

**Bank of China**

3988 HK

Target (HKD): **4.80 → 5.20**

Upside: **18.2%**

25 Mar price (HKD): **4.40**

- 1 Buy (unchanged)
- 2 Outperform
- 3 Hold
- 4 Underperform
- 5 Sell

# Sound P&L, but lower dividend

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- FX and sizeable overseas operations boost NIM, offsetting domestic NIM contraction
- We believe the lower dividend is a key disappointment
- Reaffirm Buy (1) and raise TP to HKD5.2; BOC remains our top sector pick despite our cautious sector view

■ **What's new**

Bank of China (BOC) reported a 2014 net profit of CNY169.6bn, in line with our forecast and 1% above the Bloomberg consensus. Its overseas business aided its NIM and low operating expenses offset its slightly higher-than-expected impairment. We expect BOC's 8.1% YoY net profit growth to be the highest among all the state-owned banks under our coverage.

■ **What's the impact**

The NIM at BOC has benefitted from its sizeable overseas operations, with the overall NIM edging up 1bp YoY, despite a 3bp NIM contraction in its domestic Renminbi business. Management said it aims to continue to use its higher NIM from its FX and overseas business to offset the

downward pressure on its domestic Renminbi NIM.

BOC's overseas operations recorded profit-before-tax (PBT) growth of 29.9% YoY and contributed to 23.0% of its total PBT for 2014, up 3.6ppt YoY.

**Asset quality.** BOC also followed the trends seen at its other China bank peers in terms of asset quality, but to a lesser extent in terms of deterioration. (Please refer to page 2 for detailed numbers of these metrics.)

BOC said it sold NPLs worth CNY19.9bn (27% of its end-2013 NPLs) during 2014. Its average NPL-disposal recovery rate was 35%. It wrote off NPLs worth CNY25.1bn (34% of its end-2013 NPLs) in 2014.

**The dividend payout ratio** was lowered to 32.3% in 2014 from 34.9% in 2013.

**Preferred shares.** BOC issued preferred shares of USD6.5bn and CNY32bn in 4Q14. The issuance of preferred shares helped its Tier-1 CAR by 73bps, on our estimates. It issued a further CNY28bn in preferred shares in March 2015. Core CAR had increased by 92bps to 10.61% by end-2014. We estimate that the CB conversion led to a c.25bps improvement in BOC's core CAR.

■ **What we recommend**

We are raising our Gordon Growth Model-based 12-month target price to HKD5.2 (previously a 6-month TP of HKD4.8), which implies a 2015E PBR of 1.1x. We reaffirm our Buy (1) rating on BOC. The main risk to our call would be a drag on the NIM from its overseas business due to a prolonged

delay in the Fed's interest-rate-hike decision.

For the China Banks Sector as a whole, our Neutral rating reflects our cautious view on the asset-quality trend (as we believe spiking provisions and NPL balances, which were a sector-wide issue in 4Q14, will continue in 2015), balanced by the PBOC's monetary-easing policies.

■ **How we differ**

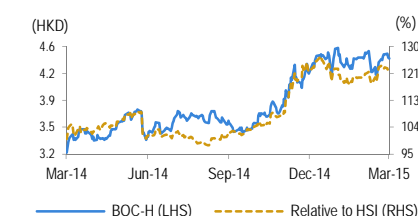
We believe the market might have been too pessimistic on BOC's credit risks with its legacy policy loans back in the 2009 credit boom in China.

**Forecast revisions (%)**

Year to 31 Dec	15E	16E	17E
PPOP change	1.1	(0.1)	n.a.
Net profit change	0.6	(0.8)	n.a.
Core EPS (FD) change	0.5	(0.9)	n.a.

Source: Daiwa forecasts

**Share price performance**



12-month range	3.30-4.53
Market cap (USDbn)	158.37
3m avg daily turnover (USDm)	4,780.50
Shares outstanding (m)	279,147
Major shareholder	Huijin (67.7%)

**Financial summary (CNY)**

Year to 31 Dec	15E	16E	17E
Total operating income (m)	497,970	530,210	559,991
Pre-provision operating profit(m)	305,344	325,823	343,090
Net profit (m)	183,008	192,552	199,824
Core EPS (fully-diluted)	0.625	0.657	0.682
EPS change (%)	8.2	5.2	3.8
Daiwa vs Cons. EPS (%)	0.7	(1.9)	(11.4)
PER (x)	5.6	5.4	5.2
Dividend yield (%)	6.0	6.3	6.6
DPS	0.212	0.223	0.232
PBR (x)	0.8	0.7	0.7
ROE (%)	15.2	14.4	13.6

Source: FactSet, Daiwa forecasts

■ **BOC: P&L summary**

(CNY m)	2014	2013	% YoY	2H14	1H14	2H13	% HoH	% YoY	4Q14	3Q14	4Q13	% QoQ	% YoY
Net interest income	321,102	283,585	13.2	164,427	156,675	146,297	4.9	12.4	82,327	82,100	75,380	0.3	9.2
Non-interest income	135,226	123,924	9.1	57,029	78,197	54,961	(27.1)	3.8	27,851	29,178	26,678	(4.5)	4.4
of which: fees	91,240	82,092	11.1	39,109	52,131	36,611	(25.0)	6.8	19,162	19,947	16,707	(3.9)	14.7
Operating income	456,328	407,509	12.0	221,456	234,872	201,258	(5.7)	10.0	110,178	111,278	102,058	(1.0)	8.0
Operating expenses	(177,788)	(172,314)	3.2	(91,891)	(85,897)	(90,105)	7.0	2.0	(48,224)	(43,667)	(46,912)	10.4	2.8
Pre-provisioning profits	278,540	235,195	18.4	129,565	148,975	111,153	(13.0)	16.6	61,954	67,611	55,146	(8.4)	12.3
Impairment losses	(48,381)	(23,510)	105.8	(20,599)	(27,782)	(9,368)	(25.9)	119.9	(9,303)	(11,296)	(4,858)	(17.6)	91.5
Operating profit	230,159	211,685	8.7	108,966	121,193	101,785	(10.1)	7.1	52,651	56,315	50,288	(6.5)	4.7
Other income	1,319	1,092	20.8	562	757	741	(25.8)	(24.2)	492	70	263	602.9	87.1
Profit before tax	231,478	212,777	8.8	109,528	121,950	102,526	(10.2)	6.8	53,143	56,385	50,551	(5.7)	5.1
Tax & others	(61,883)	(55,866)	10.8	(29,657)	(32,226)	(26,336)	(8.0)	12.6	(14,681)	(14,976)	(13,850)	(2.0)	6.0
Net profit	169,595	156,911	8.1	79,871	89,724	76,190	(11.0)	4.8	38,462	41,409	36,701	(7.1)	4.8

Source: Company, Daiwa

■ **BOC: key balance-sheet items**

(CNY m)	2014	3Q14	2Q14	1Q14	2013	% QoQ	% HoH	% YoY
Gross loans	8,483,275	8,444,403	8,424,595	8,158,329	7,607,791	0%	1%	12%
Deposits	6,339,052	5,975,261	6,153,220	5,762,508	5,741,454	6%	3%	10%
NPL balance	10,885,223	11,047,285	11,190,569	11,014,196	10,097,786	-1%	-3%	8%
Special mention loans	8,584,335	8,236,861	8,924,256	8,445,813	8,091,102	4%	-4%	6%
Overdue loans	100,494	90,695	85,860	80,320	73,271	11%	17%	37%

Source: Company, Daiwa

■ **BOC: key ratios**

(%)	2014	2013	Chg YoY (pp)	1Q14	2Q14	3Q14	4Q14
NIM	2.25	2.24	0.01	2.29	2.25	2.24	2.22
NIM - Domestic RMB	2.46	2.49	(0.03)				
Loan-to-deposit - Group *	77.9	75.3	2.6	74.1	75.3	76.4	77.9
- Loan-to-deposit (domestic RMB denominated) *	73.8	71.0	2.8	68.2	68.9	72.5	73.8
NPL ratio	1.18	0.96	0.22	0.98	1.02	1.07	1.18
SML ratio	2.37	2.49	(0.12)	n/a	2.28	n/a	2.37
Overdue loan ratio	1.48	1.16	0.32	n/a	1.35	n/a	1.48
Provision coverage	188	229	(41)	227	217	208	188
Loan-loss reserves *	2.22	2.21	0.01	2.23	2.21	2.23	2.22
Credit cost - annualized (bps)	59	32	27	78	61	56	36
Cost-to-income ratio (incl. business tax)	39.0	42.3	(3.3)	36.9	36.2	39.2	43.8
Common equity tier-1 CAR *	10.61	9.69	0.92	9.58	9.36	10.51	10.61
Tier-1 CAR	11.35	9.70	n/a				

Source: Company, Daiwa

Note: Loan-to-deposit ratio, credit cost and ROE are based on Daiwa's estimates; the capital ratio of 2014 is calculated under the advanced approaches, those of 2013 are under the non-advanced approaches.

■ **BOC: special mention, NPL and overdue loans**

(CNY m)	2014	1H14	2013	% HoH	% YoY
Special mention loans	200,654	192,359	189,293	4.3	6.0
Non-performing loans (NPL)	100,494	85,860	73,271	17.0	37.2
Overdue loans					
- less than 3 months	58,391	49,347	34,415	18.3	69.7
- over 3 months but less than 6 months	16,195	15,376	9,277	5.3	74.6
- over 6 months but less than 12 months	20,757	15,815	12,480	31.2	66.3
- over 12 months	30,593	33,464	31,941	(8.6)	(4.2)
Total overdue loans	125,936	114,002	88,113	10.5	42.9
Overdue loans over 3 months	67,545	64,655	53,698	4.5	25.8

Source: Company, Daiwa

■ **BOC: impairment losses - by geographical area**

(CNY m)	2014	2013	% YoY	2H14	1H14	2H13	% HoH	% YoY
Chinese mainland	43,940	20,562	113.7	18,229	25,711	7,831	(29.1)	132.8
BOC Hong Kong Group	2,850	584	388.0	2,549	301	286	746.8	791.3
Macau and Taiwan	-	1,311	(100.0)	(775)	775	835	(200.0)	(192.8)
Other regions	1,591	1,053	51.1	596	995	416	(40.1)	43.3
Total	48,381	23,510	105.8	20,599	27,782	9,368	(25.9)	119.9

Source: Company, Daiwa

## Financial summary

### ■ Key assumptions

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Net interest margin (%)	2.07	2.12	2.15	2.24	2.25	2.24	2.21	2.15
NPL (%)	1.1	1.0	1.0	1.0	1.2	1.3	1.3	1.3
Credit cost (bps)	24.1	31.7	28.9	31.9	58.5	65.6	67.8	69.9
Provision coverage (%)	197	221	236	229	188	177	183	193
Loan loss reserve (%)	2.17	2.20	2.25	2.21	2.22	2.29	2.43	2.60
Loan growth (%)	15.3	12.1	8.2	10.8	11.5	11.5	9.0	8.0
Deposit growth (%)	16.8	14.0	4.0	10.1	7.8	9.0	8.0	8.0
Fee to income ratio (%)	19.7	19.7	19.1	20.1	20.0	21.1	22.8	24.8
Expense to income ratio (%)	44.2	43.6	43.6	42.3	39.0	38.7	38.5	38.7

### ■ Profit and loss (CNYm)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Net interest income	193,962	228,064	256,964	283,585	321,102	345,897	360,201	369,518
Net fees & commission	54,483	64,662	69,923	82,092	91,240	104,926	120,665	138,765
Trading and other income	19,547	27,894	30,163	29,387	31,730	32,439	33,167	33,912
Net insurance income	8,526	7,678	9,126	12,445	12,256	14,707	16,178	17,796
<b>Total operating income</b>	<b>276,518</b>	<b>328,298</b>	<b>366,176</b>	<b>407,509</b>	<b>456,328</b>	<b>497,970</b>	<b>530,210</b>	<b>559,991</b>
Personnel expenses	(53,420)	(60,793)	(66,701)	(72,762)	(77,889)	(82,738)	(87,896)	(93,383)
Other expenses	(68,911)	(82,338)	(93,028)	(99,552)	(99,899)	(109,887)	(116,491)	(123,518)
<b>Total expenses</b>	<b>(122,331)</b>	<b>(143,131)</b>	<b>(159,729)</b>	<b>(172,314)</b>	<b>(177,788)</b>	<b>(192,626)</b>	<b>(204,387)</b>	<b>(216,901)</b>
Pre-provision operating profit	154,187	185,167	206,447	235,195	278,540	305,344	325,823	343,090
Total provision	(12,993)	(19,355)	(19,387)	(23,510)	(48,381)	(57,531)	(65,409)	(73,042)
<b>Operating profit after prov.</b>	<b>141,194</b>	<b>165,812</b>	<b>187,060</b>	<b>211,685</b>	<b>230,159</b>	<b>247,813</b>	<b>260,414</b>	<b>270,048</b>
Non-operating income	951	2,832	613	1,092	1,319	1,385	1,454	1,527
<b>Profit before tax</b>	<b>142,145</b>	<b>168,644</b>	<b>187,673</b>	<b>212,777</b>	<b>231,478</b>	<b>249,198</b>	<b>261,868</b>	<b>271,575</b>
Tax	(32,454)	(38,142)	(41,927)	(49,036)	(54,280)	(58,435)	(61,406)	(63,682)
Min. int./pref. div./other items	(5,273)	(6,226)	(6,090)	(6,830)	(7,603)	(7,755)	(7,910)	(8,068)
<b>Net profit</b>	<b>104,418</b>	<b>124,276</b>	<b>139,656</b>	<b>156,911</b>	<b>169,595</b>	<b>183,008</b>	<b>192,552</b>	<b>199,824</b>
<b>Adjusted net profit</b>	<b>104,418</b>	<b>124,276</b>	<b>139,656</b>	<b>156,911</b>	<b>169,595</b>	<b>183,008</b>	<b>192,552</b>	<b>199,824</b>
EPS (CNY)	0.395	0.445	0.500	0.562	0.606	0.656	0.690	0.716
EPS (adjusted) (CNY)	0.395	0.445	0.500	0.562	0.606	0.656	0.690	0.716
EPS (adjusted fully-diluted) (CNY)	0.386	0.428	0.481	0.536	0.577	0.625	0.657	0.682
DPS (CNY)	0.146	0.155	0.175	0.196	0.197	0.212	0.223	0.232

### ■ Change (YoY %)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Net interest income	22.1	17.6	12.7	10.4	13.2	7.7	4.1	2.6
Non-interest income	12.0	21.4	9.0	13.5	9.1	12.5	11.8	12.0
Total operating income	18.9	18.7	11.5	11.3	12.0	9.1	6.5	5.6
Total expenses	17.2	17.0	11.6	7.9	3.2	8.3	6.1	6.1
Pre-provision operating profit	20.3	20.1	11.5	13.9	18.4	9.6	6.7	5.3
Total provisions	(13.3)	49.0	0.2	21.3	105.8	18.9	13.7	11.7
Operating profit after provisions	24.8	17.4	12.8	13.2	8.7	7.7	5.1	3.7
Profit before tax	27.9	18.6	11.3	13.4	8.8	7.7	5.1	3.7
Net profit (adjusted)	29.2	19.0	12.4	12.4	8.1	7.9	5.2	3.8
EPS (adjusted, FD)	25.3	11.0	12.2	11.5	7.7	8.2	5.2	3.8
Gross loans	15.3	12.1	8.2	10.8	11.5	11.5	9.0	8.0
Deposits	16.8	14.0	4.0	10.1	7.8	9.0	8.0	8.0
Total assets	19.5	13.1	7.2	9.4	9.9	10.4	7.8	7.3
Total liabilities	19.2	13.2	6.7	9.3	8.9	10.3	7.6	7.1
Shareholders' equity	25.1	12.4	13.9	12.0	23.5	11.1	10.5	9.9
Avg interest-earning assets	20.5	14.4	11.4	5.6	13.0	8.0	5.7	5.3
Avg risk-weighted assets	14.0	13.1	9.0	29.9	5.5	(9.5)	11.9	8.5

Source: FactSet, Daiwa forecasts

## Financial summary continued ...

### ■ Balance sheet (CNYm)

As at 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Cash & equivalent	2,466,233	3,185,089	3,227,724	3,429,542	3,597,939	4,100,509	4,455,601	4,842,618
Investment securities	2,095,298	2,043,516	2,250,712	2,444,454	2,758,342	2,833,333	2,912,798	2,997,272
Net loans and advances	5,537,765	6,203,138	6,710,040	7,439,742	8,294,744	9,241,979	10,059,639	10,845,683
Fixed assets	137,407	152,850	167,466	179,239	190,850	209,935	230,929	254,021
Goodwill	0	0	0	0	0	0	0	0
Other assets	223,162	245,196	324,673	381,322	409,507	451,710	498,321	549,809
<b>Total assets</b>	<b>10,459,865</b>	<b>11,829,789</b>	<b>12,680,615</b>	<b>13,874,299</b>	<b>15,251,382</b>	<b>16,837,466</b>	<b>18,157,287</b>	<b>19,489,403</b>
Customers deposits	7,964,338	9,083,799	9,486,999	10,437,051	11,110,553	12,117,263	13,096,738	14,155,784
Borrowing	1,384,940	1,487,872	1,715,671	1,788,775	2,169,252	2,590,459	2,763,865	2,862,575
Debtentures	151,386	196,626	233,178	254,274	308,492	308,492	308,492	308,492
Other liabilities	283,051	304,355	383,225	432,722	479,657	506,854	535,798	566,620
<b>Total liabilities</b>	<b>9,783,715</b>	<b>11,072,652</b>	<b>11,819,073</b>	<b>12,912,822</b>	<b>14,067,954</b>	<b>15,523,069</b>	<b>16,704,893</b>	<b>17,893,471</b>
Share capital	279,147	279,147	279,147	279,365	288,731	288,731	288,731	288,731
Reserves & others	365,018	444,767	545,530	644,551	852,128	978,840	1,112,155	1,250,542
<b>Shareholders' equity</b>	<b>644,165</b>	<b>723,914</b>	<b>824,677</b>	<b>923,916</b>	<b>1,140,859</b>	<b>1,267,571</b>	<b>1,400,886</b>	<b>1,539,273</b>
Minority interests	31,985	33,223	36,865	37,561	42,569	46,826	51,508	56,659
<b>Total equity &amp; liabilities</b>	<b>10,459,865</b>	<b>11,829,789</b>	<b>12,680,615</b>	<b>13,874,299</b>	<b>15,251,382</b>	<b>16,837,466</b>	<b>18,157,287</b>	<b>19,489,403</b>
Avg interest-earning assets	9,391,932	10,743,572	11,966,813	12,637,686	14,274,546	15,413,423	16,297,872	17,153,965
Avg risk-weighted assets	5,887,170	6,656,034	7,253,230	9,418,726	9,934,105	8,993,924	10,063,437	10,914,066
<b>BVPS (CNY)</b>	<b>2.257</b>	<b>2.495</b>	<b>2.838</b>	<b>3.156</b>	<b>3.894</b>	<b>4.326</b>	<b>4.781</b>	<b>5.253</b>

### ■ Key ratios (%)

Year to 31 Dec	2010	2011	2012	2013	2014	2015E	2016E	2017E
Loan/deposit	71.1	69.8	72.4	72.9	76.4	78.1	78.7	78.7
Tier-1 CAR	10.1	10.1	10.5	9.7	10.6	13.3	13.2	13.5
Total CAR	12.6	13.0	13.6	12.5	13.9	24.4	23.9	24.0
NPLs/gross loans	1.1	1.0	1.0	1.0	1.2	1.3	1.3	1.3
Total loan-loss prov./NPLs	196.7	220.7	236.3	229.4	187.6	177.3	182.8	193.3
ROAA	1.1	1.1	1.1	1.2	1.2	1.1	1.1	1.1
ROAE	18.0	18.2	18.0	17.9	16.4	15.2	14.4	13.6
Net-interest margin	2.1	2.1	2.1	2.2	2.2	2.2	2.2	2.2
Gross yield	3.3	3.8	4.2	4.1	4.2	4.2	4.2	4.2
Cost of funds	1.4	1.8	2.2	2.0	2.1	2.1	2.1	2.1
Net-interest spread	2.0	2.0	2.0	2.1	2.1	2.1	2.1	2.1
Total cost/total income	44.2	43.6	43.6	42.3	39.0	38.7	38.5	38.7
Effective tax	22.8	22.6	22.3	23.0	23.4	23.4	23.4	23.4
Dividend-payout	37.0	34.8	35.0	34.9	32.4	32.3	32.3	32.3

Source: FactSet, Daiwa forecasts

### ■ Company profile

Established in 1912, Bank of China (BOC) is one of the big-4 banks in China, with traditional strength in the foreign-exchange business. Subsidiary Bank of China (HK) is the second-largest bank in Hong Kong and has established good synergies with BOC, especially in the Renminbi business. Among the China banks, BOC has the most international and diversified network in the world.

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