Banking Sector Outlook: Risks already priced in

Banks face several risks in 2014. The biggest risks are 1) the expected decline in trading gains, with a possible spike in interest rates further magnifying drawdowns and 2) potential capital raising activities brought about by the stricter requirements of BSP. While such events could significantly hurt the share price of banks, we believe that most of the risks are already priced in given banks' already attractive valuations. Moreover, banks' lending and fee based income are expected to remain strong notwithstanding the risks. BDO and MBT remain our top picks for the sector.

Trading gains to decline

For the first time in four years, we believe that banks' trading income will normalize. This will be brought about by rising interest rates (both globally and in the Philippines), causing banks' bond holdings to decline in value. The negative impact of the less favorable trading environment would be further magnified by banks' strong performance in 2013, particularly during the first quarter of the year. Recall that most banks booked extraordinarily large trading income in 1Q13 as they locked in profits and reduced their vulnerability to potential declines in bond prices in the future. This resulted to a 36% increase in trading profits for 9M13 and an estimated 44% rise in trading gains for 2013 despite coming from an already high base in 2012.

Given the rising interest rate environment and the high base set in 2013, we estimate trading income to decline by an average of 38% in 2014. This would mark the largest year-on-year decline since 2008.

Exhibit 1: Trading gains forecast

in PhpBil	**2013E**	**2014E**	**Y/Y**
BDO	12,365	7,104	-43%
BPI	7,939	5,384	-32%
CHIB	2,508	1,904	-24%
EW	1,486	1,021	-31%
MBT	12,406	6,513	-48%
PNB	7,965	4,959	-38%
SECB	2,793	2,530	-9%
Average			-38%

Source: COL estimates

Possible spike in interest rates pose further threat

On top of the anticipated decline in trading revenues, there are also concerns that banks could possibly incur one-time trading losses in the event of a sudden spike in interest rates. This is similar to what happened during 2Q13 when bond rates surged from 2.8% to 4.4% following the initial talks of tapering in the US. While banks have reduced their vulnerability to volatilities in bond rates (either through smaller holdings or shorter durations), banks will still be hurt by extreme movements in interest rates. Recall that in 2Q13, banks' average loss from their investment portfolio (including both trading and investment positions) reached 3.7% of their total holdings and 5.2% of equity capital. Should interest rate experience a similar surge in 2014, banks would inevitably take a hit.

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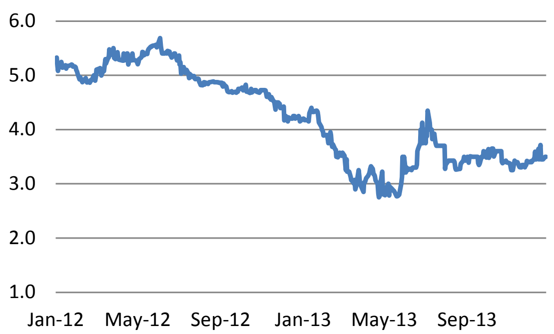
Exhibit 2: 10-year PDST-R rate



Source: Bloomberg

Banks may need to raise capital ahead of additional BSP requirements

Lastly, we believe that more banks may seek to raise equity capital in 2014 to further boost their capital position. While all banks are already well positioned to meet the stricter requirements under Basel III (which will take effect in January 2014) the central bank revealed further measures on dealing with domestic systemically important banks (DSIB). The said framework, which is not yet finalized as of the moment, aims to address systemic risks and interconnectedness of banks in the country. Effectively, this would increase the minimum core equity tier 1 ratio by 150 or 250 basis points depending on relative importance of each bank (factors include size, interconnectedness, substitutability/infrastructure, and complexity). Assuming that these additional measures are passed, the minimum core equity tier 1 ratio would increase from 8.5% to 10%-11%. Note that under the old framework (under Basel II, effective until end 2013), banks were only implicitly required to have a minimum tier 1 ratio of 5% (half of the 10% minimum total CAR).

We believe that this additional measure is largely the reason why BPI (Php25Bil), PNB (Php15Bil), and RCB (US$120Mil) all announced plans to raise equity capital late last year. Going forward, other banks could also announce capital raising activities to position themselves ahead of the finalization and eventual implementation of the BSP's stricter capital rules. Note that capital raising activities such as stock rights offerings usually put pressure on share prices in the short term due to concerns of dilution and as the market takes time to absorb the additional shares. In addition, while a higher capital adequacy would make banks stronger in terms of withstanding risks, it would also negatively affect the banks' profitability by reducing leverage.

Risks mostly priced in at current valuations

Banks have underperformed the PSEi during the second half of 2013 due to numerous risks facing the sector (Banking sector down 26% compared to the 20% decline in PSEi). However, we believe that most of the risks are already priced in given banks' current valuation. As of end 2013, most of the banks in our coverage list are already trading below their historical average P/BV multiples. This is despite expectations that their ROEs would remain higher than the average even with the risks that they face. Moreover, banks' lending and fee based income are expected to remain strong.

Exhibit 3: Bank valuations (as of end 2013)

	Price	2014 P/BV	5-Yr Ave	2014 ROE	5-Yr Ave
BDO	68.60	1.38	1.60	12.1%	10.5%
BPI	85.00	2.44	2.55	19.6%	14.9%
CHIB	59.00	1.67	1.38	12.6%	13.4%
EW	24.30	1.22	1.79	13.4%	13.2%
MBT	75.55	1.38	1.47	12.6%	10.7%
PNB	86.25	1.18	0.93	10.0%	8.3%
SECB	115.60	1.48	1.60	16.3%	23.7%
Average		1.54	1.62	14.0%	13.5%

Source: Banks, Bloomberg, COL estimates

Core businesses to continue growth

We expect the sustained growth of the banks' core businesses to help support profitability in 2014. Indeed, despite the lower trading gains, we estimate that higher net interest and fee-based income would still allow the banks to book higher revenues and even slightly higher net income. In particular, we are forecasting net interest income to grow by an average of 16.6% in 2014, driven by higher volume. We also expect net interest margin to end slightly higher in 2014, ending four years of margin declines. In addition, fee-based revenues should continue to grow steadily for the year as economic activity remains strong. Even with the expected weakness in trading operations, we estimate that banks' average ROE should remain strong at 14%, above the 5-year average of 13.5%.

Exhibit 4: 2014 growth forecasts

	Net interest	Fee-based	Revenues	Net income
BDO	17.0%	12.8%	5.2%	0.2%
BPI	15.8%	13.8%	8.6%	12.3%
CHIB	19.7%	12.3%	11.3%	10.8%
EW	30.7%	31.7%	23.6%	20.8%
MBT	13.5%	12.2%	0.7%*	2.6%*
PNB	15.0%	19.6%	-1.5%	-0.4%
SECB	15.4%	19.9%	10.0%	15.4%
Average	16.6%	14.9%	5.6%	6.2%

*Excludes one-time gain from sale of TMP and GBP in 2013

Source: COL estimates

Top picks are MBT and BDO

Our top picks for 2014 are BDO and MBT. Aside from the advantages brought about by their size and liquid balance sheet, the said banks rely less on trading gains and more on their core businesses. The said qualities should be preferred given the more challenging trading environment going forward. Indeed, trading and FX gains accounted for 12% and 17% of BDO's and MBT's total revenues from 2010 to 2012, lower than the industry average of 20%. This puts them in a better position to overcome the lower trading revenues for 2014. While BPI also shares similar qualities, valuations are not as compelling. At present, both BDO and MBT are trading at only 1.4X 14E P/BV. Capital appreciation potential based on our FV estimate is 37% for BDO and 32% for MBT. In contrast, BPI is currently trading at 2.4X 14E P/BV while capital appreciation potential based on our FV estimate is 15%.

Investment Rating Definitions

BUY	HOLD	SELL
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.	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.	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.

Important Disclaimers