

Company Outlook

Commercial Bank of Ceylon PLC (COMB - LKR 118.80) :SELL

We resume coverage on COMB with a Sell rating. Our residual income and dividend yield based total return of LKR 118 is near flat compared to the CMP. The stock has outperformed the market by 15% YTD, thus impeding the upside potential. We believe that COMB has the strongest model in the industry, aided by a low cost funding franchise, strong core income flows, extensive network, balanced loan mix and healthy capitalization. However, we are concerned about the continuous CASA erosion, leading to thin margins. COMB's loan market share has declined to 11.9% in FY 2012 (FY 2010 - 13.0%), as the LCB sector loan growth was mainly led by government borrowings and heavy exposure to pawning advances during the period.

Year Ending 31 December	2011	2012	2013E	2014E
Net interest income (LKR mn)	18,678	22,852	25,708	30,373
NIM % (calculated)	5.1%	5.3%	5.1%	5.3%
Net profit (LKR mn)	7,932	10,079	9,746	11,828
EPS (LKR)	9.53	12.11	11.48	13.94
ROA %	2.0%	2.1%	1.7%	1.9%
ROE %	20.4%	20.8%	17.3%	18.6%
NAVS (LKR)	53.01	63.62	70.18	79.63
DPS (LKR)	6.00	6.50	6.50	6.50
Dividend yield (%)	6.0%	6.3%	5.5%	5.5%
Cost to income ratio %	44.7%	41.1%	44.0%	44.4%
P/E (x)	10.5 x	8.5 x	10.3 x	8.5 x
P/BV (x)	1.9 x	1.6 x	1.7 x	1.5 x

Source: Company data and BRS Equity Research

High credit costs weighing down FY 2013E bottom line to LKR 9.75bn (-3.3% YoY)

We expect a core income growth of 15% during FY 2013E and FY 2014E, primarily aided by an average loan book expansion of 17%. The risks to our NII and margin estimates are a declining CASA base (currently at 44% - 45%) and high cost of overseas funding (due to high premia on SWAP arrangements). Our bottom line forecast for FY 2013E is LKR 9.75bn (-3.3% YoY) due to the absence of hefty unrealized revaluation gains seen in the previous year, SWAP cost on forward premia and high credit cost. We forecast COMB to surpass LKR 11bn profit mark in FY 2014E (LKR 11.8bn, +21.4% YoY), mainly supported by core income growth and YoY fall in credit cost. We expect COMB to maintain its cost leadership position in the industry and expect an average cost to income ratio of 44% during the period under review.

SME advances to drive asset growth but asset quality under stress

Our loan book growth estimates are 16% (FY 2013E) and 18% (FY 2014E), and we believe SME advances will be the growth catalyst while traditional focus on corporate lending (45% of loan book) will be maintained. COMB had the largest exposure to SME advances (LKR 95.5bn, 30% of loan book) at the end of FY 2012 and the focus was 3x larger than state owned People's Bank (LKR 25bn) and Bank of Ceylon (LKR 6bn) combined (Source: Development Finance Annual Report 2012). COMB's loan market share has declined to 11.9% in FY 2012 (FY 2010 - 13.0%), with the bank's growth rates falling behind LCB growth during the last two FY. However, we don't perceive this as a weakness from the bank's front, as the industry growth was mainly led by government borrowings and heavy pawning disbursements during the said period. We expect the bank's asset quality to come under stress during FY 2013E due to negative macro dynamics, however expect to recover to FY 2012 levels (Gross NPL - 3.6%) by end FY 2014E. We have assumed a deposit growth of 17% and a CASA ratio of 46% during the forecast period. However, COMB's increased focus on SME sector will reduce the stress on yield management, coming from a declining CASA scenario.

Valuation - Inexpensively expensive, but a possible medium-term defense play due to high payout

We have arrived at a target price of LKR 118 (-1% on CMP) based on residual income valuation and dividend yield. The stock has been historically trading at a premium (COMB's PBV median was 1.9x compared to 1.4x of the peer median during the last four FYs) and we believe this represents the liquidity premium, cost leadership and size advantage of the bank. COMB is trading at 1.8x PBV and 10.3x and 8.5x PER for FY 2013E and FY 2014E respectively.

Research Team

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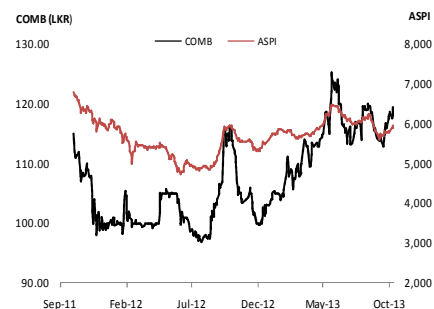
Trading Snapshot

Market cap (LKR mn)	100,820
Market cap (USD mn)	761
Outstanding shares - voting (mn)	848.7
Free float (%)	100.0%
Dividend yield (%)	5.5%
52-week High/Low (LKR)	126/97.30
3 -months average daily volume	69,730
YTD ASPI return (%)	5.7%
YTD Stock return (%)	15.3%
Beta	0.9

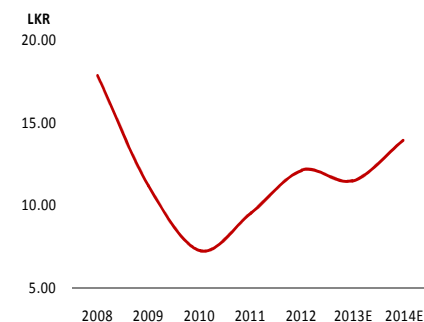
Valuation Summary

CMP (LKR)	118.80
Intrinsic value (LKR)	111.19
DPS (LKR)	6.50
Target price based on total return (LKR)	117.69
Valuation method	Residual Income
Total return %	-0.9%
Rating	Sell

Share Price Movement



EPS



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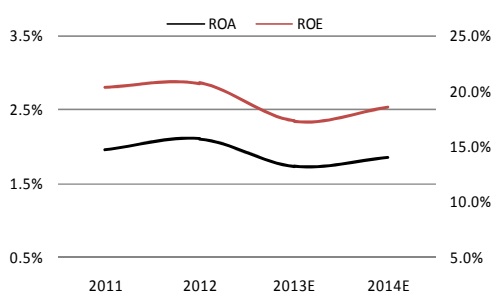
15 October 2013

Commercial Bank of Ceylon PLC (COMB)

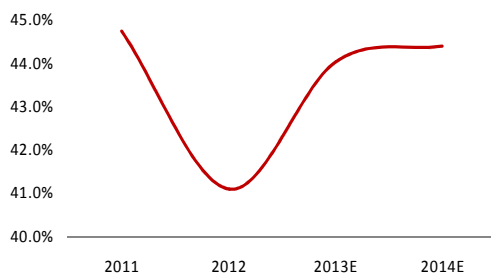
Company profile

COMB is the largest private sector commercial bank with an asset base of LKR 558.56bn as at end June 2013. The bank has a gross loan and deposit market share of 11.9% and 12.9% in the LCB sector. The bank has the highest CASA ratio in the industry (44.5% in FY 2012), despite the fall from 56.3% in FY 2010. COMB is adequately capitalized and running at Tier 1 of 13.8% and a Total Capital Adequacy ratio of 17.7%. COMB's leverage factor of 10x compares well with peer private banks.

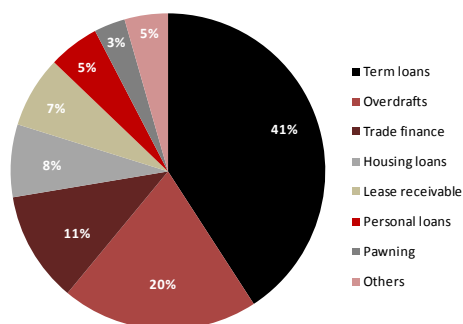
Trend in ROA and ROE (2011-14E)



Cost to income 2011-14E



Loan book Concentration - FY 2012



Source: COMB Annual Reports and BRS Equity Research

Year Ending 31 December	2011	2012	2013E	2014E
Summary Information				
BRS EPS (LKR)	9.53	12.11	11.48	13.94
BRS EPS growth (%)	32.3%	27.1%	-5.1%	21.4%
P/E (x) based on BRS EPS	10.5 x	8.5 x	10.3 x	8.5 x
Historical/current sector P/E (x)	13.2 x	11.6 x	na	na
Reported EPS LKR as per annual report	9.53	12.11	na	na
NAV per share (LKR)	53.01	63.62	70.18	79.63
Tangible NAV per share LKR	52.44	63.01	69.53	78.84
P/BV (x)	1.9 x	1.6 x	1.7 x	1.5 x
P/TBV (x)	1.9 x	1.6 x	1.7 x	1.5 x
Historical/current sector P/BV (x)	2.1 x	1.8 x	na	na
DPS LKR	6.00	6.50	6.50	6.50
Dividend yield (%)	6.0%	6.3%	5.5%	5.5%
Mkt price - voting	100.00	103.00	118.80	118.80
Weighted average shares (mn)	833	833	849	849
Average mkt cap (LKR'mn)	83,262	85,760	100,820	100,820
Income Statement (LKR'mn)				
Interest income	38,314	52,663	62,522	71,777
Interest expenses	(19,635)	(29,811)	(36,814)	(41,404)
Net interest income	18,678	22,852	25,708	30,373
Other income	7,085	10,162	8,291	8,531
Total income	25,764	33,013	33,999	38,904
Personnel cost	(6,346)	(7,837)	(8,552)	(10,284)
Other cost	(5,178)	(5,731)	(6,422)	(6,989)
Loan loss provisions	(1,747)	(3,158)	(3,002)	(2,423)
Value added tax on financial services	(1,523)	(1,987)	(1,961)	(2,305)
Profit from operations	10,969	14,300	14,062	16,903
Share of associates / (loss)	11	12	2	3
Exceptionals/non-recurring	-	-	-	-
Tax expense	(3,048)	(4,232)	(4,314)	(5,072)
Net income	7,932	10,081	9,751	11,834
Minorities	0	1	5	6
Profit attributable to equity holders	7,932	10,079	9,746	11,828
Balance sheet (LKR'mn)				
Loans and advances	278,043	330,238	382,092	449,511
Property plant & equipment	8,503	8,947	9,005	9,043
Intangible assets	475	506	557	664
Other interest earning assets	118,522	127,838	164,652	155,330
Other assets	36,055	44,691	50,816	56,680
Total Assets	441,598	512,221	607,121	671,229
Total deposits	323,698	390,569	457,284	535,521
Borrowings	62,135	53,436	75,949	52,046
Shareholders funds	44,139	52,968	59,561	67,576
Minorities	30	32	37	43
Interest earning assets	396,565	458,076	546,744	604,841
Interest bearing liabilities	385,832	444,004	533,234	587,567
Capital Adequacy				
Risk-weighted assets	300,785	358,967	403,679	476,061
Core capital (Tier I capital)	38,139	45,088	54,304	62,218
Supplementary capital (Tier II)	2,826	4,312	13,996	13,996
Core capital ratio (Tier I min 5%)	12.1%	12.6%	13.5%	13.1%
Total capital ratio (Tier II min 10%)	13.0%	13.8%	16.9%	16.0%
Tier 1 leverage ratio (%)	9.4%	9.5%	9.7%	9.7%
Asset quality				
Loans individually determined to be impaired	5,782	5,971	7,972	9,369
Such loans as a % of gross loans	2.0%	1.7%	2.0%	2.0%
Individual impairment cover ratio	58.2%	57.0%	57.0%	57.0%
Collective provision cover ratio	2.8%	2.9%	3.0%	2.9%
Growth rates and margins				
Growth in interest income %	10.4%	37.5%	18.7%	14.8%
Growth in interest expense %	7.2%	51.8%	23.5%	12.5%
Growth in net interest income %	14.1%	22.3%	12.5%	18.1%
Growth in personnel cost %	12.7%	23.5%	9.1%	20.3%
Net interest margin %	5.1%	5.3%	5.1%	5.3%
Cost to income ratio %	44.7%	41.1%	44.0%	44.4%
Return on assets	2.0%	2.1%	1.7%	1.9%
Return on equity	20.4%	20.8%	17.3%	18.6%
Interest income to interest earning assets	10.4%	12.3%	12.4%	12.5%
Interest expenses to interest bearing liabilities	5.8%	7.2%	7.5%	7.4%
Growth in interest earning assets %	17.6%	15.5%	19.4%	10.6%
Growth in interest bearing liabilities %	31.5%	15.1%	20.1%	10.2%

Valuation estimates

We have valued COMB based on a residual income valuation combined with the present dividend yield of 5.5%. We value the stock over three phases - a five year growth period, a ten year maturity period, followed by a terminal period.

We use a cost of equity of 15.0%, a beta of 0.9, a risk free rate of 10.5% (current one year treasury bill rate), and an equity risk premium of 5%.

We use a normalized ROE of 20% and 18% and a risk weighted asset growth of 10% and 8% for the growth and maturity phases.

Sensitivity Analysis for the intrinsic value

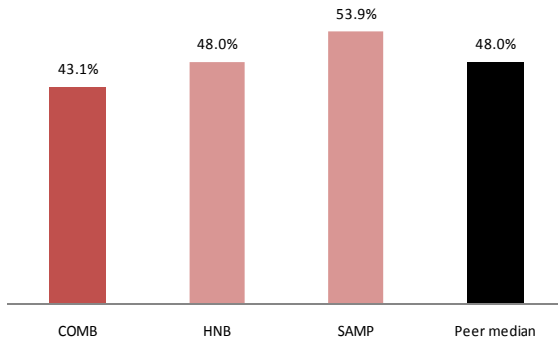
		Risk free rate				
		8.5%	9.5%	10.5%	11.5%	12.5%
Terminal growth rate %	2.0%	142.43	125.04	109.80	96.40	84.61
	3.0%	143.44	125.84	110.44	96.92	85.03
	4.0%	144.67	126.80	111.19	97.52	85.51
	5.0%	146.21	127.96	112.09	98.23	86.08
	6.0%	148.18	129.42	113.20	99.08	86.74

DuPont Analysis

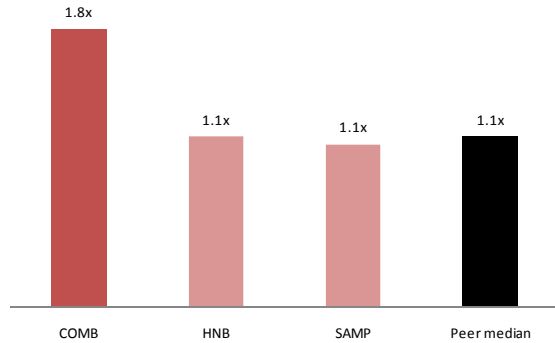
	2011	2012	2013E	2014E
ROA (%)	2.0%	2.1%	1.7%	1.9%
x leverage	10.5	9.8	9.9	10.1
= ROE (%)	20.4%	20.8%	17.3%	18.6%

Peer Comparison

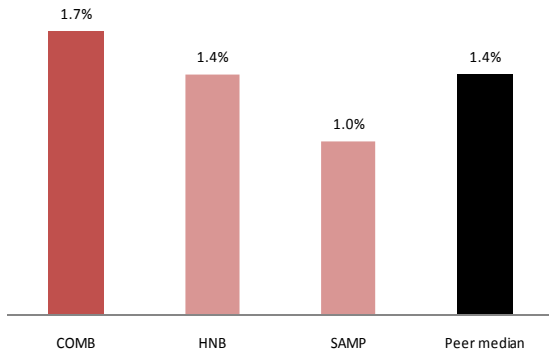
COMB is the cost leader amongst the peers
 Cost to income (%)



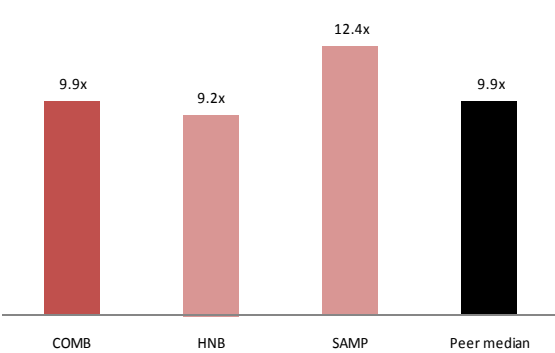
High productive assets, CASA and free float sets a premium
 PBV (x)



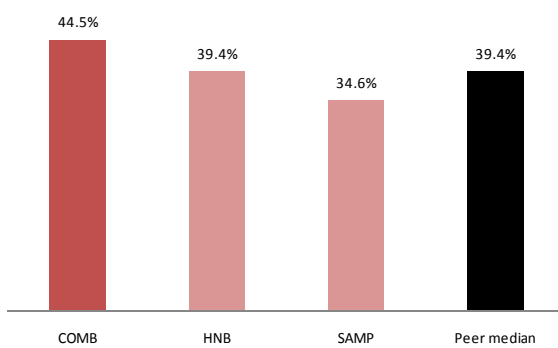
The most productive assets in the peer group
 ROA (%)



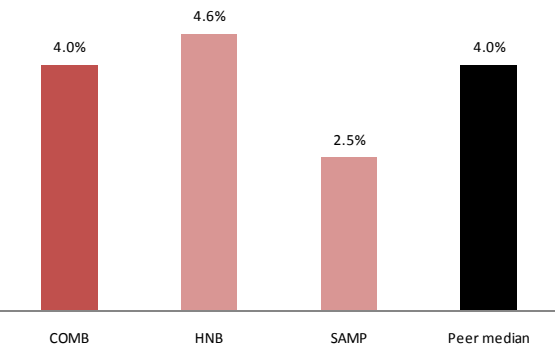
Risk appetite on par with peers
 Leverage (x)



Despite the recent erosion, still the leader in CASA supporting NIMs
 CASA ratio (%)



Average asset quality
 Gross NPL (%)



Information Note:

1. Cost to income, ROA, Leverage and Gross NPL are based on H1 FY 2013 interim financial results
2. CASA ratio as at end FY 2012

Top 20 Shareholders as of 30.06.2013

Name of the Shareholder	No. of Shares	%
DFCC Bank A/C 1	117,951,857	14.9%
Employees Provident Fund	75,890,973	9.6%
HSBC Intl. Nominees Ltd. - JPMLU- Franklin Templeton Investment Funds	57,224,769	7.2%
Sri Lanka Insurance Corporation Ltd. - Life Fund	40,219,594	5.1%
CB NY S/A International Finance Corporation	39,756,210	5.0%
Sri Lanka Insurance Corporation Ltd. - General Fund	34,583,318	4.4%
Mr.Y. S. H. I Silva	31,300,000	3.9%
HSBC Intl. Nominees Ltd. - BPSS LUX -Aberdeen Global - Emerging Markets Smaller Companies Fund	21,066,949	2.7%
HSBC Intl. Nominees Ltd. - BPSS LUX -Aberdeen Global - Asian Smaller Companies Fund	17,786,191	2.2%
Distilleries Company of Sri Lanka PLC	17,348,809	2.2%
HSBC Intl. Nominees Ltd. - SSBT -Wasatch Frontier Emerging Small Countries Fund	15,136,477	1.9%
Mrs. L. E. M. Yaseen	11,500,001	1.5%
HSBC Intl. Nominees Ltd. - BPSS LUX -Aberdeen Global Asia Pacific Equity Fund	10,736,297	1.4%
Mercantile Investments and Finance Plc	10,244,517	1.3%
Goldman Sachs & Co S/A Artha Master Fund Ltd	8,381,838	1.1%
The Bank of New York Mellon SA/NV-CF Ruffer Total Return Fund	8,071,609	1.0%
HSBC Intl. Nominees Ltd. - SSBT-Morgan Stanley Asset Management SA Acting on behalf of Morgan Stanley Galaxy Fund	7,398,991	0.9%
HSBC Intl. Nominees Ltd. - BP2S -London Aberdeen Asia Smaller Companies Investment Trust	6,672,683	0.8%
HSBC Intl. Nominees Ltd. - SSBT - Aberdeen Institutional Commingled Funds,LLC	6,250,323	0.8%
The Bank of New York Mellon SA/NV-CF Ruffer Absolute Return Fund	6,089,109	0.8%
Other Shareholders	250,474,351	31.5%

Financial Analysis

Income Statement - Commercial Bank of Ceylon PLC

Year Ending 31st December	2011	2012	2013E	2014E
All numbers in LKR¹ mn				
Interest Income	38,314	52,663	62,522	71,777
YoY Growth %	10.4%	37.5%	18.7%	14.8%
Yield on interest earning assets %	10.4%	12.3%	12.4%	12.5%
Interest Expense	(19,635)	(29,811)	(36,814)	(41,404)
YoY Growth %	7.2%	51.8%	23.5%	12.5%
Funding cost on interest bearing liabilities %	6.1%	7.8%	7.8%	7.4%
Net Interest Income	18,678	22,852	25,708	30,373
YoY growth %	14.1%	22.3%	12.5%	18.1%
Net interest margin % (calculated)	5.1%	5.3%	5.1%	5.3%
Other income	7,085	10,162	8,291	8,531
YoY growth %	8.8%	43.4%	-18.4%	2.9%
Total Income	25,764	33,013	33,999	38,904
YoY growth %	12.6%	28.1%	3.0%	14.4%
Operating expenses	(11,525)	(13,568)	(14,974)	(17,273)
YoY growth %	18.8%	17.7%	10.4%	15.4%
Cost to income ratio	44.7%	41.1%	44.0%	44.4%
Pre provision profits	14,239	19,446	19,025	21,631
YoY Growth %	8.0%	36.6%	-2.2%	13.7%
Loan loss provisions	(1,747)	(3,158)	(3,002)	(2,423)
Provision for fall in value of investment	-	-	-	-
Share of associate profits	11	12	2	3
VAT on financial services	(1,523)	(1,987)	(1,961)	(2,305)
Profit before tax	10,980	14,312	14,064	16,906
YoY Growth %	18.1%	30.3%	-1.7%	20.2%
Income tax expense	(3,048)	(4,232)	(4,314)	(5,072)
Profit after tax	7,932	10,081	9,751	11,834
YoY change %	44.1%	27.1%	-3.3%	21.4%
Reported EPS (Note 1)	9.53	12.11	-	-
BRS EPS (Note 2)	9.53	12.11	11.48	13.94

Source: Company Financial Reports and BRS Equity Research

Note 1 : Based on reported earnings after adjusting for the bonus issue and share split

Note 2 : Based on earnings after adjusting for bonus issue and share split

Financial Analysis

Balance Sheet - Commercial Bank of Ceylon PLC

Year Ending 31st December	2011	2012	2013E	2014E
All numbers in LKR'mn				
Cash and cash equivalents	12,935	19,752	17,510	14,698
Balances with Central Bank	17,343	18,168	23,596	27,847
Placements with banks	11,674	16,163	4,573	5,355
Derivative financial instruments	40	1,351	-	-
Financial assets held for trading	6,418	6,041	11,203	10,496
Financial investments - Available-for-sale	61,415	57,963	100,831	82,470
Financial investments - Held-to-maturity	-	-	-	-
Loans and advances to customers	278,043	330,238	382,092	449,511
Other investment	36,864	43,248	48,015	56,979
Other assets	7,290	9,179	9,171	13,574
Loans and receivables to banks	-	-	29	29
Leasehold property	113	112	111	111
Deferred tax assets	364	458	335	355
Investment in associates and subsidiaries	120	94	93	96
Property plant and equipment	8,503	8,947	9,005	9,043
Intangible assets	475	506	557	664
Total assets	441,598	512,221	607,121	671,229
Liabilities				
Deposits	323,698	390,569	457,284	535,521
Borrowings	62,135	53,436	75,949	52,046
Derivative financial instruments	435	84	-	-
Other liabilities	8,215	10,420	9,826	11,311
Deferred liabilities	1,640	1,890	1,674	1,774
Tax payable	1,307	2,822	2,790	2,957
Total Liabilities	397,429	459,220	547,524	603,610
Equity				
Share capital	16,474	18,009	19,557	21,254
Statutory Reserve Fund	2,890	3,433	3,696	4,288
Other Reserves	24,775	31,526	36,307	42,033
Total Equity	44,139	52,968	59,561	67,576
Minority interest	30	32	37	43
Total Liabilities & Equity	441,598	512,221	607,121	671,229

Source: Company Financial Reports and BRS Equity Research

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Stock Ratings

Recommendation

Expected absolute returns (%) over 12 months

Buy

More than 10%

Hold

Between 10% and 0%

Sell

Less than 0%

Expected absolute returns are based on the share price at market close unless otherwise stated. Stock recommendations are based on absolute upside (downside) and have a 12-month horizon. Our target price represents the fair value of the stock based upon the analyst's discretion. We note that future price fluctuations could lead to a temporary mismatch between upside/downside for a stock and our recommendation.

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