09 October 2018 | Visit Note

Malaysia Building Society Bhd

Transitioning into a full-fledged Islamic Bank

***Maintain* BUY**

***Revised* Target Price (TP): RM1.25 (from RM1.54)**

INVESTMENT HIGHLIGHTS

- **Completion of AFB acquisition will form a base for the Group's next stage of growth**
- **Revamping its branch network and launching wider product offering by FY19**
- **Transforming its assets and deposits mix**
- **Strong capital position**
- **Earnings forecasts maintained at this juncture**
- **We maintain our BUY recommendation with an revised TP of RM1.25 (from RM1.54)**

Transforming to a new entity. We visited the Group recently as we were interested to get details of its future plans following the completion of the acquisition of Asian Finance Bank (AFB) in 1QFY18. We summarised the key points of our discussion as follows:

- The completion of the AFB acquisition will form a base for the Group to become a full fledge Islamic Bank.
- FY18 and FY19 are years of which the Group will be building its foundation for its next stage.
- Transforming its asset and deposit mix.
- Strong capital position and does not require any rights issue at the moment.

Base had been set up. We believe that the Group have laid the foundation for its next stage of growth. More notably was the acquisition of AFB. We believe that the corporate exercise was to gain the banking license rather than to acquire asset size as AFB only had total asset worth RM2.6b as at 2QFY18. However, the banking license is essential for the Group to transform itself into a full fledge Islamic bank. Also, we believe that the small size of AFB gave the Group an advantage as it does not have to incur significant merger cost or manage integration issues. We understand that the Group had absorbed all of 100 AFB staff.

FY18 and FY19 can be considered foundation years. Whilst we believe that the merger with AFB provide for "easier" integration, it also meant that the Group would have to invest on physical and IT infrastructure as AFB did not have neither the branch network nor the IT platform that the Group could utilize. This had led to higher OPEX, where it went up by +28.7%yoy to RM201.8m in 1HFY18. The Group's CI ratio in 1HFY18 also went up +30.4% from 21.4% for the same period last year. We expect that OPEX in 2HFY18 and FY19 to continue to be elevated. However, we opine that this is necessary investment such as online banking platform for the Group to be able to offer wider range of products.

RETURN STATS	
Price (8 October 2018)	RM0.995
Target Price	RM1.25
Expected Share Price Return	+25.6%
Expected Dividend Yield	+4.0%
Expected Total Return	+29.6%

STOCK INFO	
KLCI	1,775.75
Bursa / Bloomberg	1171 / MBS MK
Board / Sector	Main / Finance
Syariah Compliant	No
Issued shares (mil)	6,338.1
Market cap. (RM'm)	6,357.2
Price over NTA	0.8x
52-wk price Range	RM0.99 – RM1.31
Beta (against KLCI)	1.16x
3-mth Avg Daily Vol	7.10m
3-mth Avg Daily Value	RM7.60m
Major Shareholders (%)	
EPF	63.77
Chua Ma Yu	8.14

Some banking abbreviations used in this report:

CA = Collective Assessment Allowance
CI = Cost-Income Ratio
CET1 = Common Equity Tier 1
GIL = Gross Impaired Loan
LDR = Loan-Deposit Ratio
NII = Net Interest Income
NOII = Non-interest income
NIM = Net Interest margin
CASA = Current and Savings Accounts
COF = Cost of Funds
LLC = Loan Loss Coverage
PPOP = Pre-Provisioning Operating Profit

More products to be launched in FY19. Following from the necessary investments, the Group will be launching more products especially to attract CASA accounts especially from the retail segment. We believe that this is essential as it would be able to less severe compression in NIM. We understand that current NIM is circa 3% and management expect to drop slightly below the 3% level. Presently, the bulk of its deposits are corporate fixed deposits. In contrast, retail deposits contribute circa 8% to total deposits. The drive to grow this segment will towards end of FY19.

Branch transformation and better retail offering. We note that the Group are in the midst of transforming its branch network. Its new branch model has been approved by the Management and will be transformed into 3 categories of branches, namely; Hub Branch, City Spoke and Digital Spoke. The target completion of this exercise will be 2QFY19. It is also working on corporate and retail internet banking focusing on cashless transactions aimed at enhancing the Group's core banking products and services whilst creating new channels to increase its presence and reach. The target to roll out this initiative is by this year end.

Decelerating personal finance segment. We understand that the Group is planning to decelerate the loans growth of its personal finance (PF) segment. Although this is its strength (62.6% of total loans book as at 2QFY18), we view this positively as in our opinion the Group need to diversify its risk. While the risk for the PF segment is minimized given the repayments are through salary deduction, in the likelihood of stress to household borrowers, unsecured loans (such as PF and credit cards) will be the first for borrowers to be delinquent.

Targeting more corporate and affordable housing loans. To grow its asset, management is targeting the corporate segment, where it aims for this segment to contribute between 30% to 35% of total loans book, from 25% currently. This includes growing its industrial hire purchase loans. We understand that amongst the reason for the shift to corporate loans is to reduce the average maturity as typically loans to this segment mature between 3 to 5 years. This will resolve issue with asset-liability gapping. The Group will also look to grow its mortgage portfolio but this will be for the affordable housing segment, either end financing or financing to developers. Nevertheless, we understand that the Group will be stricter in its evaluation for this segment. We believe that this is positive as it will help control the Group gross impaired loans.

Asset to be fully shariah compliant by FY19. The Group have successfully converted 75% of mortgage conventional loans of total eligible accounts to be converted from March to May 2018, where the next phase of conversion done in August FY18. For corporate conventional loans, it has successfully completed 95% of total eligible accounts. The remaining accounts are expected to be completed by year end. It has also successfully converted the total existing Deposit accounts. Given the pace of conversion, we expect that the bank's assets and liabilities will be fully shariah compliant by 1HFY19.

Focusing on improving asset quality. We believe that one of the key risks for the Group is its asset quality. As at 2QFY18, its GIL ratio stood at 5.5%, up from 4.8% as at 1QFY18. However, we noted that there was a decline in the formation of impaired loans. Loans classified as impaired as at 2QFY18 fell -21.9% to RM591.4m when compared against 4QFY17. Management guided that it is focusing on improving GIL ratio to circa 3% by 1HFY19.

Strong capital position. The Group are currently in a very strong capital position. Its CET1 and total capital ratio as at 2QFY18 stood at 17.1% and 18.3% respectively. As such, we do not foresee the Group having the need to raise additional capital anytime soon.

FORECAST

We are maintaining our FY18 and FY19 forecasts for now.

VALUATION AND RECOMMENDATION

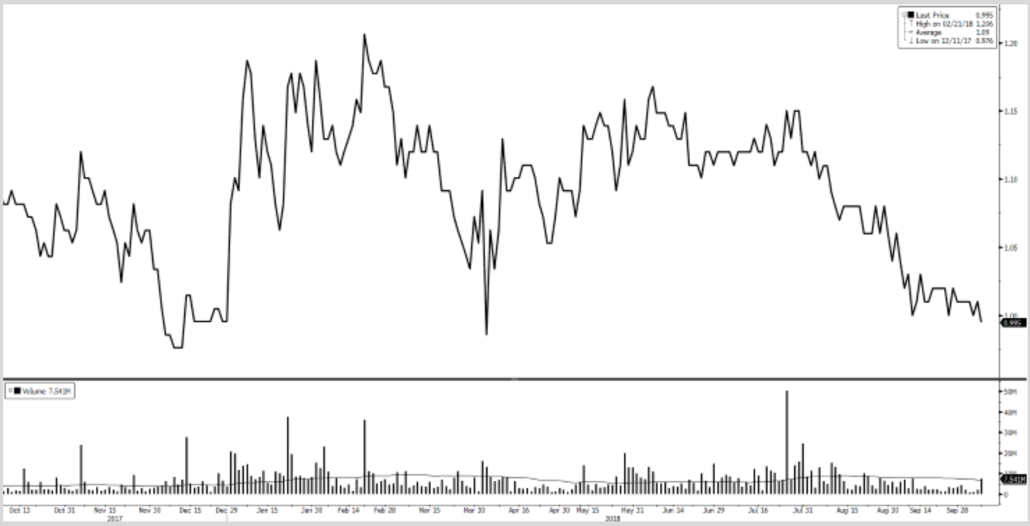
We believe that the Group have the potential to grow out of its current shell and flourish as an Islamic bank entity. We opine that the status of the Group will be significantly enhance once it becomes a full fledged Islamic bank. This is especially the case given that there are only one comparable peer that are listed. However, we are cognizant that investments will be needed to prepare for its next stage of growth. Nevertheless, we opine that any surprises from the Group will be on the upside. Therefore, we are maintaining our **BUY** call. We are revising our TP downwards to RM1.25 (from RM1.54) to adjust for the PBV multiple from 1.1x to 0.9x (or from 5-year average to 3-year average PBV). This is to take into account the fact that FY18 and FY19 will be its foundation years.

INVESTMENT STATISTICS

FYE Dec	FY15	FY16	FY17	FY18F	FY19F
Operating income (RM'm)	1,298.0	1,352.1	1,452.0	1,525.8	1,615.5
Total income (RM'm)	1,360.6	1,409.0	1,485.4	1,601.4	1,691.0
Pre-provisioning operating profit (RM'm)	1,029.4	1,115.7	1,149.3	1,211.8	1,273.7
Profit before tax and zakat (RM'm)	355.0	338.4	550.7	837.5	871.0
Net profit	**257.6**	**201.4**	**417.1**	**697.9**	**705.5**
Diluted EPS (sen)	9.2	4.9	7.2	11.6	11.5
EPS growth (%)	-76.3	-46.7	46.8	63.8	-1.0
PER (x)	12.6	23.7	16.1	8.6	8.6
Net Dividend (sen)	3.0	3.0	5.0	4.0	4.0
Net Dividend Yield (%)	2.6	2.6	4.3	4.0	4.0
BV/share (RM)	1.7	1.2	1.2	1.3	1.4
PBV (x)	0.7	1.0	0.9	0.8	0.7
ROE (%)	5.3	3.5	5.9	9.3	8.6

Source: Company, MIDFR

DAILY PRICE CHART



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Source: Bloomberg, 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.