

BoCom (3328.HK)

Stable operating performance but asset quality being hidden risk

CHINA | BANKING | COMPANY REPORT

9 September 2015

Summary

- According to the 2015H1 interim results released by Bank of Communication (“BoCom” or the “Group” in the following text), as at the end of June 2015, the Group’s net profit attributable to shareholders approximately amounted to RMB37.324 billion, up 1.5% yoy, basically in line with our previous expectation, representing the EPS of RMB0.50. However, the growth rate of net profit is far slower than 2014H1, which is mainly due to the significant increase of interest expenses in the period under review, causing the yoy growth rate of net interest income slowed down to 5.73%. Meanwhile, due to the significant increase of bad debt, the Group’s impairment of asset consistently surged: increased approximately 13% yoy to RMB11.454 billion. On the other hand, BoCom’s income from intermediate business still kept stable growth, and the net administration fee and commission incomes in the period under review increased approximately 23.5% yoy, to RMB19.386 billion;
- We keep an eye on the asset quality of BoCom, which appeared to become worse in 2015Q2. Due to the continued growth of risk of making loans, BoCom kept contracting the loans to SMMEs. As at the end of June 2015, the portions of loans to domestic SMMEs to total loans decreased to 36.73% with the amount of RMB1.29 trillion. Due to the sluggish macroeconomic environment in the recent two years, BoCom’s rates of NPLs climbed up from 1.25% in end of 2014, to 1.35% in end of June 2015, with doubtful loan and loss loan particularly surged. The provision coverage ratio dropped from 178.88% in end of 2014, to 170.43%, down 8.45ppts. We believe the asset quality of BoCom will keep deteriorating, while the amount and ratio of NPLs will keep growing, and the NPL ratio would go up to 1.45% in 2015, the trend meets our expectation;
- The level of capital adequacy ratio of BoCom has been lowered. As at the end of June 2015, the core tier-one CAR and CAR dropped 0.44 ppts and 0.92 ppts respectively compared to end of 2014, reaching 10.86% and 13.12%;
- BoCom has steady development on its business, with profit growth slowing down. We expect its net profit growth in 2015 would be lower than 2014, keeping at 2% approximately. In addition, BoCom’s dividend payout ratio still stays at the level of 30%, based on 3-stage dividend discount model, to reflect the upcoming market risk, we lower the Group’s 12-month target price to HK\$7.00, which is around 34% higher than the latest closing price, equivalent to 6.3xEPS and 0.8xBVPS in 2016E respectively. The valuation is quite attractive, and we maintain the “Buy” rating. (Closing price as at 7 September 2015)

Profit growth slows down in 2015

As at the end of June 2015, the Group’s net profit attributable to shareholders approximately amounted to RMB37.324 billion, up 1.5% yoy, basically in line with our previous expectation, representing the EPS of RMB0.50. However, the growth rate of net profit is less than that in the same period last year, which is mainly due to the significant increase of interest expenses in the period under review, causing the yoy growth rate of net interest income slowed down to 5.73%. Meanwhile, due to the significant increase of bad debt, the Group’s impairment of asset consistently surged: increased approximately 12.75% to RMB11.454 billion.

Buy (Maintain)

CMP: HK\$ 5.22

(Closing price as at 7 September 2015)

TARGET: HK\$ 7.00 (+34%)

COMPANY DATA

O/S SHARES (MN) :	35,012
MARKET CAP (HK\$ MN) :	182,762
52 - WK HI/LO (HK\$) :	8.61 / 5.22

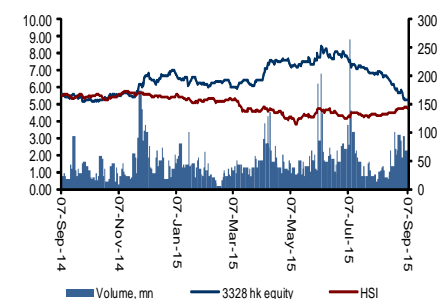
SHARE HOLDING PATTERN, %

MOF:	26.53
HKSCC Nominees	20.12
HSBC	18.70

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
BoCom	-23.91	-38.00	-10.31
HSI	-16.06	-24.65	-18.29

PRICE & HSI



Source: Phillip Securities (HK) Research

KEY FINANCIALS

Key Financial Summary

	12/13	12/14	12/15F	12/16F
FYE				
Operating Profit (RMB mn)	79,867	84,837	86,094	87,480
Net Profit, adj. (RMB mn)	62,295	65,850	66,681	67,456
EPS, adj. (RMB)	0.84	0.89	0.90	0.91
PIE (X)	5.1	4.8	4.8	4.7
BVPS (RMB)	5.65	6.34	6.80	7.30
PIB (X)	0.8	0.7	0.6	0.6
DPS (RMB)	0.26	0.27	0.27	0.27
Div. Yield	6.1%	6.2%	6.3%	6.4%

Source: Bloomberg, PSR est.

*All multiples & yields based on current market price

Source: Company reports, Phillip Securities Est.

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In 2015H1, having benefitted from the improvement of market environment, BoCom's income from intermediate business recorded faster growth, and the net administration fee and commission incomes in the period under review increased approximately 23.47% yoy, to RMB19.386 billion. Among these, incomes from investment banking business and management fees and commission surged 48.95% and 38.86% respectively, reaching RMB4.686 billion and RMB5.028 billion respectively. Income from bank card fees also recorded an increase of 7.21% yoy to RMB5.487 billion.

The market has undergone severe volatility since mid-June 2015, and therefore we expect the market situation would further worsen in 2015H2. However, BoCom's income from interest margin and intermediate business would keep stable growth throughout the whole year. On the other hand, the increase of operating expenses, in particular the surge of impairment of asset, caused a consistent drop in the Group's net profit growth rate, which kept at around 1%, approximately amounted to RMB67 billion.

It is worth to note that, with respect to the continued growth of NPL, we expect BoCom's impairment provision would still significantly increase if the Group's profit growth rate still maintain at a low level. Therefore, there is the risk for the Group's profit growth rate changing from positive to negative in 2015Q4 or the next year.

The growth of BoCom's commission fees by the end of 1H2015

RMB Million	2015H1	2014H1	growth rate y-y
			2015H1
Settlement fees	794	864	-8.10%
Bank card fees	2,909	2,407	20.86%
Guarantee and commitment commission income	1,051	785	33.89%
Management income	2,283	1,536	48.63%
Investment banking income	2,667	2,230	19.60%
agency fees	741	488	51.84%
Others	150	152	-1.32%

Source: Company, Phillip Securities (HK) Research

Asset quality keeps deteriorating

The asset of BoCom keeps stable growth. The Group's total asset recorded as at end of June 2015 increased nearly 13.62% compared to end of 2014, to RMB7.12 trillion; while net asset growth reached around 3.76%, to RMB488.779 billion, representing BVPS amounted to RMB6.58.

On the other hand, as at the end of June 2015, the portions of loans to domestic SMMEs to total loans decreased to 36.73% with the amount of RMB1.29 trillion. BoCom's rates of NPLs climbed up from 1.25% in end of 2014, to 1.35% in end of June 2015, with doubtful loan and loss loan particularly surged. The provision coverage ratio dropped from 178.88% in end of 2014, to 170.43%, down 8.45ppts.

Meanwhile, BoCom's loans overdue more than 90 days significantly increased 59% compared to end of 2014, to RMB70.993 billion. Since such overdue loans would probably turn to loss loan, there is higher risk for BoCom to face the deterioration of asset quality in the future.

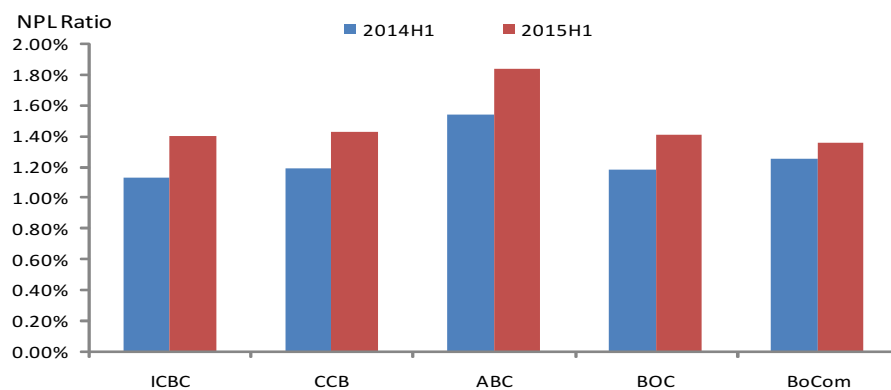
We believe the portion and amount of NPLs of BoCom would keep growing in the near future, and the NPL ratio would go up to 1.45% in 2015, such trend meets our expectation.

The breakdown of BoCom's five loan categories (stipulated by the Chinese banking regulatory authorities) in 1H2015

Loan quality analysis (RMB Million)	2014A	2015H1	Growth rate	Portion (2014)	Portion (2015H1)
Normal	3,296,815	3,538,680	7.34%	96.07%	95.40%
Special Mention	91,903	120,319	30.92%	2.68%	3.24%
Substandard	16,103	15,673	-2.67%	0.47%	0.42%
Doubtful	18,680	22,017	17.86%	0.54%	0.59%
Loss	8,234	12,463	51.36%	0.24%	0.34%
Total non-performing loans	43,017	50,153	16.59%	1.25%	1.35%
Total loans and advances to customers	3,431,735	3,709,152	8.08%	100.00%	100.00%
Asset quality ratios			Changes (ppt)		
Non-performing loan ratio	1.25%	1.35%	0.10		
Allowances for impairment losses to non-performing loans	178.88%	170.43%	-8.45		

Source: Company, Phillip Securities (HK) Research

NPL ratios of Big-5 in 1H2015



Source: Company, Phillip Securities (HK) Research

Risk

Lower-than-expected growth rate of income;
Worse-than-expected asset quality due to consistent growth of the amount of NPLs;
Increase in capital pressure;
Significant short-term drop in stock price due to market volatility.

FINANCIALS

FYE	FY12	FY13	FY14	FY15F	FY16F
Valuation Ratios					
P/E (X)	4.8	5.1	4.8	4.8	4.7
P/B (X)	0.8	0.8	0.7	0.6	0.6
Dividend Payout ratio	30.53%	30.99%	30.45%	30.00%	30.00%
Dividend Yield	5.60%	6.07%	6.21%	6.28%	6.36%
Per share data (RMB)					
EPS, reported	0.88	0.84	0.89	0.90	0.91
EPS, adj.	0.88	0.84	0.89	0.90	0.91
DPS	0.24	0.26	0.27	0.27	0.27
BV/PS	5.12	5.65	6.34	6.80	7.30
Growth					
Net interest income	17.1%	8.8%	3.2%	5.7%	4.6%
Net fee and commission income(exp.)	6.8%	24.4%	14.0%	12.3%	9.5%
Operating income	16.0%	11.4%	8.2%	4.4%	6.9%
Net Income, adj.	15.1%	6.7%	5.7%	1.3%	1.2%
Key Ratios					
Net interest spread	2.43%	2.33%	2.17%	2.29%	2.35%
Net interest margin	2.59%	2.52%	2.36%	2.48%	2.54%
Loan to deposit ratio	73.23%	79.17%	79.25%	77.29%	77.29%
Cost-to-income ratio	29.85%	29.68%	30.52%	30.08%	30.50%
Return on average assets	1.18%	1.11%	1.08%	0.98%	0.86%
Return on average equity	17.91%	15.58%	14.79%	13.66%	12.88%
Non-performing loan ratio	0.92%	1.05%	1.16%	1.28%	1.28%
Provision coverage of impaired loans	250.68%	213.65%	207.11%	186.86%	186.86%
Allowances for impairment losses to total loans	2.30%	2.24%	2.34%	2.40%	2.40%
Core capital adequacy ratio	11.24%	9.76%	11.30%	11.56%	11.32%
Capital adequacy ratio	14.07%	12.08%	14.04%	13.92%	13.60%
Income Statement (RMB mn)					
	FY12	FY13	FY14	FY15F	FY16F
Net interest income	120,126	130,658	134,776	142,483	149,075
Net fee and commission income	20,882	25,968	29,604	33,256	36,401
Other incomes	7,176	8,402	14,156	10,700	13,741
Operating income	148,184	165,028	178,536	186,439	199,217
Operating expenses	(57,805)	(65,578)	(70,732)	(72,854)	(78,682)
Insurance business expense	(630)	(1,173)	(2,528)	(4,803)	(6,965)
Operating profit before impairment losses	89,749	98,277	105,276	108,782	113,570
Impairment losses	(14,537)	(18,410)	(20,439)	(22,687)	(26,090)
Operating profit	75,212	79,867	84,837	86,094	87,480
Shares of P/L of Jonit controlled Entities	4	42	90	115	135
Profit before tax	75,216	79,909	84,927	86,209	87,615
Income tax	(16,740)	(17,448)	(18,892)	(19,270)	(19,848)
Effective income tax rate	22.26%	21.83%	22.24%	22.35%	22.65%
Net profit for the period	58,476	62,461	66,035	66,940	67,767
Minority interest	103	166	185	259	311
Net profit attributable to equity holders of the Bank	58,373	62,295	65,850	66,681	67,456
Dividend	17,823	19,308	20,051	20,004	20,237
Balance Sheet (RMB mn)					
	FY12	FY13	FY14	FY15F	FY16F
Cash and balances with banks and other financial institutions	520,963	566,429	525,033	546,034	600,638
Balances with central bank	816,846	896,556	938,055	1,181,949	1,276,505
Financial assets held for trading	52,161	73,310	135,634	203,451	254,314
Loans and advances to customers	2,879,628	3,193,063	3,354,787	3,757,361	4,245,818
Investments	833,618	1,011,594	1,057,174	1,321,468	1,585,761
Fixed assets	45,536	57,179	69,767	80,232	90,662
Deferred tax assets	12,501	17,224	16,077	16,881	20,257
Other assets	112,126	145,582	171,772	231,892	255,081
Total Assets	5,273,379	5,960,937	6,268,299	7,339,269	8,329,037
Deposits and placements from banks and other financial institutions	942,989	1,126,563	1,408,275	1,754,711	2,002,125
Deposits from customers	3,728,412	4,157,833	4,029,668	4,622,029	5,222,893
Financial liabilities at fair value through profit or loss	23,060	28,640	38,580	52,083	59,895
Other liabilities	110,769	113,435	142,139	198,995	256,703
Current taxes	7,125	6,107	7,852	9,030	10,836
Deferred tax liabilities	5	18	32	155	180
Subordinated notes issued	79,572	106,857	168,148	193,370	230,111
Total Liabilities	4,891,932	5,539,453	5,794,694	6,830,372	7,782,743
Share capital	74,263	74,263	74,263	74,263	74,263
Reserves	305,655	345,298	396,792	430,972	467,827
Shareholders' equity	379,918	419,561	471,055	505,235	542,090
Minority interest	1,529	1,923	2,550	3,661	4,205
Total shareholders' equity	381,447	421,484	473,605	508,896	546,294
Total shareholders' equity and liabilities	5,273,379	5,960,937	6,268,299	7,339,269	8,329,037

Source: PSR

Source: Company, Phillip Securities (HK) Research Estimates

(Financial figures as at 7 September 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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