

JPM-pp1

Asia Pacific Equity Research

24 March 2015

Agricultural Bank of China - H (1288 HK)

Neutral

Price: HK\$3.80

24 Mar 2015

Price Target: HK\$4.10

PT End Date: 31 Dec 2015

FY14 results first read – miss on asset quality

ABC (1288.HK) reported FY14 results today after market. FY14 net profits were RMB179bn, up 8% YoY, but missed JPM and consensus estimates by 3% and 2%, respectively. We consider this set of results a miss, mainly due to the increase in NPL ratio in 4Q by 25bps qoq. In addition, the dividend payout ratio was cut by 2ppt YoY to 33%, slightly lower than the consensus estimate of 35%. ABC's core capital ratio was 9.09% at end 2014, only 59bps above the minimum requirement of 8.5%. We believe ABC will continue to be under capital pressure, particularly amid asset quality deterioration. Key upside is on NIM, which expanded 8bps qoq in 4Q14.

What we don't like about the results:

- **Asset quality deterioration is key downside surprise:** The NPL ratio went up by 25bps qoq in 4Q14, faster than the industry level of 9bps qoq. The NPL amount went up by 21% QoQ. On a semi-annual basis, wholesales & retail, manufacturing, real estate and mining contributed 50%, 22%, 12% and 6% of the increase in NPL, respectively, HoH. The NPL coverage ratio went down by 49ppt qoq to 287% at end 4Q14 from 335% at end 3Q14. Special-mention loan amount went up by 9%, and overdue loans amount went up by 35% HoH.
- **Pressure on capital persists:** Core capital ratio was 9.09%, only 59bps above the minimum requirement of 8.5%. Tier 1 ratio was improved by 56bps to 9.46% at end 4Q14, mainly due to preference shares of RMB40bn. Preference shares are only qualified to be tier-1 ratio, not core ratio. We believe that with sharp NPL deterioration and declining of NPL coverage ratio, there is less room for ABC to cut its provision (i.e. loan-loss provision) in order to strengthen its capital level.
- **Dividend payout ratio declined:** Cash dividend per share was RMB0.182, implying a cash dividend payout ratio of 33% in FY14, down from 35% of FY13. We believe this ratio could further trend down for FY15 as ABC is under capital pressure.
- **Fee income contracted by 4% YoY:** FY14 fee income was RMB80bn, contracting 4% YoY; this missed JPM estimates by 10%. On a quarterly basis, fee income contracted by 21% qoq.

What we like about the results:

- **NIM went up by 8bps qoq:** On a semi-annual basis, loan-deposits spread only improved by 1bp to 4.22% in 2H14. And deposits costs in 2H14 went up by 8bps HoH. Thus, we believe the improvement in NIM could be due mainly to contraction in interbank funding costs by 27bps HoH; interbank liabilities accounted for 10% of total interest-bearing liabilities in 2H14. In addition, investment yield went up by 20bps HoH in 2H14, and investment assets accounted for 21% of total interest earning assets in 2H14.

The analyst briefing is at 6pm today in ABC Tower, Central, HK. We will follow up with details, with a focus on asset quality and capital management plan.

Table 1: Summary of 2014 results

RMB mn	FY13 Actual	FY14 Actual	YoY	FY14 JPM Est.	Actual vs JPM		1H14	2H14	HoH
					est				
NII	376,202	429,891	14%	428,860	0%		209,438	220,453	5%
Non-Interest Income	89,569	94,235	5%	102,702	-8%		58,471	35,764	-39%
Fees	83,171	80,123	-4%	88,579	-10%		47,848	32,275	-33%
Non-fee	6,398	14,112	121%	14,123	0%		10,623	3,489	-67%
Total Income	465,771	524,126	13%	531,562	-1%		267,909	256,217	-4%
Operating expenses	(198,607)	(223,898)	13%	(219,630)	2%		(103,386)	(120,512)	17%
Staff costs	(104,729)	(111,469)	6%	(110,565)	1%		(52,650)	(58,819)	12%
Other operating expenses	(93,878)	(112,429)	20%	(109,065)	3%		(50,736)	(61,693)	22%
PPOP	267,164	300,228	12%	311,932	-4%		164,523	135,705	-18%
LLP	(52,126)	(65,063)	25%	(67,660)	-4%		(27,085)	(37,978)	40%

Other Provisions	(864)	(2,908)	237%	(2,354)	24%	(1,854)	(1,054)	-43%
Pre-Tax	214,174	232,257	8%	241,918	-4%	135,584	96,673	-29%
Income Tax	(47,963)	(52,747)	10%	(56,235)	-6%	(31,517)	(21,230)	-33%
Attributable Income	166,315	179,461	8%	185,348	-3%	104,032	75,429	-27%
Gross Loans	7,224,713	8,098,067	12%	8,232,952	-2%	7,840,907	8,098,067	3%
Deposits	11,811,411	12,533,397	6%	12,937,599	-3%	12,809,504	12,533,397	-2%
Equity	843,108	1,031,066	22%	987,532	4%	906,216	1,031,066	14%
Total Assets	14,562,102	15,974,152	10%	16,488,081	-3%	16,006,612	15,974,152	0%
Key Ratios								
NIM	2.79%	2.92%	13 bps	2.91%	1 bps	2.93%	2.91%	-2 bps
Cost income ratio	42.6%	42.7%	8 bps	41.3%	140 bps	38.6%	47.0%	845 bps
ROE	20.9%	19.2%	-173 bps	20.2%	-110 bps	23.8%	15.6%	-821 bps
ROA	1.20%	1.18%	-2 bps	1.19%	-2 bps	1.36%	0.94%	-42 bps
NPL Ratio	1.22%	1.54%	33 bps	1.34%	20 bps	1.24%	1.54%	30 bps
NPL Coverage ratio	367%	287%	-81 pt	329%	-43 pt	346%	286.53%	-60 pt
Loan loss reserve	4.46%	4.42%	-4 bps	4.43%	-1 bps	4.31%	4.42%	12 bps
LDR	61.2%	64.6%	344 bps	63.6%	98 bps	61.2%	64.6%	340 bps
Credit costs	0.76%	0.85%	9 bps	0.88%	-3 bps	0.72%	0.95%	23 bps
Dividend payout ratio	35%	33%	-148 bps	35%	-191 bps	NA	NA	NA
Core capital ratio	9.25%	9.09%	-16 bps	8.76%	33 bps	8.65%	9.09%	44 bps
Tier 1 Ratio	9.25%	9.46%	21 bps	9.09%	37 bps	8.65%	9.46%	81 bps
Total CAR	11.86%	12.82%	96 bps	12.39%	43 bps	8.65%	12.82%	417 bps

Source: Company reports, JP Morgan estimates.

Table 2: Summary of 4Q14 financials

<i>In Rmb mm unless otherwise stated</i>	4Q13	1Q14	2Q14	3Q14	4Q14	QoQ	YoY
Key P&L Items							
s	100,578	103,142	106,296	108,355	112,098	3%	11%
Non-Interest Income	12,301	33,532	24,939	19,486	16,278	-16%	32%
Fees	15,901	26,887	20,961	18,072	14,203	-21%	-11%
Non-fee	(3,600)	6,645	3,978	1,414	2,075	47%	-158%
Total Income	112,879	136,674	131,235	127,841	128,376	0%	14%
Operating expenses	(55,691)	(53,023)	(50,363)	(50,072)	(70,440)	41%	26%
PPOP	57,188	83,651	80,872	77,769	57,936	-26%	1%
LLP	(20,903)	(13,340)	(13,745)	(16,082)	(21,896)	36%	5%
Pre-Tax	35,681	70,311	65,273	61,687	34,986	-43%	-2%
Income Tax	(7,507)	(16,789)	(14,728)	(13,249)	(7,981)	-40%	6%
Attributable Income	28,327	53,430	50,602	48,407	27,022	-44%	-5%
Key Balance Sheet Items							
Gross Loans	7,224,713	7,552,857	7,840,907	7,997,605	8,098,067	1%	12%
Including NPL amount	87,781	91,991	97,473	103,466	124,970	21%	42%
Total deposits	11,811,411	12,535,428	12,809,504	12,638,575	12,533,397	-1%	6%
Total assets	14,562,102	15,322,116	16,006,612	15,959,249	15,974,152	0%	10%
Equity	843,108	903,632	906,216	957,124	1,031,066	8%	22%
Key Ratios							
NIM	2.92%	2.96%	2.90%	2.87%	2.95%	8bp	3bp
Cost income ratio	49.3%	38.8%	38.4%	39.2%	54.9%	1570bp	553bp
ROE	13.6%	24.5%	22.4%	20.8%	10.9%	-991bp	-269bp
ROA	0.78%	1.43%	1.29%	1.21%	0.68%	-53bp	-10bp
NPL Ratio	1.22%	1.22%	1.24%	1.29%	1.54%	25bp	33bp
NPL Coverage ratio	367.0%	362.3%	346.4%	335.1%	286.5%	-4854bp	-8051bp
Loan loss reserve	4.46%	4.41%	4.31%	4.33%	4.42%	9bp	-4bp
Credit cost	1.17%	0.72%	0.71%	0.81%	1.09%	28bp	-8bp
LDR	61.2%	60.3%	61.2%	63.3%	64.6%	133bp	344bp
Core capital ratio	9.25%	9.48%	8.65%	8.90%	9.09%	19bp	-16bp
Tier 1 Ratio	9.25%	9.48%	8.65%	8.90%	9.46%	56bp	21bp
Total CAR	11.86%	11.87%	11.89%	12.38%	12.82%	44bp	96bp

Source: Company reports.

Investment Thesis

- Competitive advantage in terms of deposit-taking and higher growth potential due to its county exposure.
- ABC to have lower deposits costs and more liquid balance sheet than peers.
- ABC has the highest loan-loss reserve ratio among China banks under our coverage, so it has a higher buffer to earnings should NPL rise.
- Interbank business: We believe ABC has higher exposure to the interbank business with rural credit unions due to its county exposure. Such exposure may be subject to higher risks vs the exposure of other commercial banks.

- The market has high expectations that the issuance of preference shares will be able to lift concerns about capital (ABC has the lowest tier-1 ratio among the Big 4 SOE banks). However, we believe the issuance of preference stocks could be expensive and the process may take longer than expected.

Valuation

- We have a Dec-15 PT of HK\$4.1, based on our DDM using a cost of equity of 14.5%, normalized ROE of 12.5%, and terminal date of 31 December 16.

Risks to Rating and Price Target

- Downside risk: If ABC announces an equity-raising, this would dilute ROE and pose a downside risk to our price target.
- Upside risk: Better-than-expected macro growth, particularly in county areas, would enable ABC to leverage up its balance sheet faster than expected, which might lead to higher ROE than our estimates.

Banks & Financial Services

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Date	Rating	Share Price (HK\$)	Price Target (HK \$)
26-Aug-10	OW	3.42	4.60
29-Aug-10	OW	3.54	4.50
27-Nov-10	N	4.09	5.10
30-Mar-11	N	4.13	5.30
26-Aug-11	N	3.83	5.40
12-Jan-12	OW	3.53	5.90
23-Mar-12	OW	3.56	5.60
31-Jul-12	N	3.16	3.75
19-Feb-13	N	4.11	4.70
28-Apr-13	N	3.69	4.10
10-Sep-13	N	3.65	4.20
31-Oct-13	N	3.69	4.30
09-Feb-14	N	3.29	3.90
17-Oct-14	N	3.44	4.00
03-Mar-15	N	3.79	4.10

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