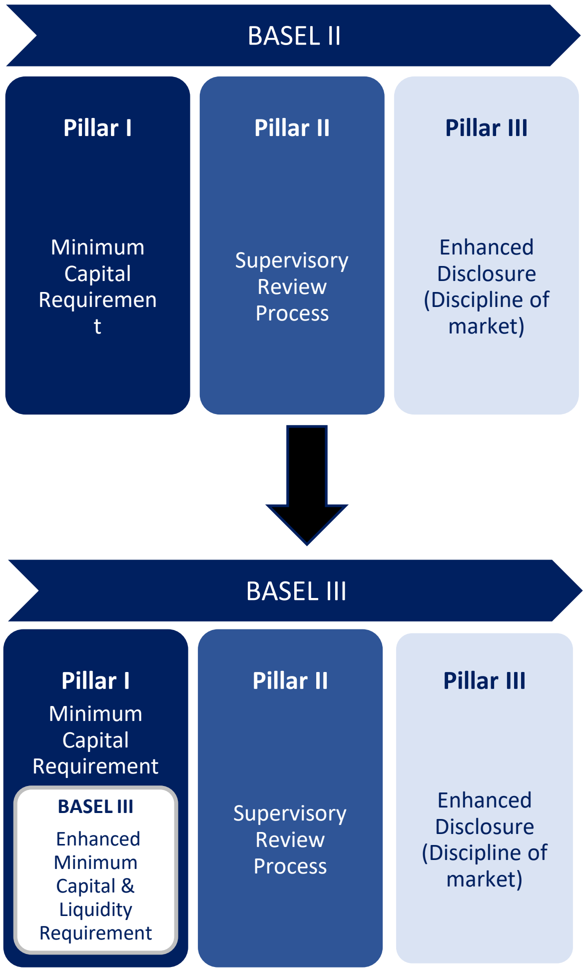


Source: CBSL & First Capital Research Estimates

Figure 8: Private Sector Credit Growth



Source: CBSL & First Capital Research Estimates



1.1 Banks credit growth is to be capped with the implementation of BASEL III requiring substantial increase in capital

Banks require to raise LKR 13Bn of Equity capital to achieve targeted 14% credit growth: First Capital Research expects Sri Lanka's private sector credit growth to slow down to 14% in 2019E and 2020E. The modest growth in private sector credit is primarily led by the heavy capital adequacy requirements under BASEL III. In order to achieve our credit growth of 14%, we expect Banking sector to raise up to LKR 24Bn of additional equity capital during 2019E. BASEL III requires an increased capital requirement ensuring that the banks can withstand losses during market panic by imposing additional supervision and risk management frameworks for the banking sector. The implementation of BASEL III by 1st Jan 2019 has prompted banks to raise their capital base through raising fresh capital or via issuance of BASEL III compliant debt instruments.

State Banks coupled with NDB & SEYB require additional capital to grow loan book at average expected market rate of 14%: BoC's Tier I capital ratio as of 30 Sep 2018 registered at 9.89%, falling marginally below the Tier I minimum capital requirement of 10%. With an asset base of LKR 2.1Tn and a lending portfolio of LKR 1.3Tn, BoC is required to raise their total tier I capital base to match the regulatory requirement of 10% by 01 Jan 2019. During the same period SEYB and NDB records their asset base at LKR 442Bn and LKR 463Bn respectively, marginally below the LKR 500Bn threshold. We expect both SEYB and NDB to move into SIB category with an asset base of LKR 500Bn by early 2019E prompting them to increase their capital bases to satisfy the Tier I and Tier II minimum requirements of 10% and 14% respectively.

BASEL III implemented to improve resilience of Banking System: With the objective of achieving a more resilient banking system in the country, CBSL implemented Basel III minimum capital requirements with effect from 01 Jul 2017 with specified timelines to increase minimum capital ratios to be fully implemented by 01 Jan 2019.

BASEL III built on BASEL II: The Basel III is a response by regulators to perceived weaknesses in the Basel II framework introducing new requirements with respect to regulatory capital for large banks to cushion against cyclical changes on their balance sheets. Basel III is built on Basel II by strengthening the regulation, supervision and risk management of that sector by maintain banks' solvency via imposing capital adequacy requirements which limit the amount of assets that a bank may have by reference to its capital. Locally incorporated LCB's are required to raise their minimal capital base to LKR 20Bn by 31 Dec 2020.

BASEL II Requirements: Basel II Accord is based on three main pillars; minimal capital requirement which plays the most important role along with, Supervisory review process and Enhanced disclosure (Discipline of market) was introduced in 1992, following the substantial losses in the international markets which were attributed to poor risk management practices. As per the regulations the banks were required to maintain a minimum core capital ratio of 5% and total capital ratio of 10% which came into effect on 01 Jan 2008.

Figure 9: Banks with Assets < LKR 500Bn

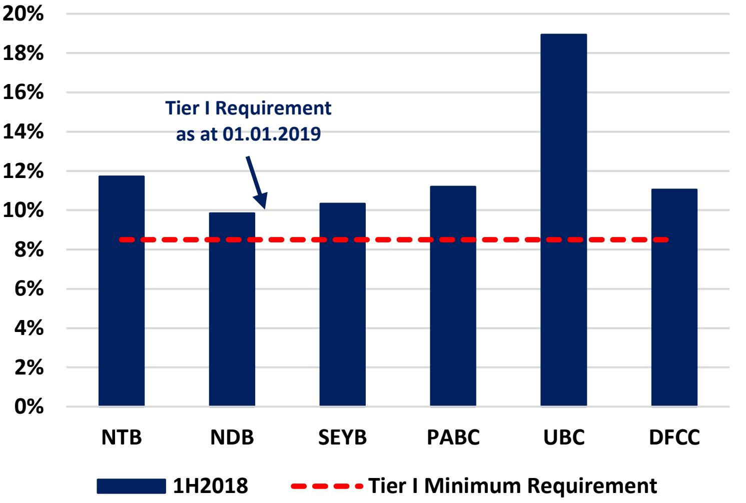
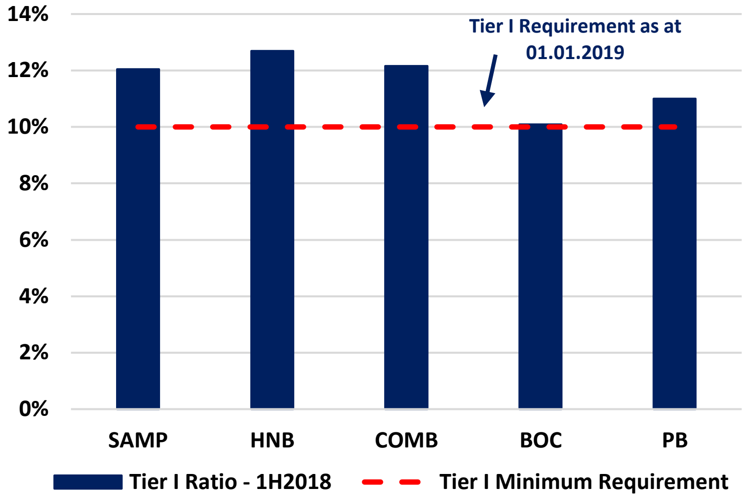


Figure 10: Banks with Assets > LKR 500Bn (Domestic Systematically Important Banks)



	01.01.2017	01.01.2018	01.01.2019
Common Equity Tier I including Capital Conservation Buffer	5.75%	6.375%	7.00%
Total Tier I including Capital Conservation Buffer	7.25%	7.875%	8.50%
Total Capital Ratio including Capital Conservation Buffer	11.25%	11.875%	12.50%

	01.01.2017	01.01.2018	01.01.2019
Common Equity Tier including Capital Conservation Buffer and Capital Surcharge on DSIB	6.25%	7.375%	8.50%
Total Tier I including Capital Conservation Buffer and Capital Surcharge on DSIB	7.75%	8.875%	10.00%
Total Capital Ratio including Capital Conservation Buffer and Capital Surcharge on DSIB	11.75%	12.875%	14.00%

*** DSIB - Domestic Systemically Important Banks*

1.2 IFRS 9 to weaken the capital via Impairment through the Expected loss model limiting credit growth

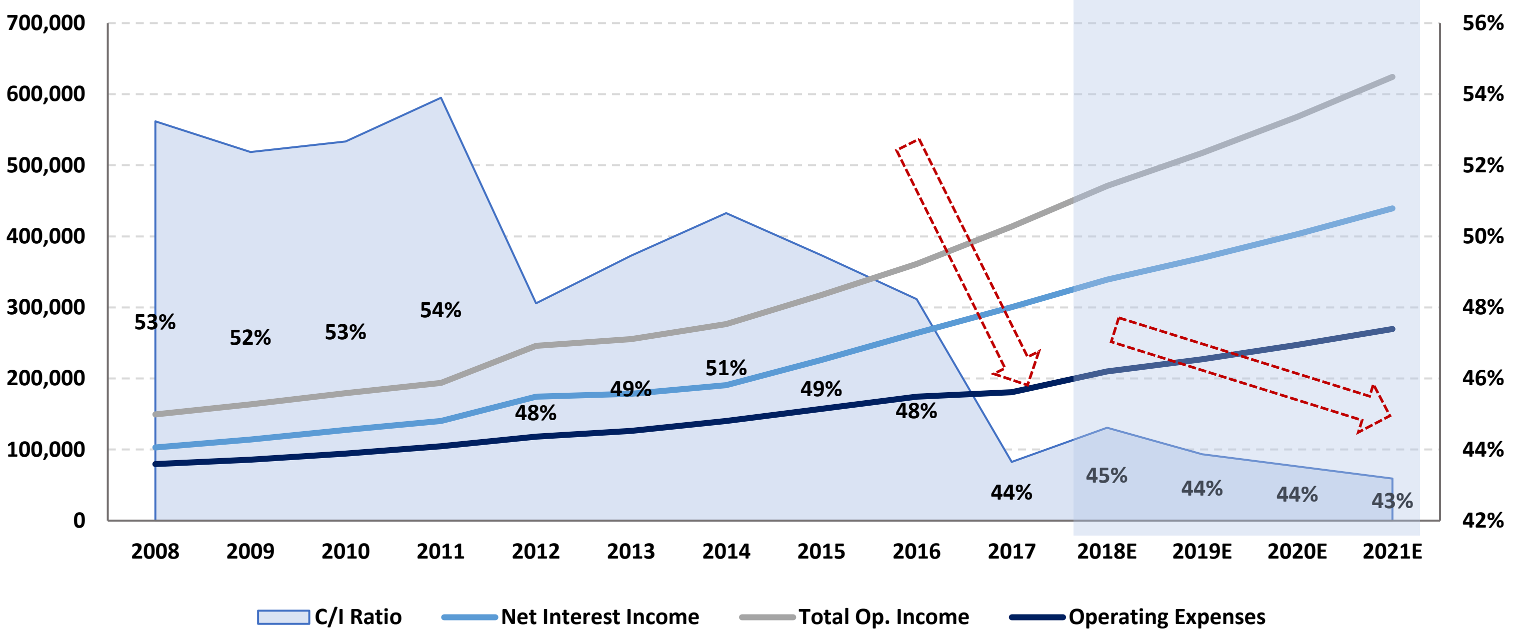
Impairment provisioning to spike by 20-30%: With the implementation of IFRS 9, impairment provisioning for the existing lending portfolio is expected to spike by appr. 20-30% which is expected to impact the total equity of the banking sector. CBSL has permitted the banks to spread the total impairment provision for the existing portfolio over a period of three years commencing from 2018 to 2021. First Capital Research estimate total banking sector equity to reduce by appr. LKR 16Bn per annum for the next three years to 2021. Gross NPA's of the sector was valued at LKR 160.7Bn as at end 2017 thus we expect the impairment provisioning of appr. LKR 48Bn on the existing loan book value to be written off from the books. Reduction in total equity base is expected to result in limiting the total asset growth which in turn would limit the credit disbursements of the sector. Banks are expected to have an impact deriving from impairment as it is expected to reduce equity and in turn impact the regulatory capital as well as the profitability.

IFRS 9 implementation: IFRS 9 which came into effect from 01 Jan 2018 covers three topics namely, classification and measurement, impairment and hedge accounting of the financial instruments. Classification is based on use of the asset and the nature of the cashflows while the impairment methodology which replaced IAS 39 is a shift to expected loss model from previously used incurred loss model under IAS 39.

2.0 Digitalization and Fin tech "The future Game changer"

Cost to income (C/I) to be a critical factor in the future in improving the profitability of banks amidst tough operating conditions*:* We expect C/I ratio to be maintained at 44% over 2019E-21E with pressure on NIMs as competition intensifies in the banking sector. C/I ratio has recorded a major dip over the last 5 years to 44% from 51% in 2014, but tough economic conditions are likely to increase competition resulting in pressure on NIMs. Macroeconomic instability, low credit growth rate and tightening regulations are making it more challenging for banks to sustain profits and growth. Pressure on NIMs may tend to have an adverse impact on C/I ratio. However, banking sector has embraced a trend of process digitalization and front office automation to manage costs while introducing innovative fintech products to enhance customer service and improve customer accessibility. A stronger focus was also noticed in increasing fee-based income amidst the rise in online retail transactions via new fintech solutions. The improvements are likely to stabilize C/I despite higher competition within the sector.

Figure 11: Consistent C/I Ratio during 2018E-2021E despite the decline witnessed during last decade

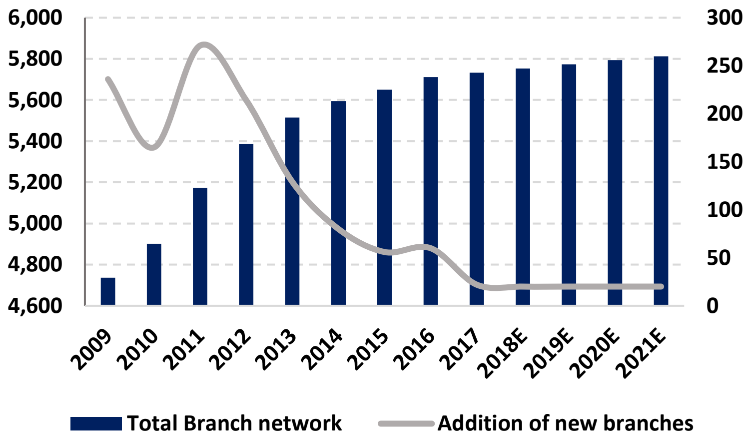


Source: CBSL & First Capital Research Estimates

1.1 Process digitalization and front office automation as an initiative to reduce Operating Expenses

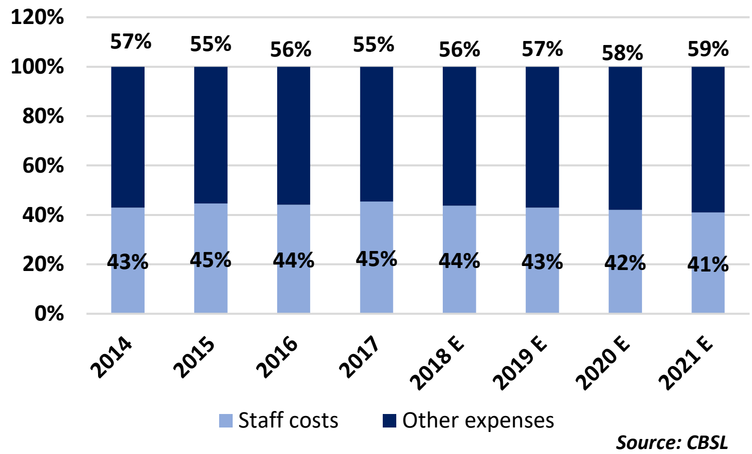
Priority shifts towards digitalization and automation: Selected banks have initiated concentration on digital banking whilst consolidating its physical branch network which has eased the cost to income ratio. With the current C/I ratio being the lowest in the region maintaining it at current low levels is a major challenge. In an environment where NIMS are likely to be under stress, continuous process digitalization and front office automation would be at the forefront managing operating expenses. Process digitalization has taken major traction with credit process centralization, E-documentation initiatives, process simplification and automation initiatives significantly improving efficiency levels across the banking sector. Front office of banks is in the process of being automated with advanced ATMs now multi-tasking by handling bulk of the front office services. We expect the process of front office automation to be implemented at an accelerated during the 2019E-21E period.

Figure 12: Stagnant banking outlets additions during last couple



Source: CBSL

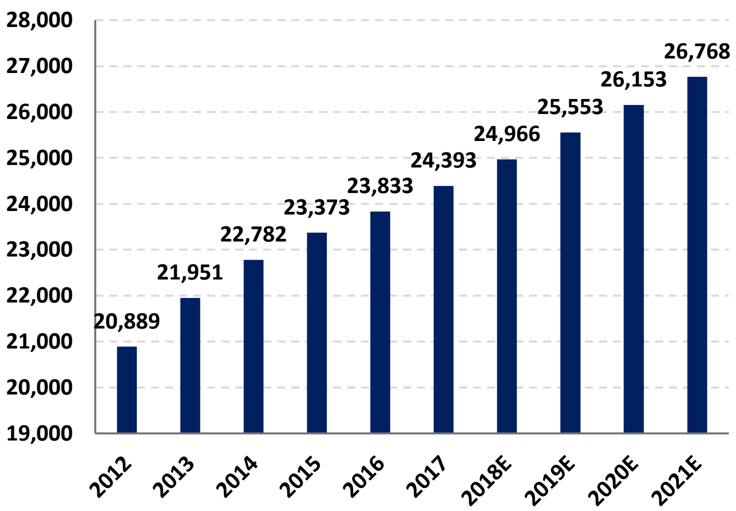
Figure 13: Gradual decline in the Staff cost % in the total Op.



Source: CBSL

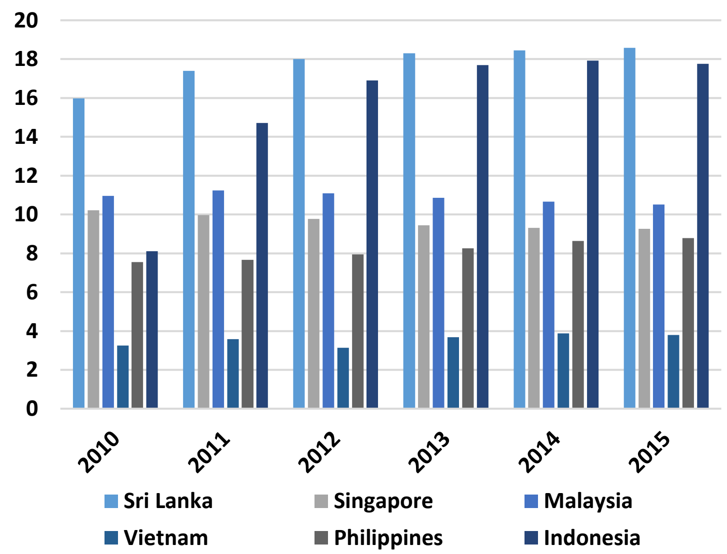
Recruitment and branch expansion freeze with digitalization and automation: Banks were seen freezing both, recruitments and branch expansions which is reflected by only 2%-3% CAGR in staff recruitments and branch expansions. Further with certain positions within the banks falling redundant amidst the digitalization and automation process, all banks have taken initiatives reorganizing banks around the needs of the customers and to make the customer service units more marketing oriented.

Figure 14: Banks were seen limiting their staff recruitments while total employees were growing only at a CAGR of 2% from 2012-2017



Source: Company Reports & First Capital Research Estimates

Figure 15: SL's branch network has deeper penetration over peers

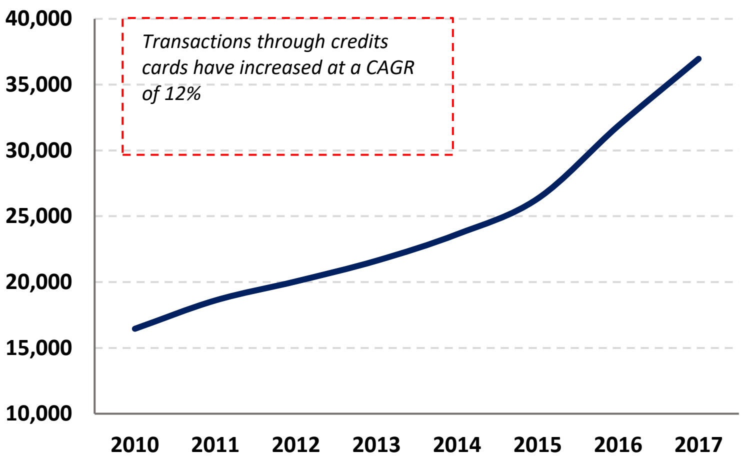


Source: World Bank

2.2 Technology and Fintech driving fee-based income in the future for banks

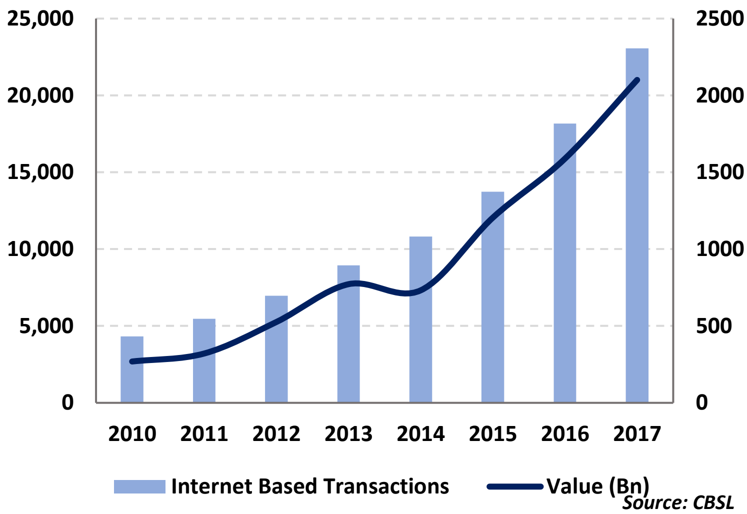
Reflecting Sri Lankan bank's initiatives towards IT investment, transactions through credit cards have increased at a CAGR of 12% from 2010 to 2017 while internet-based transactions volumes have increased at a CAGR of 27%. We believe increased virtual transactions to improve mainly Banks's non-interest income in the future while reducing the heavy dependence on the interest income as witnessed in the traditional banking system.

Figure 16: Since 2010 transactions through credit cards have increased at a CAGR of 12%



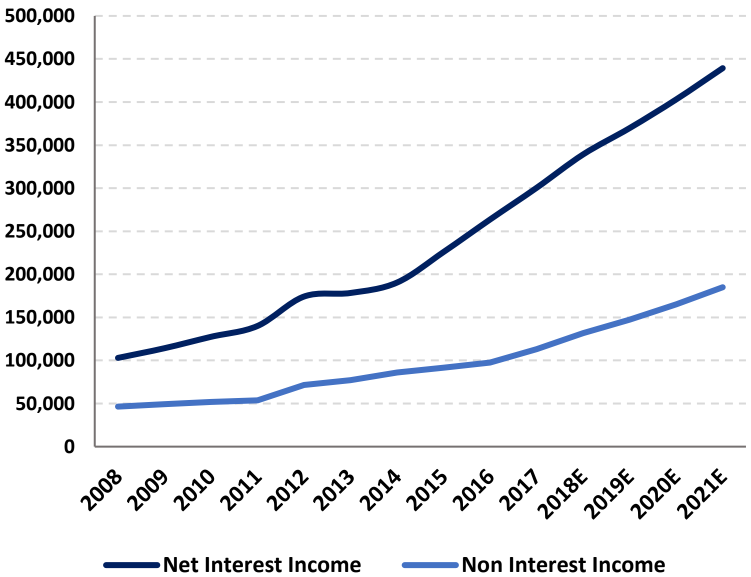
Source: CBSL

Figure 17: Internet Based transactions volume and value have increased at a CAGR 27% and 34% respectively since 2010



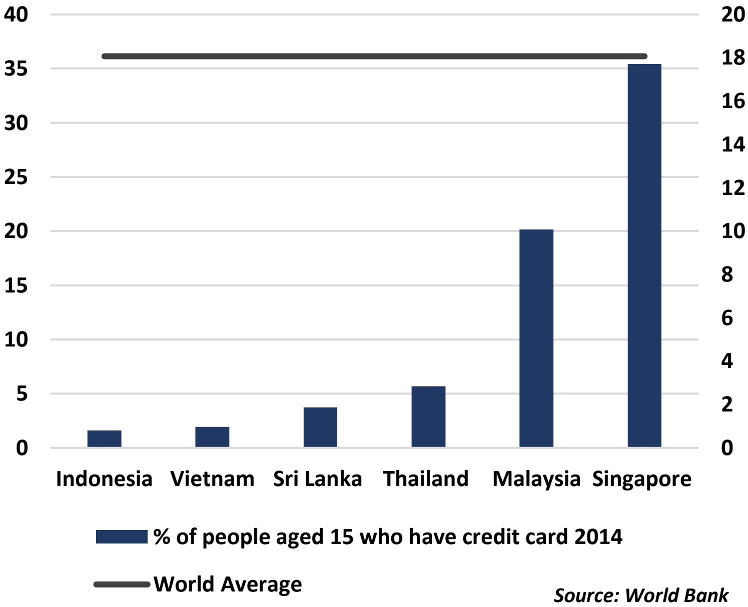
Source: CBSL

Figure 18: Income generated from Non-Interest income increased at a CAGR of 10% in line with banks' digital investments 2008 to 2017



Source: CBSL & First Capital Research Estimates

Figure 19: SL has relatively lower credit card penetration over its peers

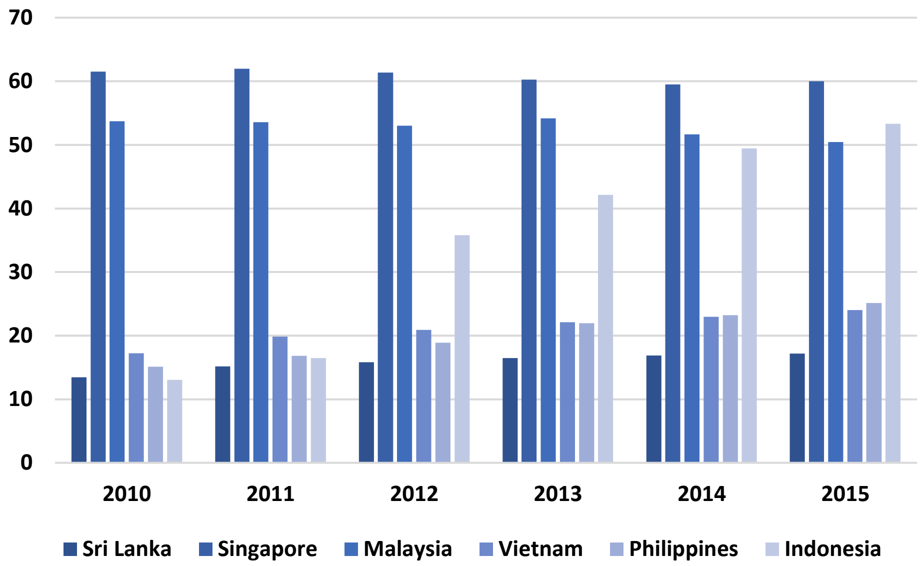


Source: World Bank

2.3 Yet Sri Lanka has still untapped sphere relative to other peers in the virtual pace:

ATM network continues to be under penetrated: Despite Sri Lankan commercial bank's heavy investment towards digitalization, Sri Lanka remains comparatively underpenetrated in terms of the ATM network while has deeper penetration in terms of the branch network. This reflects that peer countries in the region has a deeper reach to people through virtual banking over the traditional banking and thus Sri Lanka has more room to expand.

Figure 20: SL has relatively lower ATM penetration over its peers



Source: World Bank

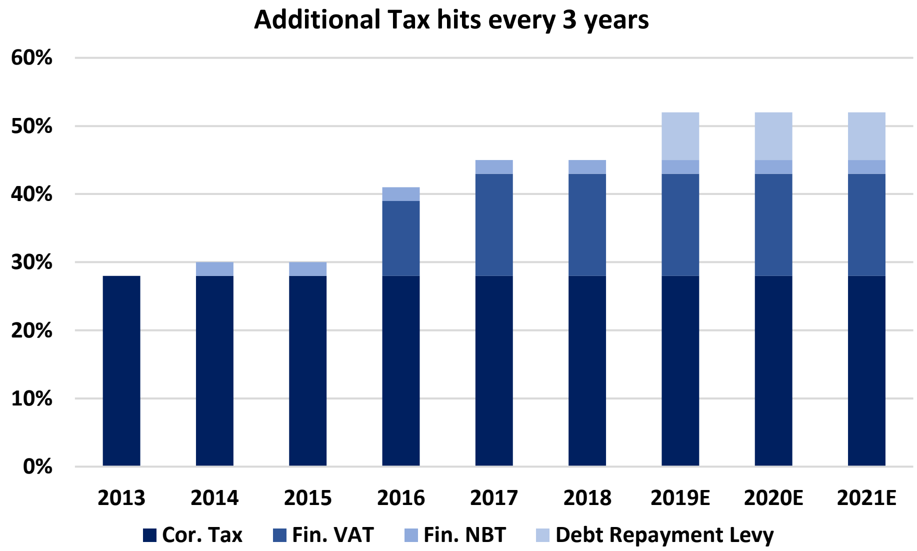
Global trend towards Digital Banking: Across the globe, the retail banking industry is fast embracing digital banking experience. Investments in mobile technologies have increased meaningfully while Asia Pacific leading the world in the rapid adoption of digital banking due to consumers' constantly evolving demands. In response, banks are deploying a mix of strategies to stay ahead in the game, including higher technology spending on channel improvement branches, ATMs, call centres, and digital banking (2019 Banking and Capital Markets Outlook- Reimagining transformation by Deloitte).

Growth in internet and mobile penetration increases opportunities in Sri Lanka: The global technology trends are gradually gaining prevalence in Asia Pacific countries. Accordingly, the growth of the internet, mobile, and communication technology suggest that Sri Lanka has enormous opportunities for digitalization of its processes. We expect Sri Lankan LCBs to reduce the operating expenses while automating the process and while at the same time improve operating income through fee and commission income by through virtual banking methods thus reducing the heavy dependence on traditional banking methods.

3.0 Debt Repayment Levy dims sector performance

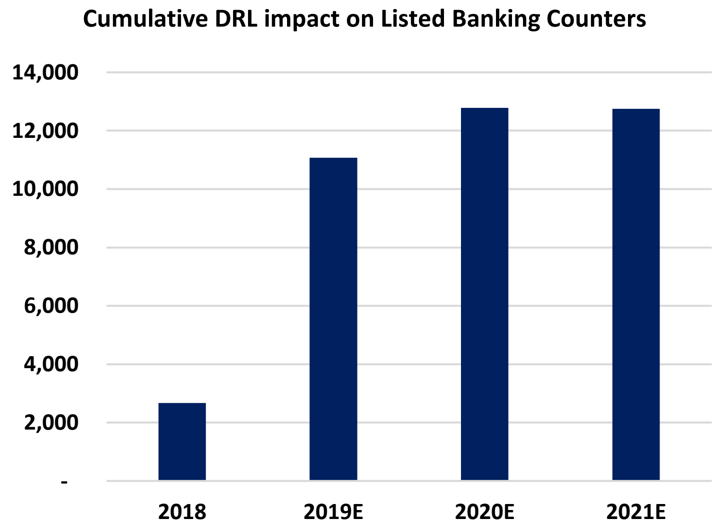
Debt Repayment Levy of 7%: We believe Debt Repayment Levy (DRL) effectively wipes out a minimum of 5% from the banking sector profitability. DRL is a new levy which was effective from 1st Oct 2018, impacting the banking sector profitability. DRL is charged at 7% calculated similar to the Financial VAT excluding the adjustments. DRL is expected to stay for a period of 3 years, thereby First Capital Research has charged DRL for all banking sector counters for the full years 2019E, 2020E and 2021E.

Figure 21: Taxation on Banking Counters



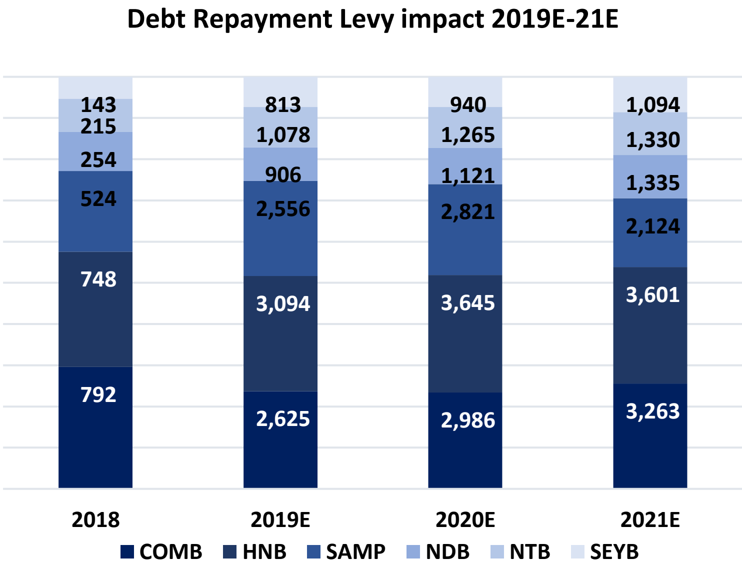
Source: Company Report & First Capital Research Estimates

Figure 22: Total DRL impact



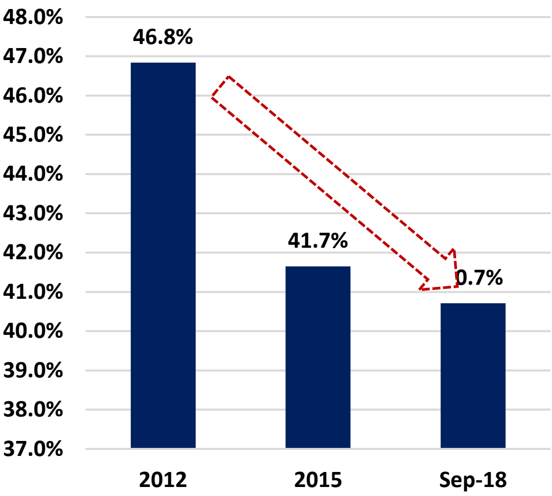
Source: First Capital Research Estimates

Figure 23: DRL individual bank impact



Source: First Capital Research Estimates

Figure 24: Market Share of State-Owned Banks



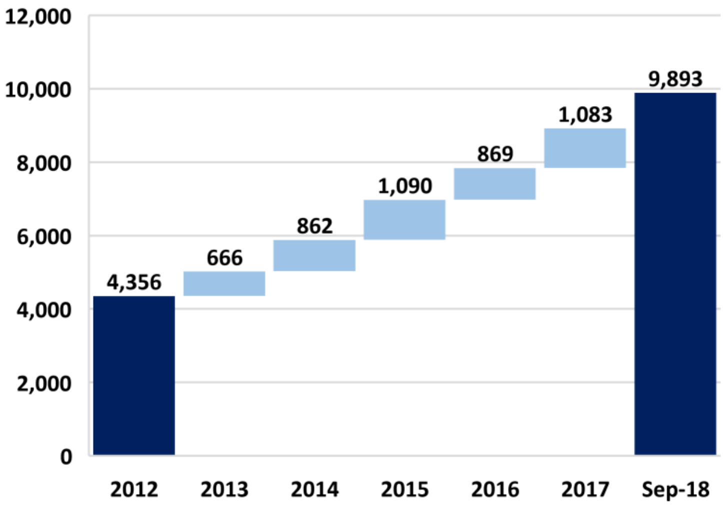
Source: Company Reports

4.0 Banking Sector 2016-18 outlook remained steady despite the challenging environment

4.1 State Banks continue to lose market share

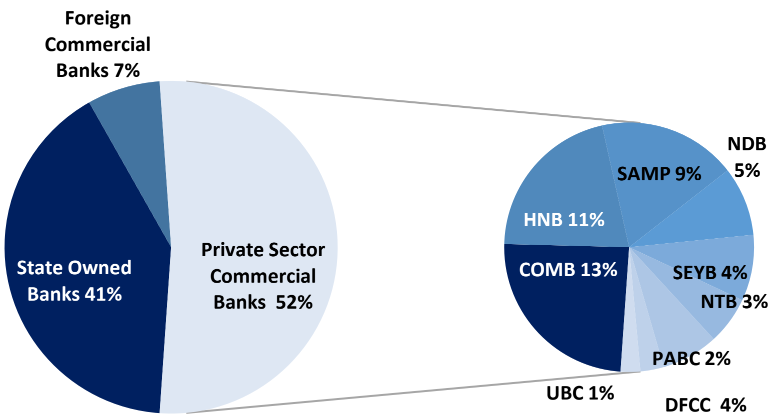
Local Private Commercial Bank market share at a dominant 52%: Sri Lanka's Commercial Banking sector consist of 13 local banks and 12 foreign banks which account for LKR 9.9Tn asset base as at Sep 2018. From the overall banking sector, private sector domestic commercial banks hold a dominant 52% market share while 2 giant state banks hold 41%. The banking sector continued to support economic growth and development by the enhanced banking services and the expansion of the banking network, thereby, promoting financial inclusion in the country. Further the no. of banking outlets (excluding student savings units) and Automated Teller Machines (ATMs) were increased to 5751 and 4,496 respectively as at 30th Sep 2018.

Figure 25: Banking Sector Assets



Source: CBSL

Figure 26: Banking Asset Segmentation



Source: Company Reports

4.2 Monetary tightening decelerates growth & profits, partly affecting 2016

4.2.1 Steady growth despite the monetary tightening in 2016

Improved lending in 2H2016 to uphold credit growth: Despite the deceleration witnessed in credit growth in the first quarter of 2016, the improvement in other lending activities in the 2H2016 resulted in a rebound in the expansion of credit. Loans and advances were extended to all major sectors of the economy. Rupee loans saw a modest 91.8% growth while the pawning portfolio contracted and the leasing portfolio marginally expanded by 3.3% in 2016, compared to 52.9% in 2015 with the implementation of a high loan to value ratio for the purchase of vehicles.

NIMs expanded with the rise in interest rates: Attributing the upward movement witnessed in the interest rates, NIMs of the banking sector widened thus favourably affecting earnings. Policy interest rates and SRR increased by 100bps and 150bps in 2016. Deposits being the main source of funding accounted for 70% of the total liabilities of the sector contributing to improved NIMs as deposits geta re-priced at a slower pace than lending. Further, increase in inflation also backed the uptick in interest rates.

Lowest NPAs in two Decades: The NPL ratio declined further to 2.6% in 2016 from 3.2% in 2015 due to a decline in NPLs by an absolute amount of LKR 10.6Bn. Total provisions increased by LKR 6.9Bn mainly with an increase in specific provisions with NPLs reporting a specific provision coverage ratio reaching 52.1%. Well diversified credit portfolio spread across certain sectors such as construction (17.8%), traders (14.0%), manufacturing (10.7%), and agriculture and fishing (9.0%), which accounted for more than 50% of the credit portfolio.

4.2.2 Credit slows down while NPLs rise amidst continued monetary tightening measures in 2017

Banking sector recorded a dip in earnings: During the 2017 period banking sector registered a growth of +20.0%YoY to reach LKR 126.0Bn, from LKR 105.0Bn mainly contributed by the growth in non-interest income of +16.0%YoY.

Effects of monetary tightening in 2016 visible in 2017: Increase in SRR to 7.5% in 2016 absorbed the excess liquidity in the market impacting private sector credit growth in 2017. During 2017 private sector credit grew by a modest +14.6%YoY growth much slower compared to 21.9%YoY in 2016. Banking sector saw its lending growing at +16.0%YoY during 2017 compared to 18.0%YoY registered in 2016. Imposition of LTV restrictions further affected the credit disbursement of the sector.

NIMs improves further amidst continued upward moving rates: During the 2017 larger banks saw their NIMs continue to improve amidst the volatile uptrend witnessed in interest rate regime. Significant fluctuations in the treasury bills and bonds market were observed during the year assisting the banking sector to make trading gains during the period.

Jump in NPAs amidst adverse economic and weather conditions: Reflecting the impact of adverse weather conditions prevailed during 1H2017 coupled with the upward movement in interest rates and inflation resulted in an increase in NPAs portfolio of the Banking sector.

4.2.3 Stable Profiles despite the Challenging Environment during 2018

Moderate Credit Growth Likely: A moderation in YoY banking sector credit growth was observed from late 2017 in response to the monetary and macro prudential policy measures introduced by the Central Bank. Banking sector credit grew by 10.5% during 9M2018 reaching LKR 7.1Tn. Credit growth was driven by rupee loans, which recorded a growth of 9.5% during this period accounting for 74% increase. Credit growth which decelerated to 14.7% YoY at the end of 6M2018 from 16.1% in 2017 displayed a slight recovery by reaching 15.7% at end of 9M2018. Growth in loans and advances was driven by increased lending by banks to the private sector and state-owned enterprises, while lending to the Central Government decreased during the period.

Interest rates show upward bias: Overall NIMs in the banking sector increased to 3.6% in 9M2018 compared to 3.5% in 2017. There was an upward trend witnessed in the interest rates throughout the period accompanied by the timely re-pricing strategies implemented by banks enabled banks to achieve the said growth in NIMs. It was observed that the larger portion of the NIMs is NII and we expect this trend to continue in the mid to long term.

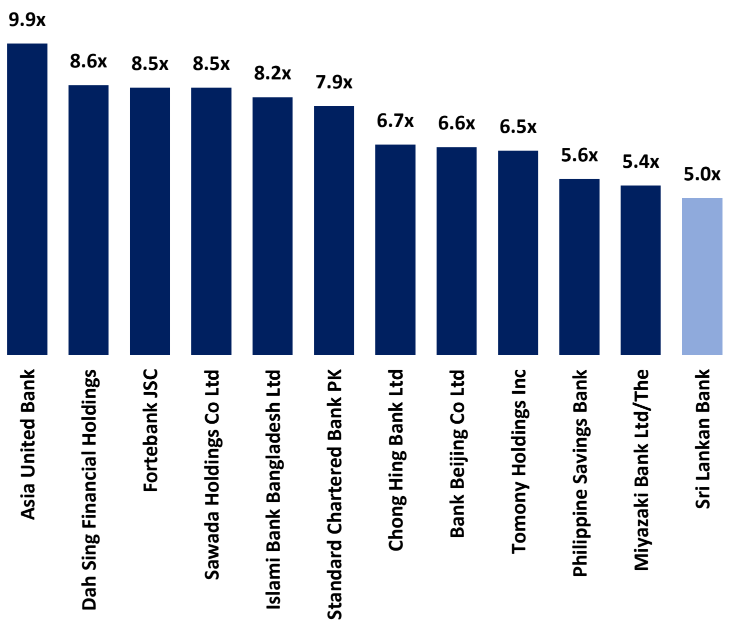
5.0 Banking Sector on HOLD

5.1 Capital Constraints and new tax provides weaker returns

Capital Rich Banks with Digitalization edge may outperform sector: Banking Sector has been under stress, with most banks in search of capital due to the implementation of BASEL III capital adequacy targets and the IFRS 9 requirements. Sector growth was further hampered by the newly implemented debt repayment levy. Sector has a heavy focus on cost management via digitization and automation. New innovative digital platforms have been launched by selected banks which have taken off amidst the smart phone adoption in the country and the accelerated move towards mobile payment platforms. We expect the capital rich banks to capture market share with the support of new digital platforms and automation measures while the overall credit is expected to grow at a moderate pace.

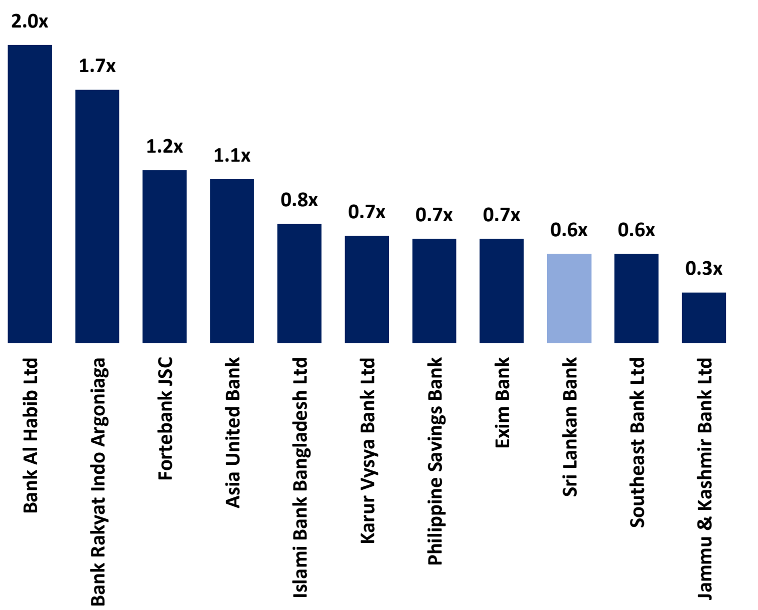
Stock	Stock Code	Recommendation	Mkt. Cap (LKR mn)	Price	Target Price	Upside (%)	PER (x) 2019E	PER (x) 2020E	PBV (x) 2019E	PBV (x) 2020E	DPS in 2019E	DY 2019E	Total Return
Commercial Bank - Voting	COMB.N	***BUY***	93,654	99.0	147.0	*48%*	4.9x	4.3x	0.8x	0.7x	4.2	*4%*	***52%***
Hatton National Bank - Voting	HNB.N	***BUY***	69,402	175.0	270.0	*54%*	4.3x	3.5x	0.6x	0.6x	10.3	*6%*	***60%***
Sampath Bank	SAMP.N	***HOLD***	52,529	187.0	210.0	*12%*	4.5x	4.2x	0.6x	0.5x	0.0	*0%*	***12%***
National Development Bank	NDB.N	***HOLD***	21,515	97.0	120.0	*24%*	3.7x	3.4x	0.4x	0.4x	0.0	*0%*	***24%***
Seylan Bank - Voting	SEYB.N	***HOLD***	11,046	60.0	70.0	*17%*	5.6x	4.9x	0.5x	0.4x	0.0	*0%*	***17%***
Nations Trust Bank - Voting	NTB.N	***BUY***	21,954	90.0	110.0	*22%*	5.4x	4.6x	0.8x	0.7x	3.0	*3%*	***26%***
Banking Sector Universe						30%						2%	32%
Non-Voting Shares													
Commercial Bank - Non-Voting	COMB.X	***BUY***	5,598	86.1	118.0	*37%*	4.3x	3.7x	0.7x	0.6x	4.2	*5%*	***42%***
Hatton National Bank - Non Voting	HNB.X	***BUY***	14,415	148.3	216.0	*46%*	3.6x	3.0x	0.5x	0.5x	10.3	*7%*	***53%***
Seylan Bank - Non-Voting	SEYB.X	***HOLD***	6,770	37.7	40.0	*6%*	3.5x	3.1x	0.3x	0.3x	0.0	*0%*	***6%***
Nations Trust Bank - Non-Voting	NTB.X	***BUY***	3,201	80.0	100.0	*25%*	4.8x	4.1x	0.7x	0.6x	3.0	*4%*	***29%***

Figure 27: PER Comparison with Asia Pacific Emerging Banks



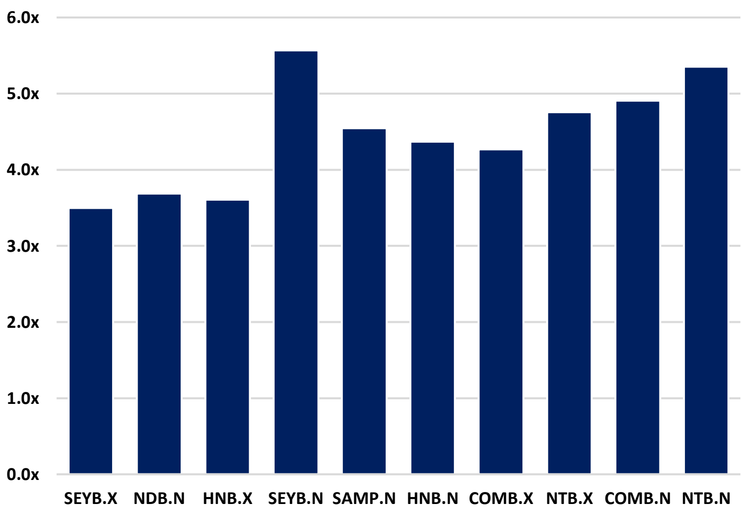
Source: Bloomberg

Figure 28: PBV Comparison with Asia Pacific Emerging Banks



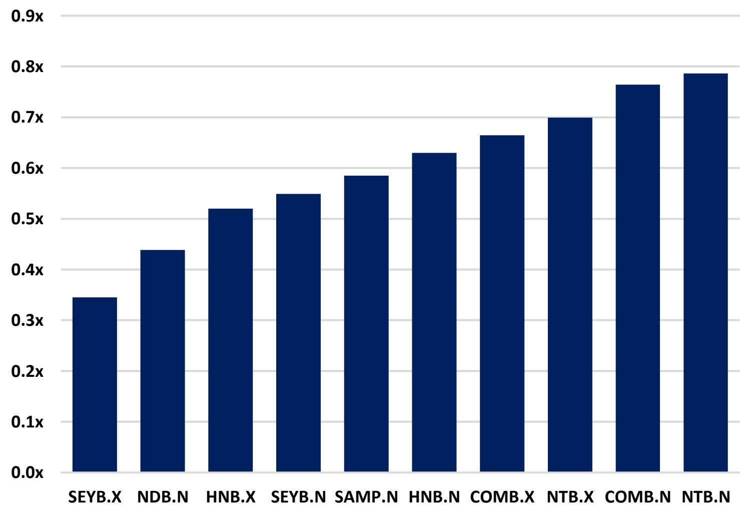
Source: Bloomberg

Figure 29: Forward PER of First Capital Research Coverage



Source: First Capital Research Estimates

Figure 30: Forward PBV of First Capital Research Coverage



Source: First Capital Research Estimates

Return	
Target Price	147.0
Current Price	99.0
Capital Gain (LKR)	48.0
Dividends upto 31.12.2019 (LKR)	4.2
Capital Gain %	48%
Dividend Yield %	4%
Total Return %	52%
Annualized Return %	72%

Commercial Bank Voting (Target Price: 152.0, Total Return: +52%): Commercial Bank, the market leader in listed space in terms of assets and market cap, captures a target price of LKR 147.0 with an earnings CAGR of c.15.2% over 2019E-21E. COMB's loan book is expected to grow by a CAGR c.15.7% over 2019E-21E to reach 1.3Tn by 2021E supported by its high ended corporate customers with strong asset quality in Sri Lanka and Bangladesh. COMB's island wide branch network provides a competitive advantage to strengthen NIMs. We expect COMB share to register a total return of 52% with 48% capital gain and dividend yield of 4% over 1-year period. **MAINTAIN BUY**

P/E 31 December	*2015*	*2016*	*2017*	*2018*	*2019E*	*2020E*	*2021E*
Estimates (LKR 'Mn)							
Net Interest Income	30,567	33,128	39,567	45,618	52,969	62,277	69,559
Total Operating Income	41,534	44,398	49,537	64,864	69,203	81,653	91,701
Net Profit	**11,855**	**14,511**	**16,606**	**17,735**	**20,535**	**23,584**	**27,115**
Adjusted EPS (LKR)	11.7	14.3	16.3	17.4	20.2	23.2	26.6
YoY Growth (%)	5%	22%	14%	7%	16%	15%	15%
Valuations							
PER (x)	***8.5x***	***6.9x***	***6.1x***	***5.7x***	***4.9x***	***4.3x***	***3.7x***
PBV (x)	***1.4x***	***1.3x***	***0.9x***	***0.8x***	***0.8x***	***0.7x***	***0.6x***
DY (%)	***5.7%***	***5.7%***	***6.5%***	***6.6%***	***7.8%***	***8.8%***	***9.9%***

Return	
Target Price	270.0
Current Price	175.0
Capital Gain (LKR)	95.0
Dividends upto 31.12.2019 (LKR)	10.2
Capital Gain %	54%
Dividend Yield %	6%
Total Return %	60%
Annualized Return %	89%

Hatton National Bank (Target Price: LKR 270, Total Return: +60%): BUY

HNB maintains cost leadership within the sector with a C/I ratio of 36.4% on the back of lean initiatives enhancing our internal processes. With the early transition to BASEL III requirements, HNB is well above the minimum Tier 1 and total capital ratios recording the latest as at Dec 2018 at 12.80% and 15.22% respectively. Thereby, improving liquidity and capital adequacy within the bank entails growth while many players in the sector may take more stringent and conservative measures. The bank is the leading retail bank with an asset base of LKR 1.1Tn while holding the largest leasing portfolio amongst private commercial banks enabling the bank to grow its loan book at a CAGR of 15% For the period 2019-21E. First Capital Research expects a total return of 60% with a capital gain of 54% and a dividend yield of 6%. The counter captures a target price of LKR 270.0 for 2019E with an earnings CAGR of 22% over 2019-21E. **INITIATING WITH A BUY**

P/E 31 December	*2015*	*2016*	*2017*	*2018*	*2019E*	*2020E*	*2021E*
Estimates (LKR 'Mn)							
Net Interest Income	29,694	39,089	45,461	53,636	59,643	67,335	78,528
Total Operating Income	42,645	53,366	61,099	75,114	81,575	92,061	106,452
Net Profit	**10,554**	**14,756**	**15,947**	**17,636**	**20,347**	**25,222**	**32,374**
Adjusted EPS (LKR)	21.6	30.2	32.6	35.8	40.9	50.0	63.1
YoY Growth (%)	10%	40%	8%	10%	14%	22%	26%
Valuations							
PER (x)	*8.1x*	*5.8x*	*5.4x*	*4.9x*	*4.3x*	*3.5x*	*2.8x*
PBV (x)	*0.9x*	*0.8x*	*0.7x*	*0.6x*	*0.6x*	*0.6x*	*0.5x*
DY (%)	*4.0%*	*4.1%*	*4.9%*	*5.1%*	*5.8%*	*7.1%*	*9.0%*

Return	
Target Price	210.0
Current Price	187.5
Capital Gain (LKR)	22.5
Dividends upto 31.12.2019 (LKR)	0.0
Capital Gain %	12%
Dividend Yield %	0%
Total Return %	12%
Annualized Return %	15%

Sampath Bank (Target Price: LKR 210, Total Return: +12%): HOLD

SAMP, 3rd largest privately-owned bank, is shifting its focus to corporate lending from SME and retail, considering the higher growth trajectory experienced in the past with a view to improve the portfolio quality. Its earnings stagnated at LKR 12.6Bn (-1%YoY) in 2018 while growing by a modest CAGR of 15% over 2016-18 signalling the moderation of the bank's growth amidst challenging environment coupled with the sizeable asset base. Recently announced Rights Issue proposes to raise LKR 12.1Bn further cementing the change in funding and lending strategies while significantly diluting the shareholding with ordinary shares increasing by 32% with funds being raised at a 58% discount to its book value. An expected moderate credit growth of 14% coupled with continuous investments into digitalisation and fintech are likely to support a modest growth in earnings, at a CAGR of +15% over 2019-21E while diluted TP for SAMP for 2019E is estimated to be LKR 210.0, providing an annualized return of 15%. **DOWNGRADE TO HOLD**

P/E 31 December	2015	2016	2017	2018	2019E	2020E	2021E
Estimates (LKR 'Mn)							
Net Interest Income	18,550	23,955	30,297	40,872	47,313	53,477	60,898
Total Operating Income	26,742	33,957	42,473	57,233	62,048	69,117	77,291
Net Profit	**6,623**	**9,496**	**12,683**	**12,606**	**14,447**	**16,618**	**19,226**
Adjusted EPS (LKR)	16.8	24.1	32.2	32.0	36.7	42.2	48.9
YoY Growth (%)	26%	43%	34%	-1%	15%	15%	16%
Valuations							
PER (x)	*11.1x*	*7.8x*	*5.8x*	*5.9x*	*5.1x*	*4.4x*	*3.8x*
PBV (x)	*1.4x*	*1.1x*	*0.8x*	*0.6x*	*0.5x*	*0.4x*	*0.4x*
DY (%)	*6.9%*	*10.0%*	*9.2%*	*8.3%*	*5.9%*	*6.6%*	*8.6%*

Return	
Target Price	120.0
Current Price	107.5
Capital Gain (LKR)	12.5
Dividends upto 31.12.2019 (LKR)	0.0
Capital Gain %	12%
Dividend Yield %	0%
Total Return %	12%
Annualized Return %	14%

National Development Bank (Target Price: LKR 120, Total Return: +12%): HOLD

NDB, a mid-sized bank, shifts focus towards Retail and SME segment, but growth may trim with capital constraints as the bank approaches DSIB status during 2019E. The Bank which was incorporated as a development bank had its strong hold in project financing with diversifications stepping in over the last decade. In 2018, NDB recorded a loan book growth of 26%YoY well above its industry average of ~20% amidst the targeted emphasis in Retail and SME verticals. Nevertheless, we estimate a moderation in the loan portfolio to a CAGR of 9% for 2019E-21E substantially below the expected industry average growth of 13%, due to the capital constraints stemming from its failed Rights Issue. As the bank considers strategies to address its capital constraints on its path to DSIB status, we recommend a HOLD on a conservative note with a fair value of LKR 120.0, despite NDB's growth potential in the mid to long term. Our conservative recommendation on NDB would be reviewed if capital raising efforts are successful. **HOLD**

P/E 31 December	2015	2016	2017	2018	2019E	2020E	2021E
Estimates (LKR 'Mn)							
Net Interest Income	7,807	8,861	11,086	15,104	15,708	18,194	20,949
Total Operating Income	13,291	13,677	16,683	22,553	22,808	26,169	29,946
Net Profit	**3,542**	**2,691**	**3,490**	**5,264**	**5,839**	**6,406**	**7,211**
Adjusted EPS (LKR)	16.0	12.1	15.7	23.7	26.3	28.9	32.5
Net Profit YoY Growth (%)	-14%	-24%	30%	51%	11%	10%	13%
Valuations							
PER (x)	*6.7x*	*8.9x*	*6.8x*	*4.5x*	*4.1x*	*3.7x*	*3.3x*
PBV (x)	*0.8x*	*0.8x*	*0.7x*	*0.6x*	*0.5x*	*0.4x*	*0.4x*
DY (%)	*10.2%*	*7.4%*	*8.4%*	*7.4%*	*7.8%*	*7.9%*	*8.9%*

Seylan Bank (Target Price: LKR 70, Total Return: +14%): HOLD

Return	
Target Price	70.0
Current Price	61.6
Capital Gain (LKR)	8.4
Dividends upto 31.12.2019 (LKR)	0.0
Capital Gain %	14%
Dividend Yield %	0%
Total Return %	14%
Annualized Return %	19%

With a total asset base of LKR 470Bn as of 2018, SEYB is at the verge of moving into D-SIB category in 2019E which is expected to increase the Tier I and Total capital requirement to 10% and 14%. We believe that this would result in restriction on credit disbursements until SEYB comply with BASEL III thus impacting the core business of the bank while IFRS 9 results in higher impairment provisioning as well as deteriorating the existing capital base over the next 3 years to 2021E. With earnings forecast of LKR 3.6Bn in 2019E (incorporating the effect of DRL of appr. LKR 924Mn) coupled with a loan portfolio growth of 12% and a TP of LKR 70.0, SEYB provides a total return of 14%. **DOWNGRADE TO HOLD.**

P/E 31 December	*2015*	*2016*	*2017*	*2018*	*2019E*	*2020E*	*2021E*
Estimates (LKR 'Mn)							
Net Interest Income	11,857	13,499	15,575	17,790	18,366	20,784	23,231
Total Operating Income	16,199	17,813	21,546	23,201	23,753	25,801	28,678
Net Profit	**3,855**	**4,013**	**4,817**	**3,137**	**3,623**	**4,129**	**4,608**
Adjusted EPS (LKR)	10.5	11.0	13.2	8.6	9.9	11.3	12.6
YoY Growth (%)	21%	4%	20%	-35%	15%	14%	12%
Valuations							
PER (x)	***5.8x***	***5.6x***	***4.7x***	***7.2x***	***6.2x***	***5.5x***	***4.9x***
PBV (x)	***0.8x***	***0.7x***	***0.6x***	***0.6x***	***0.6x***	***0.6x***	***0.5x***
DY (%)	***4.5%***	***5.3%***	***5.7%***	***4.1%***	***4.1%***	***4.9%***	***4.9%***

Nations Trust Bank (Target Price: LKR 110, Total Return: +25%): BUY

Return	
Target Price	110.0
Current Price	90.1
Capital Gain (LKR)	19.9
Dividends upto 31.12.2019 (LKR)	2.9
Capital Gain %	22%
Dividend Yield %	3%
Total Return %	25%
Annualized Return %	31%

Nations Trust Bank, one of the fastest growing commercial bank, captures a target price of LKR 110.0 with an earnings CAGR of c.14% over 2019-21E. NTB's credit card portfolio which achieved the No.1 status in lending volumes is expected drive fees & commission income with a CAGR of c.17% over 2019E-21E. NTB's loan book is expected to grow by a of CAGR c.18% over 2019-21E to reach LKR 357Bn by 2021E supported by its focused niche SME clientele. We expect NTB share to register a total return of 25% with 23% capital gain and dividend yield of 2% over 1-year period. **MAINTAIN BUY**

P/E 31 December	*2015*	*2016*	*2017*	*2018*	*2019E*	*2020E*	*2021E*
Estimates (LKR 'Mn)							
Net Interest Income	9,105	9,786	12,288	14,818	16,992	18,601	19,551
Total Operating Income	12,519	13,711	16,913	21,291	24,388	27,329	29,670
Net Profit	**2,614**	**2,869**	**3,371**	**3,852**	**4,669**	**5,567**	**5,741**
Adjusted EPS (LKR)	9.4	10.3	12.1	13.9	16.8	19.5	20.7
YoY Growth (%)	3%	10%	18%	14%	21%	16%	6%
Valuations							
PER (x)	***9.6x***	***8.7x***	***7.4x***	***6.5x***	***5.4x***	***4.6x***	***4.4x***
PBV (x)	***1.6x***	***1.4x***	***1.0x***	***0.9x***	***0.7x***	***0.7x***	***0.6x***
DY (%)	***1.9%***	***1.9%***	***1.9%***	***2.5%***	***3.3%***	***3.7%***	***4.1%***

First Capital Holdings PLC

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Colombo 3

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RESEARCH

Dimantha Mathew	+94 11 2639 853	Hiruni Perera	+94 11 2639 864
Atchuthan Srirangan	+94 11 2639 863	Nisansala Kuruppumudali	+94 11 2639 866
Amanda Lokugamage	+94 11 2639 868		

GOVERNMENT SECURITIES SALES

Anjelo Simmons	+94 77 3031 636	Neminda Jayawardena	+94 76 6644 080
Anushka Dissanayake	+94 77 2220 021	Arun Kandasamy	+94 75 4861 506
Anushi Ranawaka	+94 77 3876 819		

CORPORATE DEBT SALES

Sewwandi Kathriarachchi	+94 77 3461 734	Mahesh Amarasinghe	+94 77 0073 684
Nethalie De Mel	+94 11 2639 854	Dharshanie Vasanthajothy	+94 77 9159 878

EQUITY SALES

CEO	Jaliya Wijeratne	+94 70 2910 042	**Negombo**	
			Priyanka Anuruddha	+94 70 2910 035
Colombo			Priyantha Wijesiri	+94 70 2910 036
Damian Le Grand		+94 70 2910 032		
Nishantha Mudalige		+94 70 2910 041		
Isuru Jayawardana		+94 70 2910 034		
Ifadh Marikar		+94 77 9625 679		
Thushara Pathiraja		+94 70 2910 037		
Anushka Buddhika		+94 70 2910 030		

UNIT TRUST SALES

Kavin Karunamoorthy	+94 77 0328 060	Deepal Pathmaperuma	+94 77 9159 878
Imali Abeygunawardena	+94 77 1764 799		

BRANCHES

Kandy	**Kurunegala**	**Matara**	**Negombo**
2nd Floor,	Ground Floor	2nd Floor, E.H. Cooray Building	1st Floor
No.121 Kotugodella Veediya	No. 42,	No: 24, 1/3,	No: 163B,
(E L Senanayake Veediya)	Mihindu Mawatha,	Anagarika Dharmapala Mawatha,	Colombo Road,
Kandy 20000.	Kurunegala 60000.	Matara 81000.	Negombo 11500.
Manager: Salinda Samarakoon	**Manager:**	**Manager:** **Rohana Jayakody**	**Manager:**
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