

China Merchants Bank (3968.HK)

Steady Profit Growth Maintained

HONG KONG | BANKING | COMPANY REPORT

31 August 2015

Summary

- Based on the 2015H1 earnings result reported by China Merchants Bank (CMB / Group), CMB maintained a stable trend of profit growth. As of June 2015, net profit attributable to shareholders increased by 8.3% to RMB32.976 billion;
- The asset size of CMB maintained its high growth trend. As of 2015H1, the total assets of the Group greatly grew by 10.34% from 2014 to RMB5.22 trillion. During the period, shareholders' net assets reached RMB332.075 billion, which were equivalent to a book value (NAV) per share of RMB13.17, representing a 16.14% increase from 2014;
- The asset quality of the bank remains our main concern. As of June 2015, NPL ratio of the Group jumped by 0.39ppts from 2014 to 1.5%, which was higher than our previous expectation. However, NPL allowance coverage ratio dropped by 29.25ppts to 204.17%;
- The capital adequacy ratio of CMB has been persistently lower than its peers. Although the bank has delivered stable growth, it still faces relatively higher fund-raising pressure. As of June, the core Tier 1 capital adequacy ratio and capital adequacy ratio of CMB rose by 0.07ppts and 0.03ppts from 2014 to 9.67% and 11.77% respectively. We expect that CMB will have higher funding needs in future;
- Overall speaking, CMB delivered stable growth, but its asset quality and capital adequacy will continue to be the major operating risks in future. We are still positive on the outlook of CMB's operating performance. Factoring its stable dividend payout record into the three-stage dividend discounting model, and considering the risks associated with huge volatility of the stock market, our target price is downgraded to HKD25.00. It is higher than the latest closing price by 36% and equivalent to a prospective 2016 P/E of 8.7x and P/B of 1.3x. We maintain a "BUY" rating. (Closing price as at 27 Aug 2015)

Stable Profit Growth and Continuous Deterioration in Asset Quality

As of June 2015, net profit attributable to shareholders grew by 8.3% yoy to RMB32.976 billion, which was equivalent to EPS of RMB1.31.

Regarding its operating income, CMB's net interest income grew by 17.7% yoy to RMB6.104 billion while net fee and commission income significantly grew by 45.4% yoy to RMB31.097 billion. The higher than expected growth was mainly driven by the bull market in H1 that led to a surge in fee-based business. However, net profit of CMB was lower than expected. This was mainly due to significant increases in operating expenses, especially from the sharp increase in impairment losses of loans, which surged by 78.7% yoy to RMB291.71 billion. Considering that the asset quality of CMB will continue to deteriorate, we expect its impairment losses on loan will continue to grow at a high level in the coming two years and thus significantly affecting the profitability of CMB. We expect that net profit growth of CMB will maintain at low-teens in the coming two years.

On the other hand, looking into the assets, CMB maintained a relatively high growth trend in its asset size. As of Jun 2015, the total assets of CMB greatly grew by 10.34% from 2014 to RMB5.22 trillion. During the period, shareholders' net assets reached RMB332.075 billion, which were equivalent to a book value (NAV) per share of RMB13.17, representing 16.14% increase from 2014.

The asset quality of the bank remains our main concern. As of June 2015, NPL ratio of the Group jumped by 0.39ppts from 2014 to 1.5%, of which substandard and doubtful loans increased by 62.2% and 12.6% to RMB28.129 and 8.536 billion respectively. However, NPL allowance coverage ratio dropped by 29.25ppts to 204.17%. We expect that both NPL volume and ratio of CMB will continue to rise in the upcoming two quarters in 2015H2.

Buy (Maintain)

CMP: HK\$ 18.34

(Closing price as at 27 Aug 2015)

TARGET: HK\$ 25.00 (+36%)

COMPANY DATA

O/S SHARES (MN) :	4,591
MARKET CAP (HK\$ MN) :	84,197
52 - WK HI/LO (HK\$) :	26.85/ 13.12

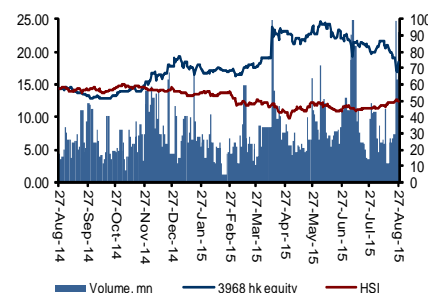
SHARE HOLDING PATTERN, %

HKSCC Nominees Ltd	17.99
China Merchants Steam Navigation Company	12.54
Anbang Property & Casualty Insurance	10.72

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
CMB	-7.09	-26.64	23.75
HSI	-10.88	-20.45	-11.73

PRICE & HSI



Source: Phillip Securities (HK) Research

KEY FINANCIALS

Key Financial Summary

FYE	12/13	12/14	12/15F	12/16F
Operating Profit (RMB mn)	68,337	73,273	76,807	77,906
Net Profit, adj. (RMB mn)	51,743	55,911	58,603	59,588
EPS, adj. (RMB)	2.30	2.22	2.32	2.37
PE (X)	6.6	6.8	6.5	6.4
BVPS (RMB)	10.53	12.47	14.21	15.78
P/B (X)	1.4	1.2	1.1	1.0
DPS (RMB)	0.62	0.67	0.70	0.70
Div. Yield	4.09%	4.39%	4.60%	4.60%

Source: Bloomberg, PSR est.

*All multiples & yields based on current market price

Source: Company reports, Phillip Securities Est.

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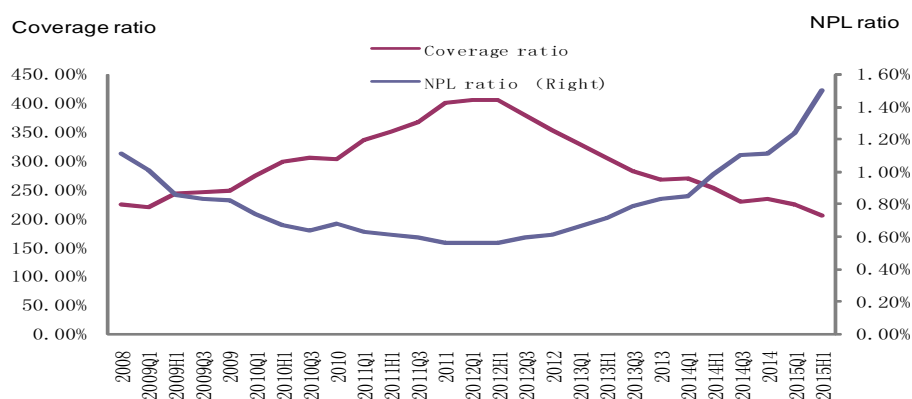
At the same time, CMB's capital adequacy ratio has been persistently low. Although it delivered stable growth, it is still facing relatively higher funding-raising pressure. As of June, the core Tier 1 capital adequacy ratio and capital adequacy ratio of CMB rose by 0.07ppts and 0.03ppts from 2014 to 9.67% and 11.77% respectively. We expect that CMB will have higher funding needs in future.

The structure of CMB's NPLs

Loan quality analysis (RMB Million)	2014A	2015H1	Growth rate y-y	Portion (2014)	Portion (2015H1)
Normal	2,439,368	2,542,454	4.23%	97.03%	96.08%
Special Mention	46,634	64,088	37.43%	1.86%	2.42%
Substandard	17,343	28,129	62.19%	0.69%	1.06%
Doubtful	7,580	8,536	12.61%	0.30%	0.32%
Loss	2,994	2,950	-1.47%	0.12%	0.11%
Total non-performing loans	27,917	39,615	41.90%	1.11%	1.50%
Total loans and advances to customers	2,513,919	2,646,157	5.26%	100.00%	100.00%
Asset quality ratios					Changes (ppt)
Non-performing loan ratio	1.11%	1.50%			0.39
Allowances for impairment losses to non-performing loans	233.42%	204.17%			-29.25

Source: Company, Phillip Securities (HK) Research

NPL and coverage ratios of CMB



Source: Company, Phillip Securities (HK) Research

Risk

Surge in NPL volume, worse than expected deterioration in asset quality;
 Slower than expected growth in Interest and non-interest income;
 Sharp share price correction amid volatile market in the near term

FINANCIALS

FYE	FY12	FY13	FY14	FY15F	FY16F
Valuation Ratios					
P/E (X)	7.2	6.6	6.8	6.5	6.4
P/B (X)	1.6	1.4	1.2	1.1	1.0
Dividend Payout ratio	30.02%	30.22%	30.00%	30.00%	30.00%
Dividend Yield	4.16%	4.09%	4.39%	4.60%	4.60%
Per share data (RMB)					
EPS, reported	2.10	2.30	2.22	2.32	2.37
EPS, adj.	2.10	2.30	2.22	2.32	2.37
DPS	0.63	0.62	0.67	0.70	0.70
BVPS	9.28	10.53	12.47	14.21	15.78
Growth					
Net interest income	15.8%	11.9%	13.2%	13.0%	9.0%
Net fee and commission income(exp.)	26.3%	47.8%	53.2%	46.1%	41.1%
Operating profit	26.4%	14.9%	7.2%	4.8%	1.4%
Net Income, adj.	25.3%	14.3%	8.1%	4.8%	1.7%
Key Ratios					
Net interest spread	2.87%	2.65%	2.45%	2.72%	2.93%
Net interest margin	3.03%	2.82%	2.64%	2.90%	3.14%
Loan to deposit	73.58%	77.41%	74.11%	75.13%	77.22%
Cost to income ratio	35.84%	34.23%	30.42%	21.28%	28.10%
ROAA	1.46%	1.39%	1.28%	1.15%	1.02%
ROAE	24.78%	22.22%	19.25%	17.38%	15.57%
NPL ratio	0.61%	0.83%	1.11%	1.79%	1.45%
Coverage ratio	351.79%	266.00%	233.42%	191.40%	176.09%
Core CAR	8.34%	9.27%	9.60%	9.80%	10.10%
CAR	11.41%	11.14%	11.74%	11.88%	12.16%
Income Statement (RMB mn)					
	FY12	FY13	FY14	FY15F	FY16F
Net interest income	88,374	98,913	112,000	126,537	137,982
Net fee and commission income	19,739	29,184	44,696	65,286	92,092
Operating income	113,754	133,030	166,367	203,196	242,586
Operating expenses	(48,350)	(54,144)	(61,081)	(69,022)	(75,924)
Operating profit before impairment losses	65,083	78,555	104,954	133,832	166,296
Impairment losses	(5,583)	(10,218)	(31,681)	(57,026)	(88,390)
Operating profit	59,500	68,337	73,273	76,807	77,906
Profit before tax	59,564	68,425	73,431	77,009	78,208
Income tax	(14,287)	(16,683)	(17,382)	(18,251)	(18,434)
Effective income tax rate	23.99%	24.38%	23.67%	23.70%	23.57%
Profit before tax	45,277	51,742	56,049	58,758	59,774
Minority interest	4	(1)	138	155	186
Net profit attributable to equity holders of the B	45,273	51,743	55,911	58,603	59,588
Declared and paid Dividends	13,593	15,636	16,773	17,581	17,877
Balance Sheet (RMB mn)					
	FY12	FY13	FY14	FY15F	FY16F
Cash and balances with banks and other financial inst	280,870	38,850	55,986	78,380	105,814
Balances with central bank	471,415	517,239	654,785	661,333	694,399
Placements with banks and other financial institutions	103,420	148,047	124,085	105,472	110,746
Loans and advances to customers	1,863,325	2,148,330	2,448,754	2,693,629	2,989,929
Investments	642,513	1,101,706	1,366,441	1,844,168	2,160,865
Fixed assets	20,392	24,199	27,445	30,190	33,208
Intangible assets	2,851	2,996	3,292	3,358	3,492
Deferred tax assets	4,993	8,064	10,291	18,009	26,113
Goodwill	9,598	9,953	9,953	9,954	9,954
Other assets	8,722	9,604	14,091	17,614	21,137
Total Assets	3,408,099	4,016,399	4,731,829	5,495,825	6,206,940
Deposits from banks and other financial institutions	258,692	514,182	697,448	927,606	1,096,430
Placements from banks and other financial institutions	109,815	125,132	94,603	95,549	109,881
Deposits from customers	2,532,444	2,775,276	3,304,438	3,585,315	3,872,140
Financial liabilities at fair value through profit or loss	6,854	21,891	13,369	15,374	18,449
Current taxation	6,679	8,722	11,656	17,134	23,988
Deferred tax liabilities	813	770	771	779	786
Other liabilities	26,471	38,028	39,678	92,847	106,773
Total Liabilities	3,207,698	3,750,443	4,416,769	5,136,469	5,800,922
Share capital	21,577	25,220	25,220	25,220	25,655
Capital reserve	37,508	67,515	67,523	67,523	67,523
Surplus reserve	18,618	23,502	28,690	28,690	28,690
Investment revaluation reserve	37	(5,539)	1,902	3,424	3,458
Regulatory general reserve	39,195	46,347	53,979	54,000	54,162
Retained profits	71,326	95,471	121,665	163,031	208,680
Shareholder's equity	200,328	265,465	314,404	358,294	404,752
Minority interest	73	491	656	1,062	1,266
Total shareholders' equity	200,401	265,956	315,060	359,356	406,018
Total shareholders' equity and liabilities	3,408,099	4,016,399	4,731,829	5,495,825	6,206,940

Source: PSR

Source: Company, Phillip Securities (HK) Research Estimates

(Financial figures as at 27 August 2015)

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 $\pm 5\%$ 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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