BANKING

***Maintain* POSITIVE**

1HCY22 Financial Stability Review: Hairline cracks visible

KEY INVESTMENT HIGHLIGHTS

- **The banking sector can look to reduced credit costs, recovering non-interest income and OPR-hike-related benefits**
- **In addition to this, dividend yields are attractive, with several >4% in FY22/23**
- **But be wary of headwinds: deposit competition, potential asset quality issues and rising competition within the SME loan space. Also, loan growth will likely moderate following OPR normalization**
- **We are also wary of the possibility of Prosperity Tax 2023 being announced in the upcoming Budget 2023 announcement**
- **Maintain POSITIVE call on sector**

Highlights from 1HCY22 Financial Stability Review:

1. **Business repayment ability may not be as rosy at BNM suggests.** We point to (1) Higher operating margins resulting from a skewed sample size, as less profitable businesses would have already closed shop, (2) Government assistance artificially elevating spending to unsustainable levels, (3) Looser monetary policy reducing interest payments, thus boosting Interest Coverage ratios.
2. **Certain sectors still lagging.** HoReCa margins have benefited from border reopening. Manufacturing, construction, and raw-material and labor-intensive industries are still falling behind.
3. **SME RA loan numbers face steep decline.** What's more promising is that impairment ratios of these graduating loans are lower than that of the system SME loan base.
4. **Household loans exiting RA programmes have it hard.** Their impaired loan ratio is ~50bps higher than that of system household loans. An improving labor market may be a saving grace for this segment.
5. **Lower income households likelier to face issues with debt servicing ability.** 65% of borrowers-at-risk are earning <RM5,000 – worth noting is that they are less directly affected by OPR hikes, given their higher % of fixed-rate loans.
6. **Household debt-to-GDP improved, though unlikely to be sustainable.** We are wary of the effects of significant government aid used as GDP stimulation measures – we worry that GDP reliance of debt will increase following reduction of such measures.
7. **Banking system still adequately protected.** NSFR and capital ratios are still healthy. External debt exposure is still manageable due to banks solid risk-containment measures. While system GIL ratio has risen to 5.8% in sensitivity analysis, capital ratios remain at 15.4%, well above requirements.
8. **Gradual SRR normalization likely.** BNM hinted that GDP growth was still a priority, and they intend for banks to maintain a pool of excess liquidity following the end of SRR flexibility in Dec-22.

COMPANY IN FOCUS

Maybank

Maintain **BUY** | Unchanged Target price: RM10.41

Price @ 6 October 2022: RM8.67

- Excellent FY22 dividend yield of 6.6%
- Expansion of non-interest income via Etiqa and transactional income
- FD paring exercises in foreign segments should result in lower cost of funds

Share price chart



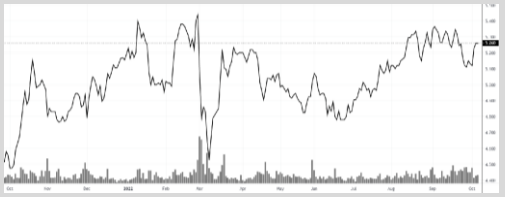
CIMB Group

Maintain **BUY** | Unchanged Target price: RM6.16

Price @ 6 October 2022: RM5.26

- Regional presence offers buffer to country-specific pressures
- Proxy to lucrative, funding-rich Indonesian market
- Thai and Indonesian commercial loan rundown close to end, removing loan contraction pressure

Share price chart



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A. How is the repayment ability of Businesses?

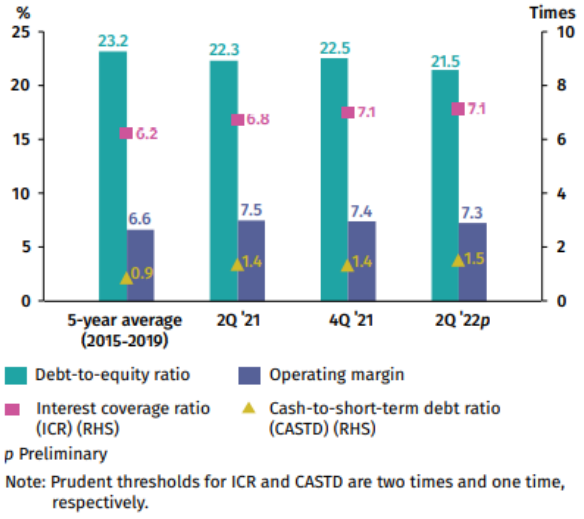
Economic activity is up. Coming out from pandemic times, multiple indicators have already seen promising improvement. Loan growth is particularly promising: The BNM banking stats for Aug-22 (link) have reflected considerable improvement in ***business loans (+5.0% annualized).*** While ***SME loan growth*** is much less impressive ***(+2.4% annualized),*** steep pickup in SME leading indicators and approval rates (Aug-22: 60%; pre-pandemic range: 35-40%) may escalate growth in coming months. Corporate players can look to improving bond yield conditions for further drawdown via the corporate bond market.

Businesses are healthier now, though signs may be less optimistic than BNM suggests... BNM's Key Financial Performance Indicators (KFPI) point towards an overall improvement in aggregate financial performance of businesses since the pandemic. It points towards an improvement in metrics in 2QCY22 (as listed in Exhibit 1), in contrast to pre-pandemic (2015-2019) performance.

We are skeptical of the lasting impact of such improvements due to several reasons: (1) The sample size is skewed towards naturally hardier, cash-intensive enterprises with better operating margins – the pandemic would have eradicated weaker businesses from the sample pool, (2) The current rate of spending is unsustainable: Cash-handouts and financial aid by EPF may have artificially elevated spending in 2QCY22, and (3) Looser monetary policy would lead to an improved Interest Coverage ratio (ICR), given the reduced payments for floating-rate loans.

EXHIBIT 1

Chart 1.4: Business Sector – Key Financial Performance Indicators



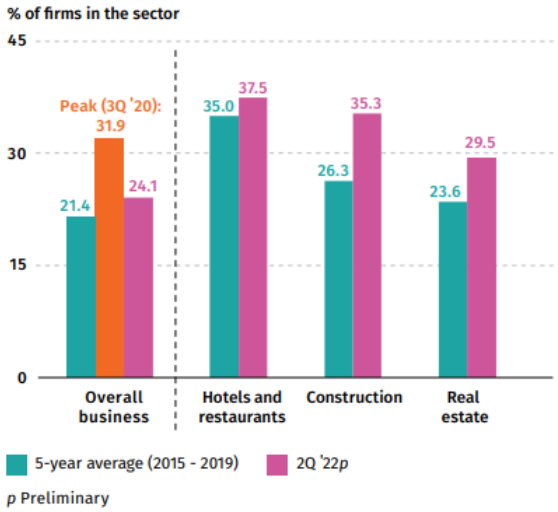
p Preliminary

Note: Prudent thresholds for ICR and CASTD are two times and one time, respectively.

Source: BNM, MIDFR

EXHIBIT 2

Chart 1.5: Business Sector – Firms-at-risk for Selected Sectors



p Preliminary

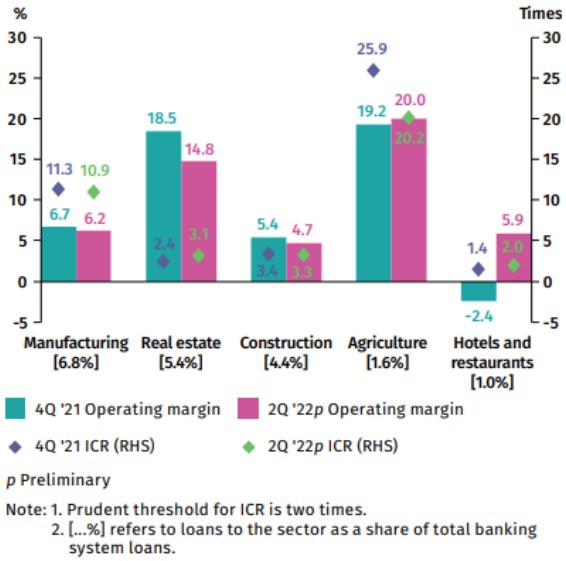
Source: BNM, MIDFR

...while certain sectors are still lagging. As articulated in Exhibit 2, while the % of total firms-at-risk in overall business has considerably improved since the pandemic peak, it has yet to fully normalise. Recovery is uneven, with more unfortunate sectors being those more vulnerable to rising costs (building material costs peaked in May-Jun-22), labor shortages (leading to more competitive pay for foreign workers, as well as the need to hire higher % of local workers) and ringgit depreciation. *(Firms-at-risk refer to corporates with ICR <x2).*

These high-risk sectors include HoReCa, construction and real-estate players. As observed in Exhibit 3, HoReCa operating margins have jumped up considerably with the reopening of international borders – on the other hand, manufacturing, construction, and real estate margins are down largely due to steel and cement prices peaking in 2QCY22. Real estate also faces the issue of oversupply of commercial real estate (CRE) amongst low-mid tier players.

EXHIBIT 3

Chart 1.6: Business Sector – Operating Margin and Debt-servicing Capacity Indicators for Selected Sectors



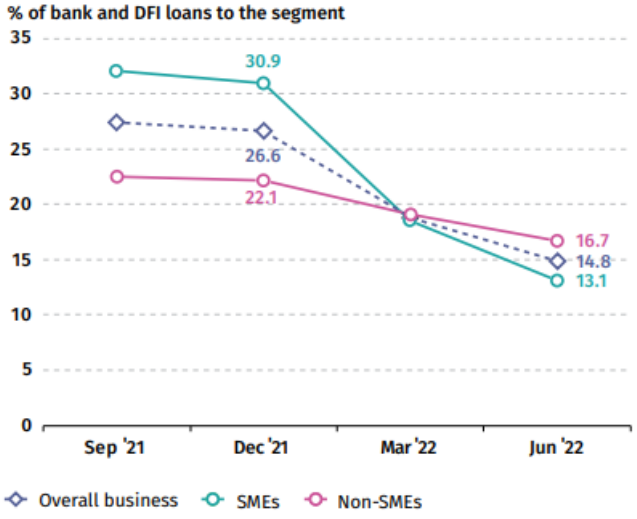
p Preliminary

Note: 1. Prudent threshold for ICR is two times.
2. [...%] refers to loans to the sector as a share of total banking system loans.

Source: BNM, MIDFR

EXHIBIT 4

Chart 1.7: Business Sector – Share of R&R Loans by Segment



Source: BNM, MIDFR

SME RA loans face steep decline. SME loans under repayment assistance (RA) programmes fell sharper than other segments, as seen in Exhibit 4. This was to be expected, given that a much higher % (95%) of total business loan accounts were initially approved for RA programmes. A higher figure should thus result in higher rundown rates.

Upon graduation, the majority have resumed regular payments, with 7% of graduates failing to hit deadlines in 2QCY22 – of this, <2% have turned into NPL (this translates to 0.3% of system SME loans). As of Jun-22, the impairment ratio of SMEs that exited RA programmes was 60-70bps lower than that of the overall SME segment – a solid indicator for good repayment ability within the segment.

B. How is the repayment ability of households?

Household borrowers show promising trend. Driven by promising residential mortgage and hire purchase growth ***(+6.5% and +6.9% annualized)***, household loans continue to perform, boasting impressive ***+6.3% annualized growth***, however, note a low base (Exhibit 5). The RM250k-1m residential property band contributed the most to impressive mortgage figures.

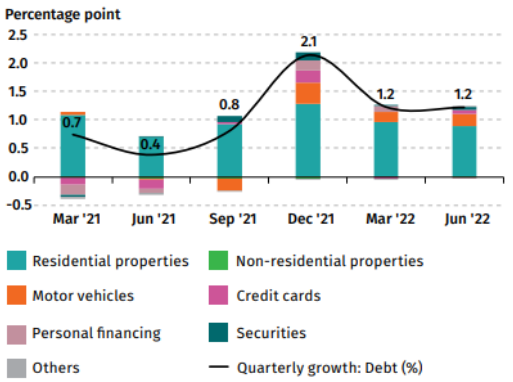
Household borrowers exiting RA programs have it hard. Household (HH) RA loans dropped significantly from Dec-21 to Jun-22 – the bulk of the remainder are under reduced instalments programmes, rather than full loan moratoriums. In contrast to SME loans, the impairment ratio of HH loans that exited RA programmes were ~50bps higher than impairment ratio of total HH loans. We believe the worst is yet to come: Note the effect of EPF assistance programmes on temporary debt-servicing ability. Also note that the brunt of recently graduated HH loans have yet to feel the OPR pinch and have not enough time to undergo the 3-month missed payment period, upon which it is fully classified as impaired.

However, HH borrowers may look to one promising sign: an improving labor market, given that a steady source of income is best indicator of repayment ability.

As of Jun-22, 2.4% of HH loans are under RA program [Dec-21: 18.8%].

EXHIBIT 5

Chart 1.9: Household Sector – Quarterly Growth of Debt

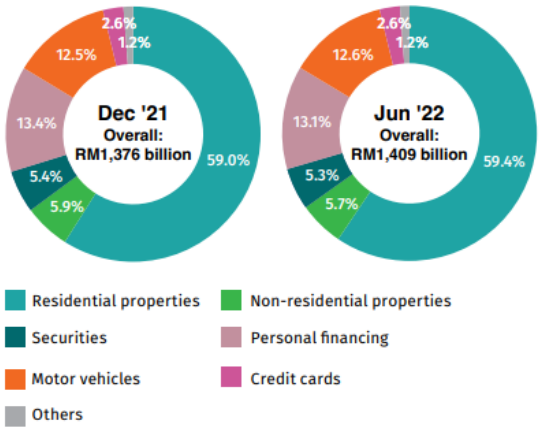


Note: The loan/financing data used is based on updated statistical reporting requirements to reflect more accurate data definition and reporting methodology and thus, may not be directly comparable to the data reported in previous publications.

Source: BNM, MIDFR

EXHIBIT 6

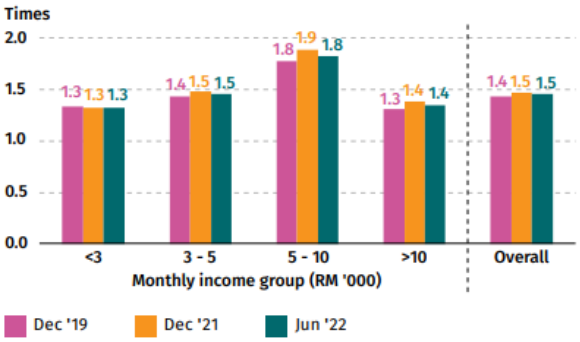
Chart 1.10: Household Sector – Composition of Debt by Purpose



Source: BNM, MIDFR

EXHIBIT 7

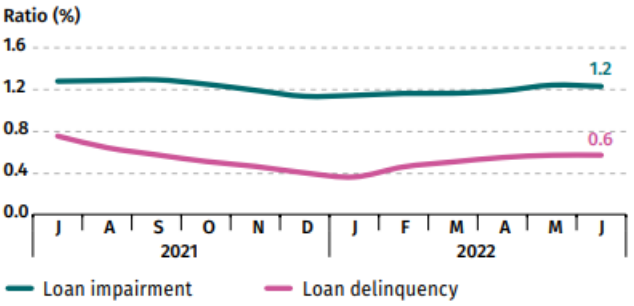
Chart 1.12: Household Sector – Median Debt-to-income Ratios by Income Group



Source: BNM, MIDFR

EXHIBIT 8

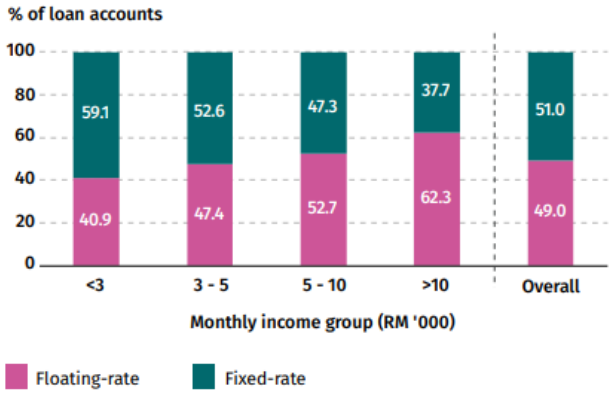
Chart 1.13: Household Sector – Loan Impairment and Delinquency Ratios in the Banking System



Source: BNM, MIDFR

EXHIBIT 9

Chart 1.15: Household Sector – Share of Fixed-rate and Floating-rate Loan Accounts by Income Group

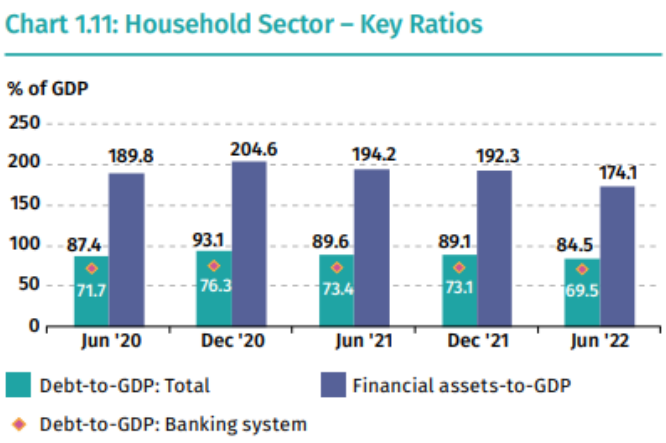


Source: BNM, MIDFR

In terms of debt servicing ability, lower income households are more vulnerable to pinch. While the median debt-to-income ratio did not vary too much from pre-pandemic times, it has shown some degree of improvement, especially in the RM5-10k earning segment (Exhibit 7).

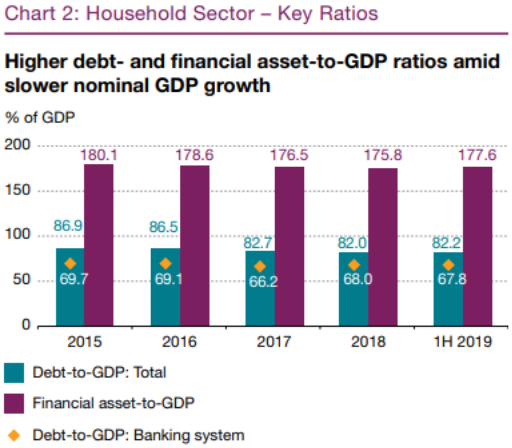
More concerning is that a sizeable 65% of borrowers-at-risk are earning <RM5,000. These individuals are more affected by rising costs of living, given a larger proportion of their income is devoted to purchasing necessities. They are believed, however, to be marginally less affected by OPR hikes, given that more than half (56%) of their loans are fixed rate (mostly vehicle loans).

EXHIBIT 10



Source: BNM, MIDFR

EXHIBIT 11



Source: BNM, MIDFR

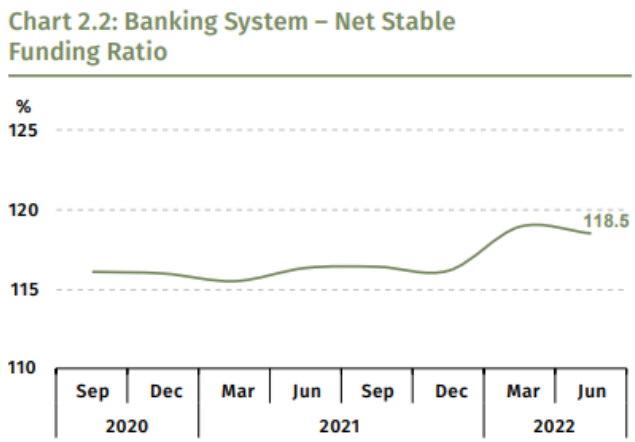
HH Debt-to-GDP still elevated. In Jun-22, it has since gone down to 84.5% (though it remains elevated from pre-pandemic levels of 82%) (Exhibit 10,11). While the reduced dependence of national GDP to HH debt is a positive sign, we are wary that the improvement is temporary, given the significant government aid (most prominently, EPF assistance) in 1HCY22 used as GDP stimulation measures. We worry that the figure will increase again in 2HCY22.

C. Is the banking sector still resilient?

Considerable buffers. The banking industry continues to report solid net stable funding ratios (NSFR) (Exhibit 12), offering a strong buffer to further system shocks. Capital ratio was still healthy [Jun-22: 18.0%]. There has been a reduction in liquidity coverage ratio (LCR) (Exhibit 13), which was to be expected following the tightening of interest rates.

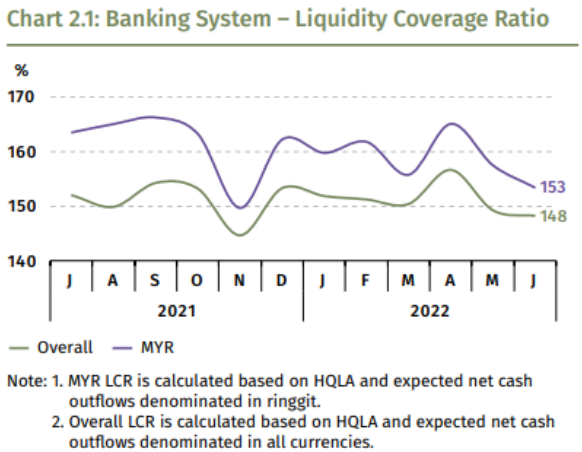
SRR normalization should be gradual. BNM did hint towards a gradual normalization of the SRR following the end of flexibility to use MGS and MGII to meet SRR compliance, ending at Dec-22. They mentioned that GDP growth was still BNM's priority, and banks maintaining a pool of excess liquidity would be beneficial to the goal.

EXHIBIT 12



Source: BNM, MIDFR

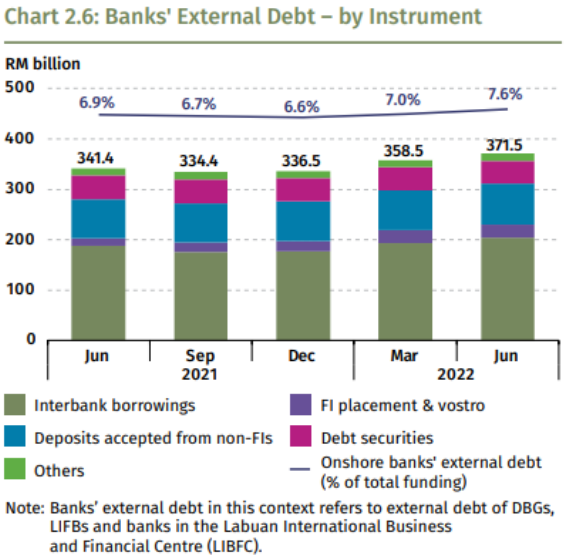
EXHIBIT 13



Source: BNM, MIDFR

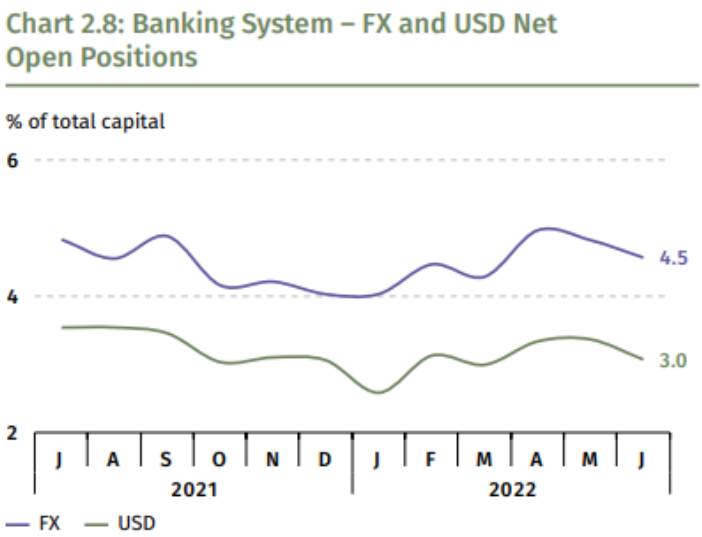
External debt exposure still manageable. In line with higher customer demand for foreign currency (FCY) fueled by robust trade activity, bank's external debt has recovered considerably since the start of the pandemic. Nevertheless, banks continue to keep such risks well-maintained: (1) The brunt of such debt is in the form of intergroup borrowings (70%), reducing refinancing risk, (2) Banks maintain sizeable FCY liquid assets – 2.6x times cover of short-term external "debt-at-risk", roughly the same level as pre-pandemic times, (3) Overall net open position remains low (Exhibit 13). *(Net open position refers to net outstanding balance of assets, liabilities, and off-balance sheet items in that currency.)*

EXHIBIT 14



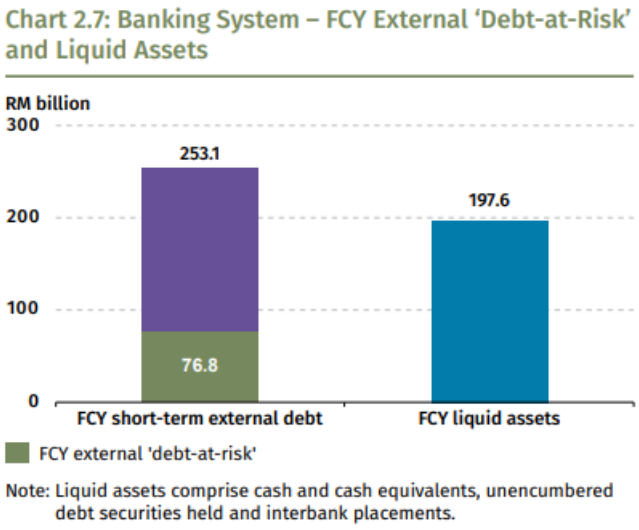
Source: BNM, MIDFR

EXHIBIT 15



Source: BNM, MIDFR

EXHIBIT 16

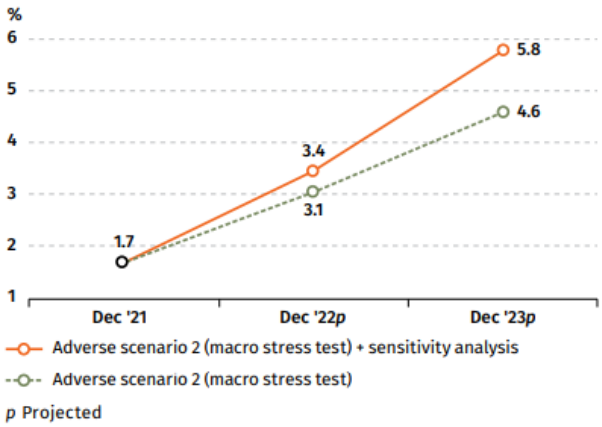


Source: BNM, MIDFR

Capital ratios still healthy even with additional sensitivity analysis. Based on a sensitivity analysis conducted by the bank, BNM further stressed selected parameters used in the Bank's earlier macro solvency stress test (performed in Dec-21), further including higher MGS yields and ringgit values worse than seen during the Asian Financial Crisis. While it did bring up the system GIL ratio to a worrying 5.8%, industry capital ratios are projected to remain at 15.4% which is still far above the necessary requirement.

EXHIBIT 17

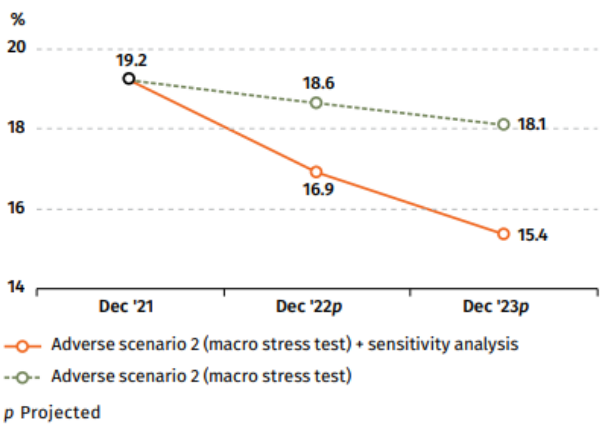
Chart 2.16: Sensitivity Analysis: Banking System – Impaired Loans Ratio



Source: BNM, MIDFR

EXHIBIT 18

Chart 2.17: Sensitivity Analysis: Banking System – Post-shock Total Capital Ratio



Source: BNM, MIDFR

D. Outlook and Recommendation

Maintain POSITIVE. Going forward, banks may still reap the benefits of lower credit costs and OPR hike-related benefits and recovery of non-interest income sources. Additionally, the banking sector is often synonymous with high dividend yields, with several names offering yields above >4%. This should offset headwinds: namely asset quality concerns, normalization of operating expenses, heightened deposit competition, and a moderation in loan growth following OPR normalization. However, we are wary of the possibility of Prosperity Tax 2023 being announced in the Budget 2023 announcement, which may result in downward pressure to earnings forecasts and share price. Our top picks for the sector remain **Maybank (BUY, TP: 10.41)** and **CIMB (BUY, TP: 6.16).**

PEER COMPARISON TABLE

Company	Rec.	Share P*	Target P	Upside	Mkt Cap	PER (x)		P/B (x)		ROE (%)		Net Div Yield (%)	
		(RM)	(RM)	(%)	(RM 'b)	FY22/23	FY23/24	FY22/23	FY23/24	FY22/23	FY23/24	FY22/23	FY23/24
Maybank	BUY	8.67	10.41	20.1	100.77	11.2	9.6	1.1	1.1	10.3	11.4	7.6	8.9
CIMB	BUY	5.26	6.16	17.1	52.72	10.2	8.7	0.9	0.8	7.7	9.4	4.9	5.8
Public Bk	BUY	4.25	5.67	33.5	82.50	14.1	12.2	1.6	1.5	11.7	12.6	3.6	4.1
RHB	BUY	5.68	6.94	22.2	23.00	8.6	7.0	0.8	0.7	10.1	10.5	5.8	7.1
HL Bank	BUY	20.80	23.96	15.2	45.09	11.7	10.8	1.3	1.2	10.5	11.0	3.0	3.3
HL FG	BUY	18.54	23.51	26.8	21.02	7.6	7.1	1.2	1.1	10.3	11.2	3.0	3.3
AMMB	BUY	3.99	4.56	14.3	13.17	8.2	7.5	0.7	0.7	8.6	8.7	4.3	4.7
BIMB	NEUTRAL	2.61	2.66	1.8	6.38	13.2	10.7	1.0	0.9	7.8	8.3	3.8	4.7
Affin Bk	BUY	2.02	2.55	26.2	4.26	7.7	6.3	0.4	0.4	5.5	6.4	7.8	4.8
ABMB	BUY	3.65	4.58	25.3	5.65	8.3	7.8	0.8	0.8	10.0	9.8	6.0	6.4
Simple avg						**10.1**	**8.7**	**1.0**	**0.9**	**9.3**	**9.9**	**5.0**	**5.3**

**Closing prices from 6th October 2022*

Source: BNM, MIDFR

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MIDF AMANAH INVESTMENT BANK: GUIDE TO RECOMMENDATIONS	
STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >10% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >10% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -10% and +10% over the next 12 months.
SELL	Total return is expected to be <-10% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >10% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.
SECTOR RECOMMENDATIONS	
POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.
ESG RECOMMENDATIONS* - source Bursa Malaysia and FTSE Russell	
☆☆☆☆	Top 25% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell
☆☆☆	Top 26-50% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell
☆☆	Top 51%- 75% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell
☆	Bottom 25% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell

* ESG Ratings of PLCs in FBM EMAS that have been assessed by FTSE Russell in accordance with FTSE Russell ESG Ratings Methodology