JPM-pp1

Asia Pacific Equity Research

26 March 2015

Far East Horizon (3360 HK)

Overweight

Price: HK$6.69

25 Mar 2015

Price Target: HK$7.80

PT End Date: 31 Dec 2015

2014 results: seeing pressure on NIM and fee growth; asset quality stable

FEH reported FY14 net profit of Rmb2.3bn, up 20% YoY, broadly in line with J.P. Morgan and Bloomberg consensus estimates. However, the sequential trend in NIM and fee income growth deteriorated in the 2H14. Leasing asset growth in 4Q14 was largely flat qoq. The upside is that asset quality was relatively stable compared to peers. The 20% annual growth in net profit was partly driven by one-off items; stripping these out, net profit growth would have been 7% YoY in 2014. Part of the negative news was in the price, in our view, as the share price has corrected by 10% in the past month. We believe the market may have anticipated a slowdown in profit growth given interest rate cuts and Rmb depreciation. We expect share price performance to come under further pressure in the near term.

- **NIM contraction due to rate cut, de-risking, rising hedging costs:** FY14 NIM was 3.3%, down 61bp YoY. This implies that 2H14 NIM was 2.99%, down 62bp from 3.61% in 1H14. As FEH reported that 3Q14's NIM was better than 2H14's, NIM contraction mainly happened in 4Q14. For the NIM contraction, management gave some explanation:
    - Change in tax calculation: ~16bp of the contraction in FY14 was due to the effect (Rmb148m) of changing business tax into VAT tax. For our detailed comment on this, please refer to FEH: Beneficiary of financial disintermediation with low regulatory risk, initiate with OW and FEH: Clarity on tax impact from change in VAT rule, time to move on.
    - Increasing hedging costs on forex-denominated liabilities: ~10bp of NIM contraction in FY14 was due to hedging costs on forex-denominated liabilities. FEH entered into three (nil in 2013) forward currency contracts to manage its exchange rate exposure. Management mentioned that the hedged portion was 90% at the end of 2014, and hedging costs increased with rising expectations on Rmb depreciation.
    - Declining asset yield due to de-risking: Management mentioned that it had actively exited some higher-risk borrowers. For example, we noted that the lease yield of the Transportation sector was 7.56% in 2H14, 71bp higher than the overall yield. But the NPL ratio of the Transportation sector was 4.84%, 392bp higher than the overall NPL ratio of 0.91% at end 2014. Thus, exposure to the Transportation sector declined by 1.6ppt YoY to 9.8% at end 2014.
    - Funding costs have been resilient: 42% of interest-bearing liabilities were raised offshore, and thus won't be affected by the PBOC cutting benchmark interest rates, while 95% of lease receivables are denominated in Rmb and are likely affected by the PBOC rate cut. Referencing 2013 data (2014 not disclosed), 92% of lease receivables are repriced within three months.

- **Fee income growth contracted by 29% HoH in 2H14**. We believe this is partly due to the de-risking process. Transportation (including shipping) and Printing and Packaging sectors, which saw higher NPL formation pressure, experienced the sharpest contraction in fee income of 83% HoH and 49% HoH.

- **Asset quality remains stable and strengthening provision level**: Non-performing asset ratio rose by only 2bp HoH in 2H14, much better than that of commercial banks, which saw the NPL ratio go up by 17bp HoH. In addition, special-mention asset ratio went down by 6bp HoH, better than for commercial banks, which saw a 56bp rise HoH. Loan loss reserve ratio and NPL coverage ratio went up by 9bp HoH and 3.4ppt HoH, respectively, to 2.02% and 219%. One alarming sign is that loans overdue more than 30 days went up by 39% HoH to 0.91% of total loans at end 2014. Management commented that they have stopped asset growth in some sectors in 4Q14 in order to conduct a thorough assessment on asset quality. They identified that Transportation and Paper & Packaging are the high-risk sectors. Thus we saw a decline in exposure to those sectors. This may explain the flat lease receivable sequential growth in 4Q14. Management expects asset quality to be stable in 2015 following the stringent exercise.

Table 1: Summary of 2014 results

Rmb MM	FY13 Actual	FY14 Actual	YoY	FY14E JPM Est.	Actual vs JPM est	1H14 Actual	2H14 Actual	HoH
NII	2,779	3,035	9%	3,195	-5.0%	1,582	1,454	-8%
Non interest income	2,672	3,559	33%	3,588	-0.8%	1,757	1,802	3%
Total operating income	5,451	6,594	21%	6,784	-2.8%	3,339	3,255	-3%
Total operating expenses	(2,324)	(2,646)	14%	(2,774)	-4.6%	(1,338)	(1,309)	-2%
Operating profits	3,127	3,948	26%	4,009	-1.5%	2,001	1,947	-3%
Provisions	(535)	(750)	40%	(813)	-7.7%	(395)	(355)	-10%
Pre-tax profit	2,601	3,211	23%	3,201	0.3%	1,607	1,591	-1%
Tax	(685)	(869)	27%	(874)	-0.6%	(440)	(429)	-2%
Minority interest	(3)	(10)	206%	(11)	-5.2%	(5)	(5)	-1%
Net income (attributable to common equity shareholders)	1,913	2,296	20%	2,316	-0.8%	1,165	1,131	-3%
Interest-earning assets	80,746	100,829	25%	100,946	-0.1%	94,491	100,829	7%

NPA	646	920	42%	1,008	-8.7%	837	920	10%
Total assets	86,513	110,726	28%	111,588	-0.8%	99,903	110,726	11%
Total interest-bearing liabilities	56,554	71,778	27%	73,669	-2.6%	65,905	71,778	9%
Bond payable	5,864	12,751	117%	16,487	-22.7%	10,019	12,751	27%
Common equity	14,125	16,113	14%	15,915	1.2%	14,717	16,113	9%
NIM	3.91%	3.30%	-61 bps	3.45%	-15 bps	3.61%	2.99%	-62 bps
Cost/Income ratio	42.6%	40.1%	-2 pt	40.9%	1 pt	40.1%	40.2%	0 pt
Credit cost	0.75%	0.79%	4 bps	0.86%	-7 bps	0.86%	0.70%	-16 bps
Non-performing asset ratio	0.80%	0.91%	11 bps	1.00%	-9 bps	0.89%	0.91%	2 bps
Coverage ratio	219.2%	218.7%	-1 pt	215.8%	-3 pt	215.3%	218.7%	3 pt
Provision/EOP Loans	0.64%	0.71%	7 bps	0.79%	-8 bps	0.80%	0.67%	-13 bps
Debt/Equity	4.0x	4.1x	0.1x	4.3x	0.2x	4.1x	4.1x	0.0x
ROA	2.59%	2.35%	-24 bps	2.33%	2 bps	2.50%	2.15%	-35 bps
ROE (attributable to common equity shareholders)	14.2%	15.2%	100 bps	14.8%	37 bps	15.5%	14.7%	-84 bps

Source: J.P. Morgan estimates, Company data.

Table 2: FEH 2H14 results summary

Rmb MM	1H13	2H13	1H14	2H14	HoH	YoY
NII	1,339	1,440	1,582	1,454	-8%	1%
Non interest income	1,264	1,408	1,757	1,802	3%	28%
Total operating income	2,603	2,848	3,339	3,255	-3%	14%
Total operating expenses	(974)	(1,350)	(1,338)	(1,309)	-2%	-3%
Operating profits	1,630	1,498	2,001	1,947	-3%	30%
Provisions	(258)	(277)	(395)	(355)	-10%	28%
Pre-tax profit	1,372	1,228	1,611	1,601	-1%	30%
Tax	(339)	(346)	(440)	(429)	-2%	24%
Minority interest	1	(4)	(5)	(5)	-1%	31%
Net income (attributable to common equity shareholders)	1,034	879	1,165	1,131	-3%	29%
Interest-earning assets	1,575	2,250	2,608	3,191	22%	42%
NPA	527	646	837	920	10%	42%
Total assets	72,996	86,513	99,903	110,726	11%	28%
Total interest-bearing liabilities	42,148	50,690	55,886	59,027	6%	16%
Bond payable	4,627	5,864	10,019	12,751	27%	117%
Common equity	13,261	14,125	14,717	16,113	9%	14%
NIM	4.22%	3.60%	3.61%	2.99%	-62 bps	-61 bps
Cost/Income ratio	37.4%	47.4%	40.1%	40.2%	0 pt	-7 pt
Credit cost	0.80%	0.71%	0.86%	0.70%	-16 bps	-1 bps
Non-performing asset ratio	0.77%	0.80%	0.89%	0.91%	2 bps	11 bps
Coverage ratio	216.6%	219.2%	215.3%	218.7%	3 pt	-1 pt
Provision/EOP Loans	0.74%	0.65%	0.80%	0.67%	-13 bps	2 bps
Debt/Equity	3.5x	4.0x	4.1x	4.1x	0.0x	0.1x
ROA	3.10%	2.20%	2.50%	2.15%	-35 bps	-6 bps
ROE (attributable to common equity shareholders)	15.8%	12.8%	15.5%	14.7%	-84 bps	184 bps

Source: Company reports, J.P. Morgan estimates.

Investment Thesis

- Higher growth rate than other China financial companies due to positive industry trends, as lease penetration is low in China, but has been rising steadily in recent years, and the government's reform efforts on increasing leasing as a percentage of total social financing;
- FEH faces fewer regulatory headwinds than banks, as it is not involved in shadow banking, the interbank market or local government lending activities;
- FEH could see lower risks from interest rate de-regulation as it does not take deposits and FEH has a matching re-pricing cycle on its assets and liabilities side. In short, it is able to pass on higher funding costs to its leasing tenants.
- FEH has lower credit risks than banks, mainly because: 1) all FEH’s lending book is more transparent than banks with all leases secured by underlying leased assets; 2) as FEH owns the legal title and deeds of the lease assets, the repossession process at times of defaults will be easier than banks; 3) the repayment of principal plus interest is on a quarterly basis, this means that exposure to defaults is lower;
- FEH has been diversifying its funding source to ensure stable growth. FEH obtained 41% of interest-bearing liabilities from overseas markets at end 1H14. According to SAFE regulations, FEH can transfer funds which are equivalent to 9 times its net assets from overseas to China; currently overseas liabilities are equivalent to about 1 times FEH's net assets.
- Issuance of perpetual bonds, which is counted as part of equity, has significantly lower risks on equity raising.

Valuation

We derive a Dec-15 price target of HK$7.80 with a dividend-derived valuation. Key assumptions include: cost of capital of 13.7%, normalized ROE of 12.9%, a long-term growth rate of 6% and a terminal date of valuation of Dec-16.

Risks to Rating and Price Target

- Equity raising risk due to rapid asset expansion
- Slowdown in fee growth due to pressure on corporate cash flow
- Slowdown in asset growth if growth in interest-bearing liabilities slows down due to liquidity tightening in China
- Losing market share due to fierce competition
- Asset quality deterioration amid slower macro growth

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Date	Rating	Share Price (HK$)	Price Target (HK $)
06-Jan-14	OW	6.33	7.60
27-Oct-14	OW	6.66	7.80

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