

JPM-pp1

Asia Pacific Equity Research

22 March 2015

China Citic Bank - H (998 HK)

Underweight

Price: HK\$5.99

20 Mar 2015

Price Target: HK\$4.80

PT End Date: 31 Dec 2015

FY14 results – no dividend, rising troubled loans, tight balance sheet liquidity

Citic Bank announced FY14 net profits of RMB40.7bn, up 4% YoY. As Citic has made pre-announcements on its net profits and key data (i.e. NPLs), we believe the market will focus on the details of the data and sequential trends. NIM went up by 10bps qoq in 4Q14, and is a key upside surprise. However, the continued worsening asset quality indicators (newly overdue loans and special-mention loans) signal pressure on NPL formation is yet to peak, despite declining NPLs due to the increase in write-off/disposal efforts. In addition, rising exposure to high-risk investment assets may increase overall credit risks and regulatory risks. On the other hand, Citic Bank cut its cash dividend to zero, as they do not want to affect the progress of the pending placement plan. This is a key negative surprise. The read-across, in our view, is that Minsheng may also cut its cash dividend as they also have a placement plan pending regulatory approval. We remain UW rating on Citic Bank.

What we like about the results?

- **NIM improved by 10bps qoq.** This is mainly due to: a) reduction in deposit costs as deposit costs declined by 7bps HoH. We noted that after PBOC announced to allow deposits to be priced at 1.3x base rates, Citic's demand deposit rate was still at 1.1x and term deposits at ~1.1-1.2x base rates (Table 3); b) the decline in interbank funding costs due to declining market rates (in 4Q); and c) due to reduction of interbank assets in interest-earning assets (IEA) from 12% at end 3Q14 to 7% of IEA at end 4Q14, at the same time, investment increased to 26% of IEA, up 4ppt qoq. Interbank yield was 162bps lower than investment yield in 2H14.
- **Declining NPL and some de-risking in corporate loan book:** The NPL ratio declined by 8bps qoq to 1.30%, however, as this was included in the results pre-announcement on 27 January 2015, this is not a surprise to the market. Credit cost was 98bps in 4Q14, and loan-loss provision was 2.36% at end 2014, down 16bps qoq. We believe the NPL decline is mainly due to efforts to write down NPLs, as provision released from NPL write-off/disposal was RMB8.1bn in 2H14, up from RMB3.5bn in 1H14 and RMB5.3bn in 2013. Manufacturing and wholesale & retail contributed to 49% of total NPL growth in 2H14. We note that these two categories of loans contracted by 11% and 10%, respectively, HoH. We believe this is partly due to NPL write-off.
- **Announced to issue up to RMB35bn of preference shares:** We calculate that this will increase the tier-1 capital ratio by 106bps and reduce common shareholders' equity by 29bps in 2015 (Table 5). Structure of preference share is similar to a few details: a) size: no more than RMB35bn of preference shares; b) investors: no more than 200 investors for each tranche, and the RMB35bn can be issued in multiple tranches; c) preference shares will be issued domestically; d) CITIC has the right to redeem the preference shares after five years of issuance; e) preference shares are subject to conversion into equity if the core ratio drops to 5.125% or at the discretion of CBRC/relevant regulatory bodies. Conversion price will be average of 20-days trading price prior to this announcement (RMB6.98); and f) the plan is subject to approvals by shareholders (A and H), CSRC and CBRC. We assume that with the completion of placement RMB11.9 bn new shares announced on 29 October 2014 and RMB35bn of preference shares, tier 1 ratio will be up by ~140bps in total.

What don't we like about the results?

- **Pressure on asset quality persists:** Overdue loans increased by 41% HoH to 3.4% of total loans at end 2H14. More alarmingly, loans overdue less than 90 days increased by 69% HoH, indicating that NPL formation pressure continues. In addition, special mention loans amount increased by 79% HoH, to 3.1% of total loans. Also, we note that CITIC bank aggressively expanded its retail loan book, such as credit card loans and small business loans. NPLs from the retail sector went up by 15% HoH, contributing 23% of total NPL growth.
- **High-risk investment assets continue to increase:** such assets include trust beneficial rights, asset management plans and WMP issued by other financial institutions. The balance increased to RMB640bn, up 14% HoH. This contributed to 15% of total assets at end 2014, up from 13% at end 1H14.
- **Liquidity still remains tight:** under the new rule on LDR calculation, loan-deposits ratio was 73.08%, not far from the 75% cap; LDR on calculated basis was 76.8% at end 2014. At the same time, deposit contraction continues at -1% qoq in 4Q14.
- **No cash dividend payment, a negative surprise:** Citic announced a private placement of RMB35bn on 29 October 2014, (please see our note [China Citic Bank: Private placement plan announced, 3Q14 results missed expectations](#)), in order not to affect the progress of approval process of the private placements. We believe this is a negative surprise to the markets. Total tier 1 CAR and

core CAR was 8.99% and 8.93% respectively at end 2014. We assume that the completion of private placements and preference shares issuance will improve core CAR and tier 1 CAR by ~35bps and ~140bps, respectively. But Citic may still see pressure on capital. We believe that Citic will resume cash dividend for 2015 profits, but cash dividend ratio may decline from FY13 level of 30%.

Table 1: Summary of 2014 results

RMB mn	FY13 Actual	FY14 Actual	YoY	Actual vs JPM				
				FY14 JPM Est.	est	1H14	2H14	HoH
NII	85,688	94,741	11%	94,339	0%	45,614	49,127	8%
Non-Interest Income	19,125	30,098	57%	29,948	1%	16,487	13,611	-17%
Fees	16,811	25,313	51%	24,974	1%	12,807	12,506	-2%
Non-fee	2,314	4,785	107%	4,974	-4%	3,680	1,105	-70%
Total Income	104,813	124,839	19%	124,286	0%	62,101	62,738	1%
Operating expenses	(40,435)	(46,796)	16%	(46,150)	1%	(21,086)	(25,710)	22%
Staff costs	(17,797)	(21,156)	19%	(21,657)	-2%	(9,844)	(11,312)	15%
Other operating expenses	(22,638)	(25,640)	13%	(24,494)	5%	(11,242)	(14,398)	28%
PPOP	64,378	78,043	21%	78,136	0%	41,015	37,028	-10%
LLP	(11,327)	(22,074)	95%	(22,055)	0%	(10,914)	(11,160)	2%
Other Provisions	(613)	(1,599)	161%	(1,406)	14%	(703)	(896)	27%
Pre-Tax	52,549	54,574	4%	54,675	0%	29,503	25,071	-15%
Income Tax	(12,832)	(13,120)	2%	(13,397)	-2%	(7,078)	(6,042)	-15%
Attributable Income	39,175	40,692	4%	40,692	0%	22,034	18,658	-15%
Gross Loans	1,941,175	2,187,908	13%	2,182,718	0%	2,119,144	2,187,908	3%
Deposits	2,651,678	2,849,574	7%	2,931,084	-3%	3,053,213	2,849,574	-7%
Equity	225,601	259,677	15%	259,677	0%	239,287	259,677	9%
Total Assets	3,641,193	4,138,815	14%	4,138,818	0%	4,311,187	4,138,815	-4%
Key Ratios								
NIM	2.60%	2.40%	-19 bps	2.35%	6 bps	2.36%	2.45%	9 bps
Cost income ratio	38.6%	37.5%	-109 bps	37.1%	35 bps	34.0%	41.0%	703 bps
ROE	18.5%	16.8%	-171 bps	16.8%	0 bps	19.0%	15.0%	-400 bps
ROA	1.19%	1.05%	-14 bps	1.05%	0 bps	1.1%	0.9%	-23 bps
NPL Ratio	1.03%	1.30%	27 bps	1.33%	-3 bps	1.19%	1.30%	11 bps
NPL Coverage ratio	207%	181%	-25 pt	189%	-7 pt	193%	181%	-11 pt
Loan loss reserve	2.13%	2.36%	23 bps	2.51%	-15 bps	2.30%	2.36%	6 bps
LDR	73.2%	76.8%	357 bps	74.5%	231 bps	69.4%	76.8%	737 bps
Credit costs	0.63%	1.07%	44 bps	1.07%	0 bps	1.08%	1.04%	-4 bps
Tier 1	8.78%	8.99%	21 bps	9.32%	-32 bps	8.77%	8.99%	22 bps
CAR	11.24%	12.33%	110 bps	12.55%	-21 bps	10.98%	12.33%	135 bps
Dividend payout ratio	30%	0%	-30 pt	25%	-25 pt			

Source: Company reports, JP Morgan estimates.

Table 2: Summary of 4Q14 financials

RMB mn	4Q13	1Q14	2Q14	3Q14	4Q14	QoQ	YoY
Key P&L Items							
NII	23,085	22,136	23,478	24,434	24,693	1%	7%
Non-Interest Income	4,911	7,617	8,870	6,073	7,538	24%	53%
Fees	4,421	6,168	6,639	6,028	6,478	7%	47%
Non fee	490	1,449	2,231	45	1,060	2256%	116%
Total Income	27,996	29,753	32,348	30,507	32,231	6%	15%
Operating expenses	(12,708)	(10,510)	(10,576)	(10,807)	(14,903)	38%	17%
PPOP	15,288	19,243	21,772	19,700	17,328	-12%	13%
LLP	(3,711)	(4,647)	(6,267)	(5,876)	(5,284)	-10%	42%
Pre-Tax	11,358	14,374	15,129	13,590	11,481	-16%	1%
Income Tax	(2,882)	(3,443)	(3,635)	(3,162)	(2,880)	-9%	0%
Attributable Income	8,313	10,706	11,328	10,246	8,412	-18%	1%
Key Balance Sheet Items							
Gross Loans	1,941,175	2,043,630	2,119,144	2,124,128	2,187,908	3%	13%
Including NPL amount	19,966	23,584	25,246	29,428	28,454	-3%	43%
Total deposits	2,651,678	2,798,070	3,053,213	2,875,725	2,849,574	-1%	7%
Total assets	3,641,193	3,981,514	4,311,187	4,045,887	4,138,815	2%	14%
Equity	225,601	237,953	239,287	250,091	259,677	4%	15%
Key Ratios							
NIM	2.58%	2.37%	2.34%	2.40%	2.49%	10bp	-9bp
Cost income ratio	45.4%	35.3%	32.7%	35.4%	46.2%	1081bp	85bp
ROE	14.93%	18.48%	18.99%	16.75%	13.20%	-355bp	-173bp
ROA	0.94%	1.12%	1.09%	0.98%	0.82%	-16bp	-12bp
NPL Ratio	1.03%	1.15%	1.19%	1.39%	1.30%	-8bp	27bp
NPL Coverage ratio	206.6%	191.9%	192.7%	181.5%	181.3%	-23bp	-2536bp
Loan loss reserve	2.13%	2.21%	2.30%	2.51%	2.36%	-16bp	23bp
Credit cost	0.78%	0.93%	1.20%	1.11%	0.98%	-13bp	20bp
LDR	73.2%	73.0%	69.4%	73.9%	76.8%	292bp	357bp
Tier 1	8.78%	8.90%	8.77%	9.35%	8.99%	-36bp	21bp
CAR	11.24%	11.09%	10.98%	12.99%	12.33%	-66bp	110bp

Source: Company reports.

Table 3: Citic deposit rates vs PBOC benchmark rates

	PBOC	Citic *	Citic/PBOC
Demand	0.35	0.385	1.10
3 Months	2.10	2.52	1.20
6 Months	2.30	2.76	1.20
1 Year	2.50	3.00	1.20
2 Years	3.10	3.41	1.10
3 Years	3.75	4.13	1.10

Source: Company website. * Deposit rates for urban and rural residents

Table 4: Citic reduce exposures to sectors seeing fast NPL formation

RMB mn	1H14	2H14	HoH growth	Contribution to NPL growth
NPL amount				
Manufacturing	7,735	8,758	13%	32%
W&R	10,490	11,025	5%	17%
Others	2,135	3,040	42%	28%
Total NPL (domestic corporate)	20,360	22,823	12%	77%
Total personal NPL	4,886	5,614	15%	23%
Total NPL	25,246	28,454	13%	100%
O/S loans	1H14	2H14	HoH growth	
Manufacturing	423,064	377,992	-11%	
W&R	306,087	275,963	-10%	
Others	734,075	811,123	10%	
Total loans (domestic corporate)	1,463,226	1,465,078	0%	

Source: Company reports

Table 5: Effects of the preference share issuance on the Citic's financials (2015E), assuming Citic does not leverage up on the preference shares

RMB mn	Before issuance	2015E After issuance	Difference
Share capital, without conversion	46,787	46,787	0%
Share capital, with conversion	46,787	51,801	11%
Common equity	291,732	291,732	0%
Net profit attributable to common equity holders	42,228	41,440	-2%
Return on net assets attributable to ordinary shareholders	15.32%	15.03%	-29bps
Earnings per share attributable to ordinary shareholders	0.90	0.89	-2%
Core capital (net)	299,099	298,311	0%
Tier-1 capital (net)	299,099	333,311	11%
Total capital	390,799	425,011	9%
Risk-weighted assets	3,228,849	3,228,849	0%
Core capital adequacy ratio	9.26%	9.24%	-2bps
Tier-1 capital adequacy ratio	9.26%	10.32%	106bps
Capital adequacy ratio	12.10%	13.16%	106bps

Source: JP Morgan estimates. * Assuming the Issuance of Preference Shares was completed on 1 January 2015 with a total size of RMB80 billion and a coupon rate of 6.0%, and investment yield on additional capital is 5%

Table 6: Citic's overdue loans less than 90 days increased by 69% HoH

RMB mn	2H13	1H14	2H14	HoH	YoY
NPL	19,966	25,246	28,454	13%	43%
SML	23,156	38,008	68,161	79%	194%
Overdue loans	35,589	54,039	75,944	41%	113%
Overdue loans (less than 90 days)	15,424	25,416	43,034	69%	179%

Source: Company reports

Table 7: Overview of Citic's provision

	4Q13	1Q14	2Q14	3Q14	4Q14	QoQ	YoY
Loan loss reserve ratio	2.13%	2.21%	2.30%	2.51%	2.36%	-16 bps	23 bps
NPL coverage ratio	207%	192%	193%	181%	181%	0 pt	-25 pt
Credit cost	0.78%	0.93%	1.20%	1.11%	0.98%	-13 bps	20 bps

Source: Company reports

Table 8: Overview of Citic's high-risk assets

RMB mn	2H13	1H14	2H14	HoH	YoY
Trust schemes	96,999	119,595	108,535	-9%	12%
Brokers' Targeted Asset Management Plans	114,987	350,620	452,319	29%	293%
WMPs by other FIs	65,558	90,782	78,859	-13%	20%
Sum	277,544	560,997	639,713	14%	130%
As % of total assets	2013	1H14	2H14	HoH	YoY

Trust schemes	3%	3%	3%	0 pt	0 pt
Brokers' Targeted Asset Management Plans	3%	8%	11%	3 pt	8 pt
WMPs by other FIs	2%	2%	2%	0 pt	0 pt
Sum	8%	13%	15%	2 pt	8 pt

Source: Company reports

Investment Thesis

- BBVA still holds a 9.9% stake in Citic. Its potential sell-down remains a tangible overhang.
- Citic's retail business lags JSB peers by some distance, with the lowest retail contribution to loan and deposit mix and the highest retail deposit cost.
- Rising risk from non-standardized investment on balance sheets with thin provision: High-risk investment assets increased by 102% HoH to RMB561bn, accounted for 13% of total assets at end 1H14, vs only 8% at end 2013. However, the provision on such assets was only RMB100 mil (nil at end 2013), reserve ratio is only 0.02% (vs loan loss reserve ratio of 2.30% at end 1H14).
- Faster NIM contraction, NPL formation and tighter balance sheet liquidity than peers in 1H14: in 1H14, Citic NIM contracted by 25bps HoH vs peers of 1bp contraction HoH. Citic's NPL and Overdue loans ratio rose by 16bps and 72bps HoH respectively, faster than peers of 7bps and 40bps on average.
- Weak capital position may induce concerns on dividend cut. Citic's tier 1 ratio is 8.77% at end 1H14, lowest among peers (same as Minsheng). And Citic is not on the list for IRB adoption or preference shares issuances. Thus, we believe its capital will come under pressure if Citic wish to continue the growth on non-standardized investments to keep up its NIM. This may induce concern on equity raising or cash dividend cut.

Valuation

Our Dec-15 price target of HK\$4.8 is based on DDM, using a cost of equity of 14.9%, normalised ROE of 10.7%, and terminal date of 31 December 2016.

Risks to Rating and Price Target

- Better-than-expected macro growth should enable Citic to improve its loan pricing power. This may lead to higher ROE than our estimates.
- Synergy with Citic Group subsidiaries may lead to increasing income
- Internet banking business may develop faster than expectation, leading to faster fee income growth

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Date	Rating	Share Price (HK\$)	Price Target (HK\$)
23-Nov-09	OW	6.47	8.60
10-Mar-10	OW	5.71	8.00
30-Apr-10	OW	5.07	7.70
09-Aug-10	OW	5.47	7.50
10-Nov-10	OW	6.14	8.80
27-Nov-10	OW	5.39	7.50
23-Mar-11	OW	5.23	7.40
02-Apr-11	OW	5.54	8.00
30-Aug-11	OW	4.07	7.50
12-Jan-12	OW	4.64	7.70
01-Apr-12	OW	4.60	8.20
31-Jul-12	N	3.80	5.00
07-Nov-12	N	4.05	5.10
19-Feb-13	N	5.05	5.30
01-Apr-13	UW	4.66	4.40
28-Apr-13	UW	4.28	3.95
10-Sep-13	UW	4.16	3.60
30-Oct-13	UW	4.04	3.95
09-Feb-14	UW	3.73	3.60
28-Mar-14	N	4.36	4.00
26-Jun-14	N	4.71	4.20
31-Aug-14	UW	4.89	4.20
03-Mar-15	UW	5.90	4.80

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*Percentage of investment banking clients in each rating category.

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