

JPM-pp1

Asia Pacific Equity Research

19 March 2015

China Merchants Bank - H (3968 HK)

Neutral

Price: HK\$17.02

11 Mar 2015

Price Target: HK\$18.00

PT End Date: 31 Dec 2015

FY14 results: beat expectation on NIM expansion and and de-risking of balance sheet

CMB reported FY14 net profits of RMB56bn, up 8% YoY. Net profits in 4Q14 declined by 20% YoY, mainly due to increase in credit costs, which went up to 149bps on annualized basis in 4Q14, up by 112bps YoY, and 56bps qoq. As CMB pre-announced net profits on 13 February, market will focus on details trend instead of bottom-line data. We believe this is a positive set of results. We noted sequential NIM expansion of 18bps qoq, increase in provisioning as loan loss reserve up 8bps qoq to 2.59% and most importantly, de-risking of balance sheet. We expect stock price to react positively following the results announcement.

- **Sequential NIM expansion is upside surprise:** 4Q14 NIM expanded 18bps qoq, reversing the contracting trend seen in previous three quarters. Its NIM improvement is better than industry trend of 2bps qoq. Asset yield went up by 3bps qoq to 4.99% in 4Q14 despite interest rate cut. We believe this is partly contributed by reducing interbank assets of 19% qoq, as interbank yield would be lower than loan yield. Funding costs declined by 15bps qoq to 2.61% in 4Q14, this likely due to reduction of high-cost negotiation deposits and effects of interest rate cut. We noted that CMB's demand deposit rate remained at 1.0x base rate, and term deposits rate remain at 1.07-1.12x PBOC base rate, despite that the ceiling for deposits rate could be 1.3x subsequent to 1 March 2015. We believe CMB has stronger deposits franchise compare to other mid-cap banks.

- **De-risking on investment and interbank book:** High-risk assets, such as trust beneficial rights, WMP and asset management plans issued by other financial institutions, declined to 10% of total assets as at end 2014, compare to 13% as at 1H14. Such high risks assets in investment book declined by 17% HoH to RMB366bn in investment book; and the amount in interbank book was contracted by 31% HoH to RMB110bn at end 2014.

- **De-risking on loan book:** loans in manufacturing, wholesale & retail and mining contributing to 48%, 36% and 14% of HoH NPL increase in 2H14 (Table 2). As such, we saw CMB reducing exposures to these sectors, the total balances of loans manufacturing, wholesale & retail and mining reduced by 10%, 5% and 7% of HoH in 2H14. The focus on loan growth in 2H14 is mainly mortgage and credit loans, which went up by 20.6% and 21.2% HoH respectively.

- **Rising provisioning in 4Q14:** NPL coverage ratio and loan loss provision went up by 5.4ppt qoq and 8bps qoq, respectively to 233% and 2.59% respectively at end 4Q14. As a result, credit costs went up to 149bps in 4Q14 on annualized basis. We believe this will reduce provision pressure in 2015 when pre-provisional profits are going to see pressure due to pricing in of interest rate cuts.

- **Asset quality is a more mixed message:** NPL ratio was 1.11% at end 2014. we noted that NPL amount and ratio only went up by 4% and 1bps qoq in 4Q14. This is better than industry trend, which showed NPL ratio went up by 9bps qoq to 1.25% for commercial banks in China. However, we believe the slow down in CMB's NPL growth likely due to increasing write-off efforts. NPL provision written back due to NPL write-off increased to RMB9.3trn in 2H14, up from RMB5.6trn in 1H14 and RMB2.1trn in FY13. Special-mentioned loans went up by 55% HoH in 2H14, speeded up from 22% HoH in 1H14. On the positive side, loans overdue less than 90 days only went up by 8% HoH in 2H14, slow down from 49% HoH in 1H14, suggesting declining pressure on new NPL formation.

- **Balance sheet liquidity gets relief due to new regulation:** loan-deposits ratio on calculated basis is 76.1%, up 119bps qoq. However, under the new guidelines on LDR regulation released by CBRC, LDR was 70.49%, lower than maximum level of 75%. Therefore, this new guideline relieves CMB from deposits composition and removes some constraint on loan growth.

Table 1: Summary of 2014 results

RMB mn	FY13 Actual	FY14 Actual	YoY	FY14 JPM Est.	Actual vs JPM			
					est	1H14	2H14	HoH
NII	98,913	112,000	13%	109,801	2%	53,858	58,142	8%
Non-Interest Income	34,117	54,367	59%	56,394	-4%	30,559	23,808	-22%
Fees	29,184	44,696	53%	45,034	-1%	23,702	20,994	-11%
Non-fee	4,933	9,671	96%	11,360	-15%	6,857	2,814	-59%
Total Income	133,030	166,367	25%	166,195	0%	84,417	81,950	-3%
Operating expenses	(54,144)	(61,081)	13%	(63,259)	-3%	(27,762)	(33,319)	20%
Staff costs	(26,990)	(29,179)	8%	(33,063)	-12%	(14,375)	(14,804)	3%
Other operating expenses	(27,154)	(31,902)	17%	(30,196)	6%	(13,387)	(18,515)	38%
PPOP	78,886	105,286	33%	102,936	2%	56,655	48,631	-14%
LLP	(10,196)	(31,254)	207%	(29,619)	6%	(16,345)	(14,909)	-9%

Other Provisions	(22)	(427)	1841%	(75)	469%	25	(452)	-1908%
Pre-Tax	68,425	73,431	7%	73,335	0%	40,265	33,166	-18%
Income Tax	(16,683)	(17,382)	4%	(17,497)	-1%	(9,746)	(7,636)	-22%
Attributable Income	51,743	55,911	8%	55,772	0%	30,459	25,452	-16%
Gross Loans	2,197,094	2,513,919	14%	2,513,918	0%	2,422,092	2,513,919	4%
Deposits	2,775,276	3,304,438	19%	3,304,438	0%	3,420,748	3,304,438	-3%
Equity	265,465	314,404	18%	314,632	0%	285,936	314,404	10%
Total Assets	4,016,399	4,731,829	18%	4,731,829	0%	5,033,122	4,731,829	-6%
Key Ratios								
NIM	2.82%	2.52%	-30 bps	2.50%	2 bps	2.57%	2.48%	-9 bps
Cost income ratio	40.7%	36.7%	-399 bps	38.1%	-135 bps	32.9%	40.7%	777 bps
ROE	22.3%	19.3%	-298 bps	19.2%	15 bps	22.1%	17.0%	-514 bps
ROA	1.40%	1.28%	-12 bps	1.27%	1 bps	1.35%	1.04%	-30 bps
NPL Ratio	0.83%	1.11%	28 bps	1.11%	0 bps	0.98%	1.11%	13 bps
NPL Coverage ratio	266%	233%	-33 pt	236%	-3pt	251%	233%	-18 pt
Loan loss reserve	2.22%	2.59%	37 bps	2.62%	-2 bps	2.46%	2.59%	13 bps
LDR	79.2%	76.1%	-309 bps	76.1%	0 bps	70.8%	76.1%	527 bps
Credit costs	0.50%	1.33%	83 bps	1.26%	7 bps	1.42%	1.21%	-21 bps
Tier 1 Ratio	9.27%	10.44%	117 bps	10.38%	5 bps	9.47%	10.44%	97 bps
Total CAR	11.14%	12.38%	125 bps	12.37%	1 bps	11.45%	12.38%	93 bps
Dividend payout ratio	30%	30%	19 bps	30%	22 bps			

Source: Company reports, JP Morgan estimates.

Table 2: CMB reduce exposures to sectors seeing fast NPL formation

RMB mn	1H14	2H14	HoH growth	Contribution to NPL growth
NPL amount				
Manufacturing	7,618	9,628	26%	48%
W&R	5,012	6,547	31%	36%
Mining	1,043	1,629	56%	14%
Others	10,024	10,113	1%	2%
Total NPL	23,697	27,917	18%	100%
O/S loans	1H14	2H14	HoH growth	
Manufacturing	378,795	342,005	-10%	
W&R	272,456	259,298	-5%	
Mining	65,625	61,179	-7%	
Others	1,705,216	1,851,437	9%	
Total loans	2,422,092	2,513,919	4%	

Source: Company reports

Table 3: Summary of 4Q14 financials

RMB mn	4Q13	1Q14	2Q14	3Q14	4Q14	QoQ	YoY
Key P&L Items							
Nil	26,341	26,183	27,675	28,409	29,733	5%	13%
Non-Interest Income	9,007	14,748	15,811	12,569	11,239	-11%	25%
Fees	7,478	11,611	12,091	10,544	10,450	-1%	40%
Non-fees	1,529	3,137	3,720	2,025	789	-61%	-48%
Total Income	35,348	40,931	43,486	40,978	40,972	0%	16%
Operating expenses	(17,121)	(13,707)	(14,055)	(15,148)	(18,171)	20%	6%
PPOP	18,227	27,224	29,268	25,830	22,632	-12%	24%
LLP	(2,018)	(7,428)	(8,917)	(5,678)	(9,231)	63%	357%
Pre-Tax	16,342	19,761	20,504	20,107	13,059	-35%	-20%
Income Tax	(3,760)	(4,794)	(4,952)	(4,707)	(2,929)	-38%	-22%
Attributable Income	12,576	14,945	15,514	15,345	10,107	-34%	-20%
Key Balance Sheet Items							
Gross Loans	2,197,094	2,349,185	2,422,092	2,445,504	2,513,919	3%	14%
Including NPL amount	18,332	19,870	23,697	26,923	27,917	4%	52%
Total deposits	2,775,276	3,057,360	3,420,748	3,265,520	3,304,438	1%	19%
Total assets	4,016,399	4,404,549	5,033,122	4,722,648	4,731,829	0%	18%
Equity	265,465	283,335	285,936	301,915	314,404	4%	18%
Key Ratios							
NIM	2.79%	2.65%	2.49%	2.39%	2.57%	18bp	-22bp
Cost income ratio	48.4%	33.5%	32.3%	37.0%	44.3%	738bp	-409bp
ROE	19.3%	21.8%	21.8%	20.9%	13.1%	-776bp	-613bp
ROA	1.27%	1.42%	1.32%	1.26%	0.86%	-40bp	-42bp
NPL Ratio	0.83%	0.85%	0.98%	1.10%	1.11%	1bp	28bp
NPL Coverage ratio	266.0%	268.0%	251.3%	228.0%	233.4%	543bp	-3258bp
Loan loss reserve	2.22%	2.27%	2.46%	2.51%	2.59%	8bp	37bp
Credit cost	0.37%	1.31%	1.50%	0.93%	1.49%	56bp	112bp
LDR	79.2%	76.8%	70.8%	74.9%	76.1%	119bp	-309bp
Tier 1 Ratio	9.27%	9.09%	9.47%	10.35%	10.44%	9bp	117bp
Total CAR	11.14%	10.90%	11.45%	12.28%	12.38%	10bp	125bp

Source: Company reports.

Table 4: CMB's SML growth increased while overdue loans growth slowed down

RMB mn	2H13	1H14	2H14	HoH	YoY
NPL	18,332	23,697	27,917	18%	52%

SML	24,603	30,071	46,634	55%	90%
Overdue loans	32,995	45,050	52,704	17%	60%
Overdue loans (less than 90 days)	17,017	25,338	27,480	8%	61%

Source: Company reports

Table 5: Overview of CMB's provision

	4Q13	1Q14	2Q14	3Q14	4Q14	QoQ	YoY
Loan loss reserve ratio	2.22%	2.27%	2.46%	2.51%	2.59%	8 bps	37 bps
NPL coverage ratio	266%	268%	251%	228%	233%	5 pt	-33 pt
Credit cost	0.37%	1.31%	1.50%	0.93%	1.49%	56 bps	112 bps

Source: Company reports

Investment Thesis

- CMB increased the non-standardized assets issued by other financial institutions, such as Trust beneficial rights, from 0.4% of total assets at end 2012 to 9% at end 2013, making it more vulnerable to new regulation on interbank transactions.
- CMB potentially has provisions and capital charges on the TBR on its balance sheets.
- In addition, new regulations may slow down expansion of WMPs, add pressure on its deposits growth and funding costs, as well as reduce assets yield if the mix of TBR reduced on its investment and interbank book. This would eventually lead to further NIM contraction (NIM contracted 14bps qoq in 1Q14).
- Nonetheless, we think CMB has the best retail franchise among the mid-cap banks, with the highest retail deposits per branch and lowest retail deposit costs among peers.
- CMB's demand-deposit ratio was 50.9% at end-2013, the highest among joint-stock banks under our coverage.

Valuation

Our Dec-15 price target of HK\$18.0 is DDM-derived, assuming a cost of equity of 14.9%, normalized ROE of 13.8%, and terminal date of 31 December 2016.

Risks to Rating and Price Target

- Downside risk: Further NIM compression due to pressure on liability business.
- Downside risk: Asset quality worse than expected.
- Upside risk: Fee income higher than expected
- Upside risk: NIM expansion due to loan mix optimization

Banks & Financial Services

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Date	Rating	Share Price (HK\$)	Price Target (HK\$)
13-Apr-07	OW	14.03	21.50
17-Apr-07	OW	15.14	22.30
09-Jul-07	OW	18.77	27.20
12-Aug-07	OW	21.85	32.00
23-Oct-07	OW	29.96	46.60
13-Jan-08	N	24.54	40.40
26-Feb-08	N	19.12	36.30
18-Mar-08	OW	16.46	33.70
28-Apr-08	N	24.46	35.90
07-Nov-08	N	9.82	24.10
07-Jan-09	N	11.34	21.60
04-Mar-09	N	9.23	20.80
28-Jun-09	N	17.72	21.80
31-Aug-09	N	16.88	21.50
02-Mar-10	N	19.80	23.30
14-Apr-10	N	20.85	23.50
09-Aug-10	N	21.45	22.50
27-Nov-10	N	20.75	23.50
23-Mar-11	N	20.65	24.70
31-Aug-11	N	16.40	23.30
12-Jan-12	N	16.70	22.90
29-Mar-12	N	15.36	21.30
31-Jul-12	UW	14.12	14.25
20-Feb-13	N	18.00	19.40
28-Apr-13	N	16.14	17.90
10-Sep-13	N	14.74	17.00
09-Feb-14	OW	13.62	16.40
19-May-14	N	13.76	15.50
26-Jun-14	N	15.30	15.40
03-Mar-15	N	17.46	18.00

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