26 September 2014

2014 Interim Report of China's Banking Sector

Stable growth of profits with potential risks of asset quality

PhillipCapital
Your Partner In Finance
Phillip Securities (Hong Kong) Ltd

Rating: **Buy**

Maintained at Buy

HONG KONG | MAINLAND FINANCIAL | SECTOR REPORT

- In all, China's economic growth slowed down but sill maintained on quite stable increase over 7% in 1H2014. Stable macroeconomic environment provided the good external condition for the development of China's banking sector. According to NBSC, as at the end of 2Q2014, accumulated GDP increased by 7.4% to RMB26.9 trillion, the same as the growth in 1Q;
- By the end of 1H2014, China's foreign reserve increased largely by 14.20% y-y to US$3.99 trillion accumulatively, but both the growth rate and the amount went down. The scale of China's reserve increased consistently mainly benefited from FDI, trade surplus and international capital inflow, representing that international investors have confidence in China's economy, but the growth of capital inflow will slow down. On the other hand, this will reduce inflationary pressure to China and bring more rooms of the adjustment for the PBOC to manage the growth of loans;
- Due to the reduce of the liquidity, CPI decreased slowly this year, by the end of Aug 2014, China's CPI increased by 2.0% y-y, of which food index increased by 3.0% y-y, both dropped obviously compared with the beginning of the year. We think China may face the deflationary pressure in future if CPI dropped largely under the downward trend of the economy;
- The PBOC continues to hold quite easing monetary policy in 2014. By the end of Aug 2014, 1-year deposit and lending interest rates of Chinese financial institutions maintained 3% and 6% respectively. According to the money supply, China's M1 and M2 increased by 5.71% and 12.84% y-y respectively, which trended to decrease;
- Deposit of residents decreased continually in 2014 while RMB loans of financial institutions dropped as well. By the end of Jun 2014, personal savings increased by 8.45% to RMB4.837 trillion, and RMB loans of China's financial institutions reached to RMB77.63 trillion, up 14.03% y-y, as 14.15% in Jun 2013. It is worth noting that personal savings decreased in Jul and Aug;
- Due to the slow-down of macroeconomic environment, the performance of domestic banks trended to decrease in 1H2014. According to the data in 1H2014, Chinese banks' profit growth decreased, in line with our expectation. In all, considering the large difference of the operating scale, we exclude city commercial banks, NIMs of 9 domestic listed banks continued to decrease, and net profits increased by 8.7% in average;
- By the end of 2Q, net loans of 9 domestic banks increase by 8.07% in average. BOC's net loans recorded the largest growth, up 10.73% to RMB8.024 trillion compared with the end of 2013, the only one gained more than 10% of growth rate among the peers. BoCom had the lowest growth rate, up 5.06% to RMB3.35 trillion;
- In 1H2014, banks scale remained stable growth, most of them gained the higher growth of assets compared with the end of last year. CMB and CITIC Bank's total assets increased by 25.3% and 18.4% respectively, and BOC's total assets also increased by 11.5%;
- According to the distribution of loans, manufacturing, wholesale and retail, transportation, storage & postal, and property development are still the major parts of the banks' loans, especially the proportion of the loans in manufacturing was much higher than others;

- The bank's asset quality still remained stable, and however, the NPL ratios went up slowly with the increased amount of the NPLs. By the end of 2Q2014, ABC still owned the highest NPL ratio as 1.24% among the peers while CMBC had the lowest one as 0.93%. We expect most of the banks' NPL ratio will up continually in the next few quarters, representing the continued deterioration of banks' asset quality;
- Based on the new method approved by the CBRC since 2013, domestic banks' CAR declined obviously, but started to rebound this year. As at the end of Jun 2014, all banks' CAR increased y-y except BOC, CARs of state-owned banks were much lower than others. We expect the CARs will continue to go up in 2H2104;
- By the end of June, BOC's NIM was the lowest among the peers, but continued to increase slowly. ABC's NIM was the highest, maintained at the stable level. Additionally, CMBC's NIM increased rapidly, and its incomes gained the large growth due to the low base. The performance of ABC's profit growth was better than other large-sized banks. Quarterly net profit of 9 domestic banks increased by 8.67% in average. CMB gained the highest growth as 17.09% while CITIC Bank owned the lowest one as 1.39% only;
- Currently, the valuation of domestic banks is relatively lower. Overall, domestic banks' P/B now is below 1.0x and P/E is lower than 10x, around 4.0-6.0x, therefore the valuation is quite attractive and we still recommend the Buy rating for the sector;
- Considering the operating performance and share prices of banks, we prefer ABC and BOC among the large-sized state-owned banks, and CMBC, CITIC Bank and CMB among joint-stock commercial banks.

China's macroeconomic environment maintained stable

Overall, China's economic growth slowed down but sill maintained on quite stable increase over 7% in 1H2014. Stable macroeconomic environment provided the good external condition for the development of China's banking sector. According to NBSC, as at the end of 2Q2014, accumulated GDP increased by 7.4% to RMB26.9 trillion, the same as the growth in 1Q;
We believe the range of decrease should be small although China's economy trends to go down based on the current data, and it should be around 7.3%-7.4% in 2014.

Figure 1. Quarterly GDP growth of China

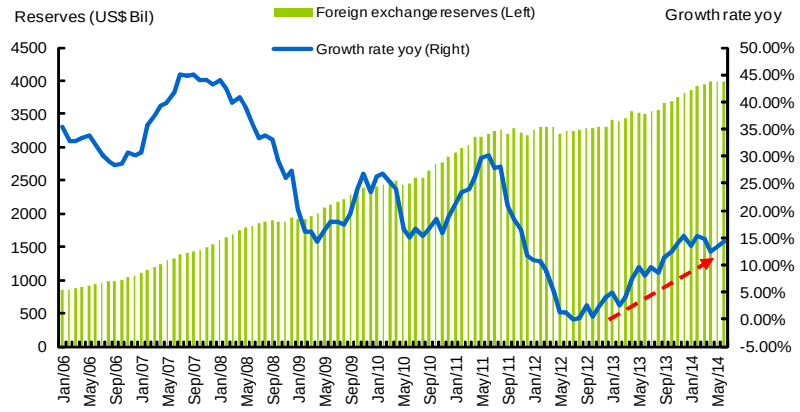
Source: NBSC, PSR

According to the foreign reserve, China's reserve decreased obviously after 2011 based on the previous high base. However, it has started to increase since 2H2012 affected by internal and external economic environment.
By the end of Jun 2014, China's foreign reserve increased largely by 14.20% y-y to US$3.99 trillion accumulatively, but both the growth rate and the amount went down. The scale of China's reserve increased consistently mainly benefited from FDI, trade surplus and international capital inflow, representing that international investors have confidence in China's

economy, but the growth of capital inflow will slow down. On the other hand, this will reduce inflationary pressure to China and bring more rooms of the adjustment for the PBOC to manage the growth of loans.

However, we expect the scale of international capital inflow will continue to increase under the further opening of China's market in future.

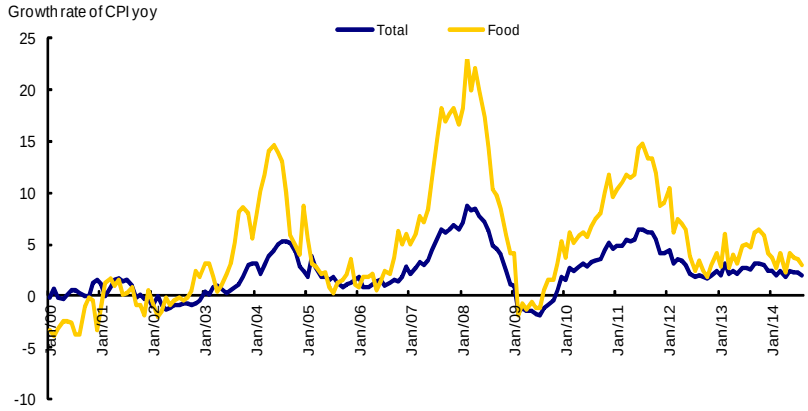
Figure 2. China's foreign reserves



Source: PBOC, PSR

Due to the decrease of the liquidity, CPI decreased slowly this year, by the end of Aug 2014, China's CPI increased by 2.0% y-y, of which food index increased by 3.0% y-y, both dropped obviously compared with the beginning of the year. We think China may face the deflationary pressure in future if CPI dropped largely under the downward trend of the economy;

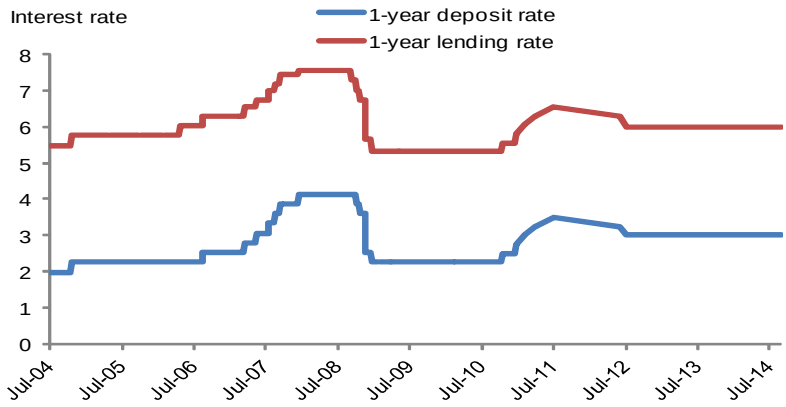
Figure 3. China's CPI



Source: NBSC, PSR

The PBOC continues to hold quite easing monetary policy in 2014. By the end of Aug 2014, 1-year deposit and lending interest rates of Chinese financial institutions maintained 3% and 6% respectively.

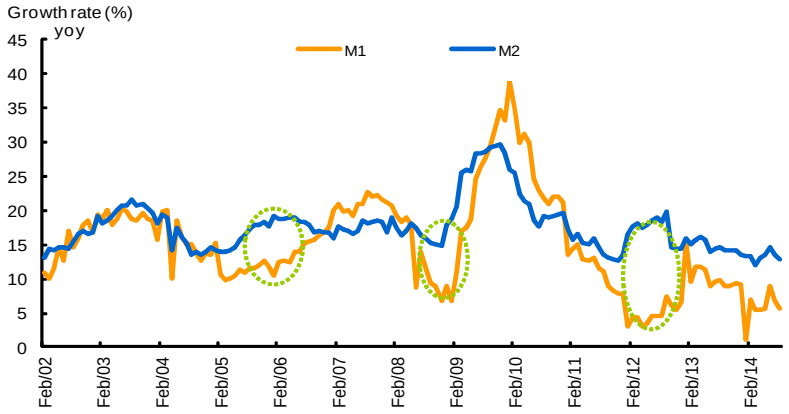
Figure 4. China's 1-year deposit and lending rates



Source: PBOC, Bloomberg, PSR

According to the money supply, as at the end of Aug, China's M1 and M2 increased by 5.71% and 12.84% y-y to RMB33.20 trillion and RMB119.75 trillion respectively, which trended to decrease;

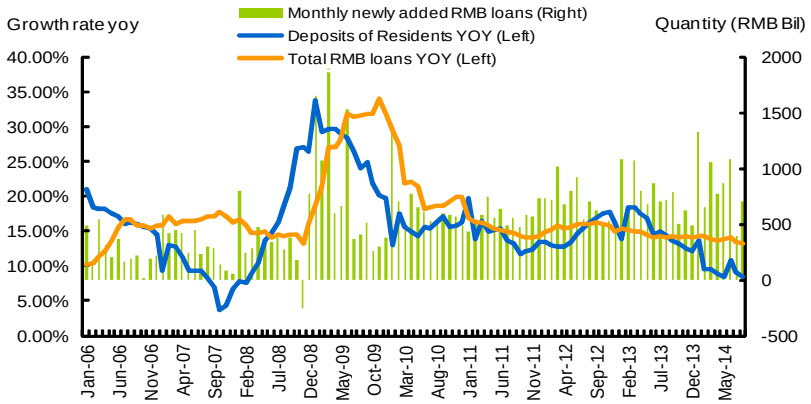
Figure 5. The growth of China's money supply



Source: PBOC, Bloomberg, PSR

The PBOC has strictly controlled the loans since 2010, and the growth of both deposits and loans of China's financial institutions maintained at the low level. Deposit of residents decreased continually in 2014 while RMB loans of financial institutions dropped as well. By the end of Jun 2014, personal savings increased by 8.45% to RMB4.837 trillion, and RMB loans of China's financial institutions reached to RMB77.63 trillion, up 14.03% y-y, compared with 14.15% in Jun 2013. It is worth noting that personal savings decreased in Jul and Aug, down to RBM47.1 trillion in Aug.

Figure 6. China's RMB loans and deposits of residents by the end of Aug 2014



Source: PBOC, PSR

Currently, loans of financial institutions still increase by over 10%. By the end of Aug, RMB loans of China's financial institutions reached to RMB78.72 trillion. The market concerned about the risks of shadow banks of financial institutions in China.

Currently, the concern is mainly from the uncertainty of the scale of shadow banks, and there are large differences of the estimation based on different methods. According to FSB, take the US as the benchmark, China is still at the early stage of the financial market, and the scale of shadow banks would be very small based on the financial derivatives, hedge funds, etc., around RMB5-10 trillion as estimated.

However, considering China's unique financial system, including non-banking financial institutions such as securities, funds, trusts, leasing, wealth management and PE, etc., we forecast China's shadow banks would amount to RMB45 trillion approximately, around 60% of total RMB loans of China's financial institutions.

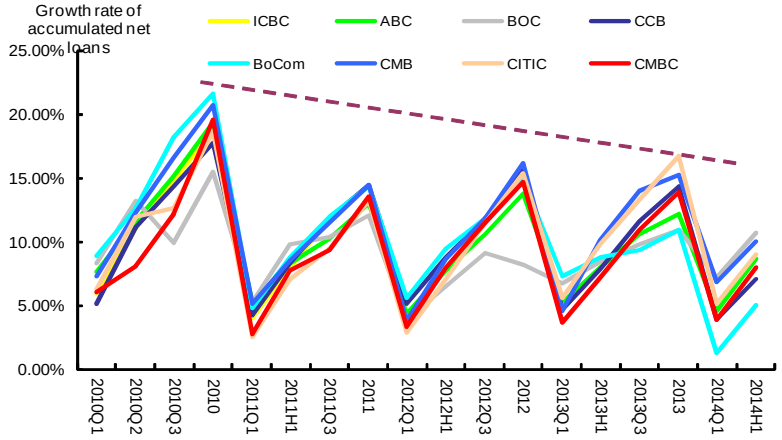
Shadow banks would be one of the largest threats for China's current financial system considering it was one of main reasons of financial crisis in the U.S. in 2008, and it is difficult to estimate its real scale. We believe it may be one of major causes for China's financial crisis in future.

Stable operating performance of domestic banks

Due to the slow-down of macroeconomic environment, the performance of domestic banks trended to decrease in 1H2014. According to the data in 1H2014, Chinese banks' profit growth decreased, in line with our expectation. In all, considering the large difference of the operating scale, we exclude city commercial banks, NIMs of 9 domestic listed banks continued to decrease, and net profits increased by 8.7% in average;

By the end of 2Q, net loans of 9 domestic banks increase by 8.07% in average. BOC's net loans recorded the largest growth, up 10.73% to RMB8.024 trillion compared with the end of 2013, the only one gained more than 10% of growth rate among the peers. BoCom had the lowest growth rate, up 5.06% to RMB3.35 trillion;

Figure 7. Growth of accumulated net loans of domestic banks

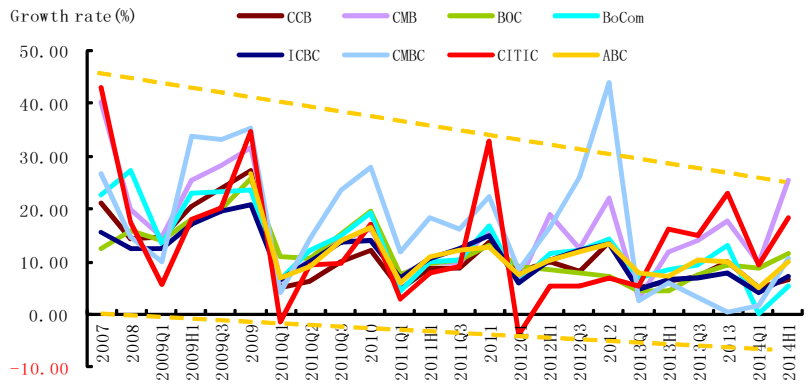


Source: the company's reports, PSR

In 1H2014, banks scale remained stable growth, most of them gained the higher growth of assets compared with the end of last year. CMB and CITIC Bank's total assets increased by 25.3% and 18.4% respectively, and BOC's total assets also increased by 11.5%.

We believe total assets of banks will continue to increase stably in 2H2014, with the average growth of 10% approximately.

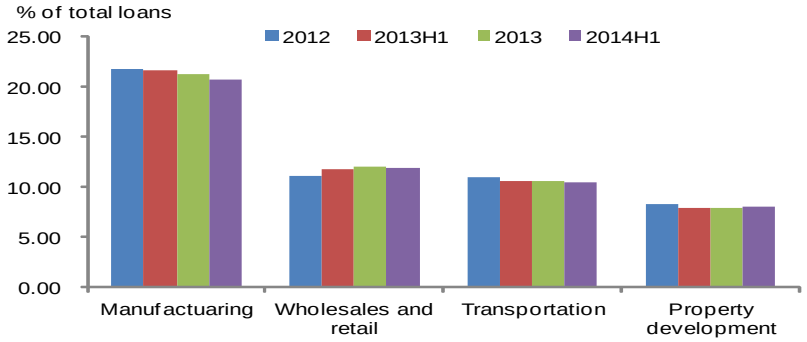
Figure 8. Total assets growth of domestic banks



Source: the company's reports, PSR

According to the distribution of loans, manufacturing, wholesale and retail, transportation, storage & postal, and property development are still the major parts of the banks' loans, especially the proportion of the loans in manufacturing was much higher than others. However, in recent years, the banks increased the proportion of loans in wholesale and retail sector, and reduced the proportion of other main sectors.

Figure 9. Distribution of the loans of domestic banks

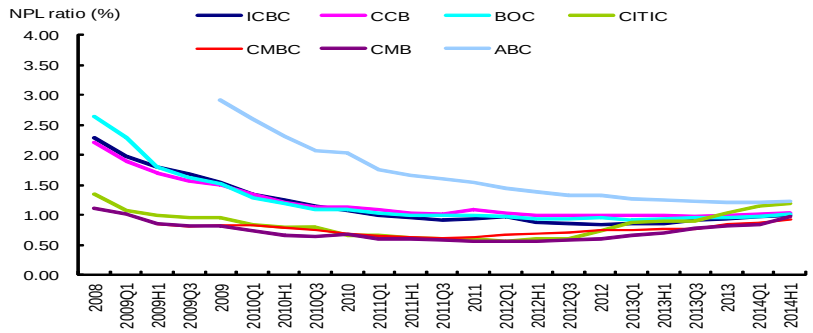


Source: the company's reports, PSR

The bank's asset quality still remained stable, and however, the NPL ratios went up slowly with the increased amount of the NPLs. By the end of 2Q2014, ABC still owned the highest NPL ratio as 1.24% among the peers while CMBC had the lowest one as 0.93%.

We expect most of the banks' NPL ratio will up continually in the next few quarters, representing the continued deterioration of banks' asset quality. However, the absolute value of the NPL ratio still maintained at the low level as 1% in average, therefore total risks are under control in the short term.

Figure 10. NPL ratios of domestic banks

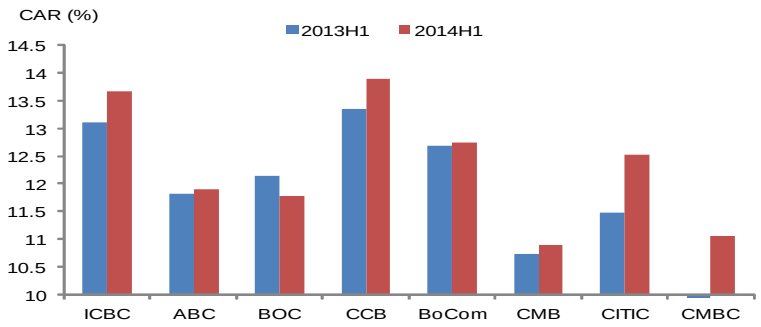


Source: the company's reports, PSR

The other main risk is coming from the capital pressure. Based on the new method approved by the CBRC since 2013, domestic banks' CAR declined obviously, but started to rebound this year. As at the end of Jun 2014, all banks' CAR increased y-y except BOC, CARs of state-owned banks were much lower than others. CMBC and CITIC Bank gained the largest growth of CAR, and CCB had the highest CAR of 13.89% based on the absolute value among the peers.

We expect the CARs will continue to go up in 2H2104.

Figure 11. CARs of domestic banks (based on new method)



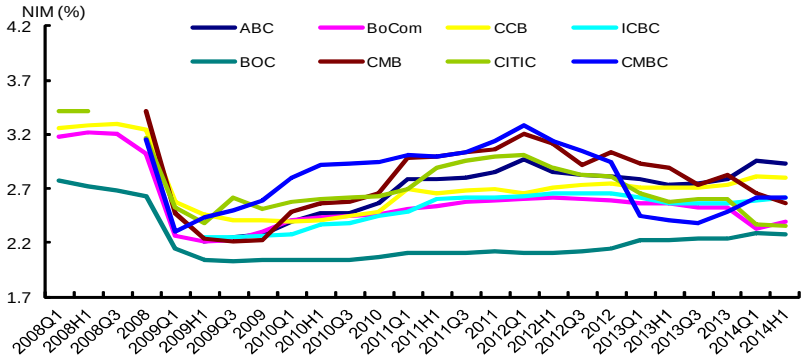
Source: the company's reports, PSR

On the other hand, according to the profit performance, profits of domestic banks continued to increase stably. This is because the bank's NIM maintained at the stable level under the unchanged interest rates made by the PBOC.

By the end of June, BOC's NIM was the lowest among the peers, around 2.27%, but continued to increase slowly. ABC's NIM was the highest as

2.93%, maintained at the stable level. Additionally, CMBC's NIM increased rapidly, and its incomes gained the large growth due to the low base. The performance of ABC's profit growth was better than other large-sized banks.

Figure 12. NIM of domestic banks

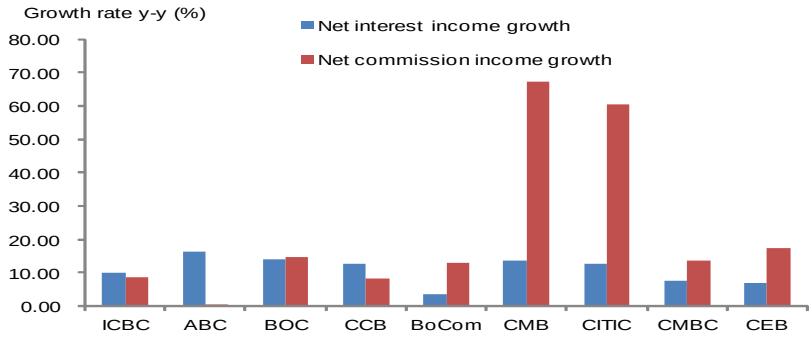


Source: the company's reports, PSR

Due to the stable level of NIM, interest incomes of domestic banks increased slowly, and the growth of non interest incomes also declined because of the stronger market competition. It is worth noting that intermediate businesses of both CMB and CITIC Bank increased significantly, net commission income and fee grew 67.34% and 60.55% y-y to RMB23.702 billion and 12.807 billion respectively.

We expect the banks' incomes would increase continually, but the growth of non interest incomes, especially for commission income and fee will be higher than that of interest incomes.

Figure 13. Growth of net interest incomes and non-interest incomes of domestic banks in 2Q2013

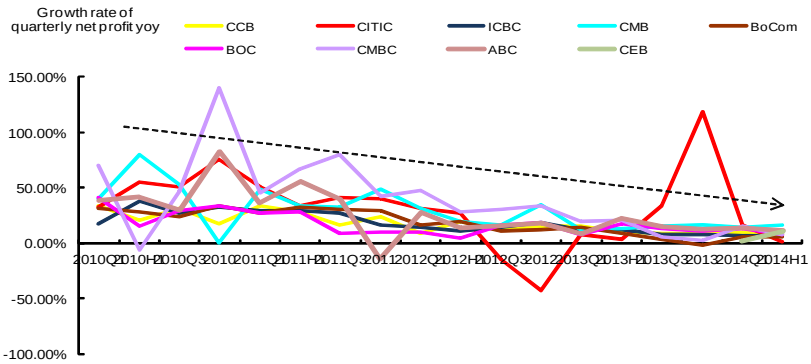


Source: the company's reports, PSR

However, the slow-down of the growth of interest income also caused the bank's profits to decline. By the end of 2Q2014, quarterly net profit of 9 domestic banks increased by 8.67% in average, among which CMB gained the highest growth as 17.09% to RMB15.514 billion, and ABC and CEB also gained the growth rates of 11.6% and 10.43% respectively. CITIC Bank had the lowest one as 1.39% only.

We estimate the quarterly profit growth of domestic banks would continue to decrease, around 7%-8% in average in 2H 2014.

Figure 14. Growth of quarterly net profits of domestic banks

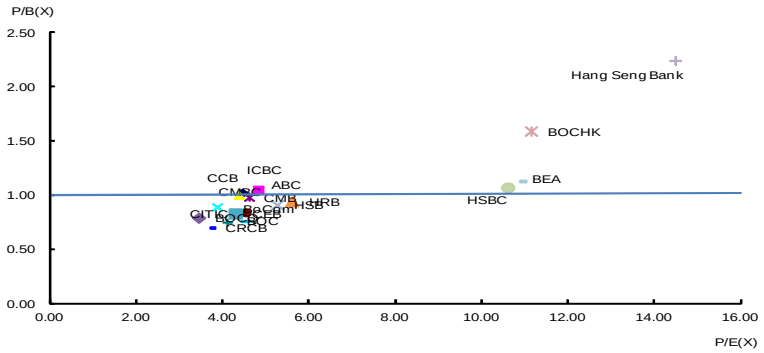


Source: the company's reports, PSR

Recommendation and valuation

Currently, the valuation of domestic banks is relatively lower. Overall, domestic banks' P/B now is below 1.0x and P/E is lower than 10x, around 4.0-6.0x, therefore the valuation is quite attractive.

Figure 15.Valuation of the banks in H Shares



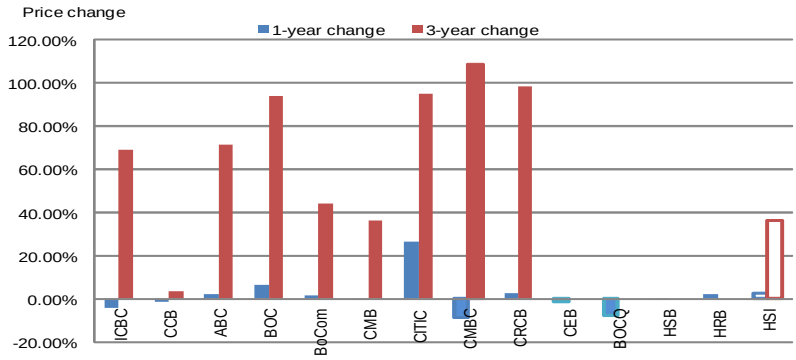
Source: Bloomberg, PSR

Additionally, according to the share price performance, based on the latest closing price (25 Sep), we can see CITIC Bank gained the best share price performance in terms of the return in 1 year. In the long run, most banks' share price performance is better than the benchmark, among which CMBC's return is the highest, as 108.7% in terms of the price return in 3 years, and CCB has the lowest return, only around 3.7%. In the long term, the banks' risk resistance capability is still quite strong.

However, share prices of banks have changed with a remarkable periodicity, and therefore, timing is a very important issue for purchasing.

In summary, considering the operating performance and current share prices of banks, we prefer ABC and BOC among the large-sized state-owned banks, and CMBC, CITIC Bank and CMB among joint-stock commercial banks, and still recommend the Buy rating for the sector.

Figure 16. Price performance of domestic banks



Source: PSR

PHILLIP RESEARCH STOCK SELECTION SYSTEMS

Total Return	Recommendation	Rating	Remarks
>+20%	Buy	1	>20% upside from the current price
+5% to +20%	Accumulate	2	+5% to +20%upside from the current price
-5% to +5%	Neutral	3	Trade within ± 5% from the current price
-5% to -20%	Reduce	4	-5% to -20% downside from the current price
<-20%	Sell	5	>20%downside from the current price

We do not base our recommendations entirely on the above quantitative return bands. We consider qualitative factors like (but not limited to) a stock's risk reward profile, market sentiment, recent rate of share price appreciation, presence or absence of stock price catalysts, and speculative undertones surrounding the stock, before making our final recommendation

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PhillipCapital
Your Partner In Finance
Phillip Securities (Hong Kong) Ltd

Contact Information (Regional Member Companies)

SINGAPORE
Phillip Securities Pte Ltd
Raffles City Tower
250, North Bridge Road #06-00
Singapore 179101
Tel : (65) 6533 6001
Fax : (65) 6535 6631
Website: www.poems.com.sg

HONG KONG
Phillip Securities (HK) Ltd
Exchange Participant of the Stock Exchange of Hong Kong
11/F United Centre 95 Queensway
Hong Kong
Tel (852) 22776600
Fax (852) 28685307
Websites: www.phillip.com.hk

INDONESIA
PT Phillip Securities Indonesia
ANZ Tower Level 23B,
Jl Jend Sudirman Kav 33A
Jakarta 10220 – Indonesia
Tel (62-21) 57900800
Fax (62-21) 57900809
Website: www.phillip.co.id

THAILAND
Phillip Securities (Thailand) Public Co. Ltd
15th Floor, Vorawat Building,
849 Silom Road, Silom, Bangrak,
Bangkok 10500 Thailand
Tel (66-2) 6351700 / 22680999
Fax (66-2) 22680921
Website www.phillip.co.th

UNITED KINGDOM
King & Shaxson Capital Limited
6th Floor, Candlewick House,
120 Cannon Street,
London, EC4N 6AS
Tel (44-20) 7426 5950
Fax (44-20) 7626 1757
Website: www.kingandshaxson.com

AUSTRALIA
PhillipCapital Australia
Level 12, 15 William Street,
Melbourne, Victoria 3000, Australia
Tel (613) 96188238
Fax (613) 92002272
Website: www.phillipcapital.com.au

MALAYSIA
Phillip Capital Management Sdn Bhd
B-3-6 Block B Level 3 Megan Avenue II,
No. 12, Jalan Yap Kwan Seng, 50450
Kuala Lumpur
Tel (603) 21628841
Fax (603) 21665099
Website: www.poems.com.my

JAPAN
PhillipCapital Japan K.K.
Nagata-cho Bldg.,
8F, 2-4-3 Nagata-cho,
Chiyoda-ku, Tokyo 100-0014
Tel (81-3) 35953631
Fax (81-3) 35953630
Website:www.phillip.co.jp

CHINA
Phillip Financial Advisory (Shanghai) Co. Ltd
No 436 Hengfeng Road,
Greentech Unit 604,
Postal code 200070
Tel (86-21) 51699400
Fax (86-21) 63532643
Website: www.phillip.com.cn

FRANCE
King & Shaxson Capital Limited
3rd Floor, 35 Rue de la Bienfaisance 75008
Paris France
Tel (33-1) 45633100
Fax (33-1) 45636017
Website: www.kingandshaxson.com

UNITED STATES
Phillip Futures Inc
141 W Jackson Blvd Ste 3050
The Chicago Board of Trade Building
Chicago, IL 60604 USA
Tel +1.312.356.9000
Fax +1.312.356.9005