



February 13, 2014

Sector Rating:
OVERWEIGHT

Analyst :Johannes Au
Tel: (852) 2147 8802
Email: johannesau@abci.com.hk

Key Data

Avg.14E P/E (x)	4.50
Avg.14E P/B (x)	0.78
Avg.14E Dividend Yield (%)	6.33

Source(s): Company, Bloomberg, ABCI Securities

Sector relevant metrics

Interest income	77.54
Non-interest income	22.46

Source(s): Company, ABCI Securities

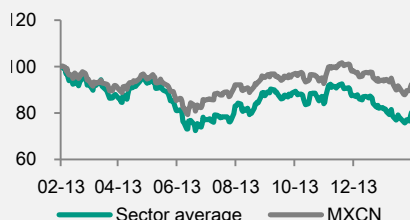
Sector performance (%)

	Absolute	Relative*
1-mth	(2.45)	(0.67)
3-mth	(5.00)	(3.59)
6-mth	(3.80)	(4.08)

*Relative to MXCN

Source(s): Bloomberg, ABCI Securities

1-Year Sector performance



Source(s):Bloomberg, ABCI securities

China Banks Sector

The rise of city commercial banks

Investment themes

- ❖ The addition of highly regional city commercial banks in the H-share Chinese bank universe currently dominated by nationwide banks provide more investment choices within the sector
- ❖ We expect more district banks to be listed in Hong Kong given the prolonged delay of listing approval in the A-share market
- ❖ City commercial banks achieve the highest growth among the six FI categories; their profitability and asset quality are better than the big banks
- ❖ City commercial banks' higher SME loan yields are able to offset costs related to their relatively weaker retail franchises and higher reliance on interbank funding
- ❖ Big banks such as ICBC, CCB and ABC remain our sector top picks. We initiate coverage on HB and BoCQ with a **BUY** rating. We prefer HB over BoCQ for its larger business scale, market share and geographical advantage

Additions to the H-share bank universe. With two city commercial banks - BoCQ and HB, having been listed in HKEx, we expect more small banks will seek listings in HK in the next few years, especially after the prolonged suspension of listing approval by regulators in China. Since operation of city commercial banks are quite different from the existing H-share banks, we believe the addition will diversify investment choices within the bank sector.

High growth and superb asset quality. According to CBRC's data, city commercial banks experienced the fastest asset growth (07-12 CAGR: 29.9%) among the six FI categories in China. We believe such rapid growth is sustainable on robust economic growth in individual regions. Besides, these banks have outstanding asset quality and high profitability with an NPL ratio of 0.8% and ROA of 1.22% in 2012, comparable to JSB and lower than the big five banks.

Key characteristics of district banks. With outlets focusing in specific urban regions, district banks operate based on the high efficiency model instead of the diversification model adopted among national banks. Local relationships and expertise allow them to focus strategically and closely monitor small business customers to tap on fast growth and high yields without sacrificing asset quality. Nevertheless, the relatively weaker retail franchises post risks in deposit competition and high reliance on interbank funding. Looking forward, we expect fee income and SME businesses in district banks to expand rapidly.

BUY HB and BoCQ for fast growth and high profitability. Big banks such as ICBC, CCB and ABC, remain our sector top picks for their relatively higher diversification and defensiveness against policy risks. We believe the rise of city commercial banks will nonetheless offer new investment opportunities, supported by their fast growth and high profitability. We initiate coverage on HB and BoCQ, with the **BUY** recommendation. We, however, prefer HB over BoCQ for its relatively larger business scale, domestic market share, and geographical location that enables the bank to benefit earlier from industry migration.

Risk factors: 1) Fiercer loan and deposit competition; 2) Collapse of shadow banking system; 3) Increasing competition from non-bank financial institutions; 4) Stringent regulatory control on bank operations.

Sector Valuation Summary (data as of Feb 12, 2014)

Company	Ticker	Rating	Price (HK\$)	TP (HK\$)	FY13E P/E(x)	FY14E P/E (x)	FY13E P/B (x)	FY14E P/B (x)	FY13E Yield (%)	FY14E Yield (%)
ICBC	1398 HK	BUY	4.82	6.91	4.94	4.59	1.04	0.91	6.74	7.52
CCB	939 HK	BUY	5.43	8.19	5.11	4.62	1.01	0.88	6.91	7.60
ABC	1288 HK	BUY	3.49	4.74	5.37	4.99	1.05	0.93	6.45	7.16
BOC	3988 HK	BUY	3.30	4.13	5.08	4.80	0.80	0.72	6.82	7.20
BoCom	3328 HK	BUY	5.09	6.60	4.85	4.38	0.71	0.63	5.16	5.65
CMB	3968 HK	BUY	14.36	17.80	5.25	4.63	1.04	0.89	5.75	6.44
MSB	1988 HK	BUY	7.94	11.94	4.10	3.78	0.91	0.77	4.09	4.57
CITICB	998 HK	HOLD	4.02	4.05	4.59	4.02	0.66	0.57	5.29	6.22
HB	3698 HK	BUY	3.55	4.21	4.90	5.36	0.97	0.82	3.87	4.58
BoCQ	1963 HK	BUY	4.88	5.72	3.49	3.87	0.80	0.66	5.38	6.40

Source(s): Companies, Bloomberg, ABCI Securities estimates



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The rise of city commercial banks

Upon recent debut of the IPOs of Bank of Chongqing (1963 HK, BoCQ) and Huishang Bank (3698 HK, HB), according to the local media, more than 20 city commercial banks have been queuing up to be listed in the A-share market to fuel their capital positions so as to comply with China's new capital rule.

Despite the resumption of A-share IPO market in Jan 2014, no approval has been made to any bank IPOs so far. Hence, overseas listing seems to be a more viable option for these smaller banks in China. We expect more city commercial banks will seek to raise funds in the Hong Kong market in the next few years.

We believe the rise of city commercial banks will expand the variety of investment choices available in the banking sector. In general, city commercial banks are different from the national banks listed in the H-share market. While big banks such as ICBC, CCB, and ABC are still our preferred choices on their relatively higher business diversification and defensiveness against policy change and interest rate deregulation, we also believe district banks would offer great investment opportunities based on their fast growth, high profitability, and concentration in the domestic market.

Small banks, big advantages

- With clear geographical focuses, city commercial banks are usually the major beneficiaries of robust economic growth in specific / neighboring regions
- Capture strong banking demand supported by economic growth; strong capability to capture the niche SME and MSE markets leveraging on local expertise, ability to monitor and react to changes in business environment
- Easier to maintain healthy asset quality as district banks usually operate in specific regions where they possess in-depth knowledge in local enterprises and economies
- Sustainable profitability outlook driven by high operating efficiency and increasing contribution from fee income growth
- Relatively lower policy risks from innovative products, as city commercial banks are less aggressive than mid-cap banks in expanding their fee income and tend to be market followers
- Industry consolidation through M&A between district banks could be the most effective way to expand business scale; any potential talks could result in short-term momentum in share prices
- Cross-regional expansion would be a long-term growth driver to district banks; city commercial banks could penetrate into other high growth region and erode market share of national banks

Potential risks

- Sharp slowdown in regional economies; specific political or economic incidents in particular regions may have material impacts on business outlook and asset quality of district banks
- Competition intensified by big banks; new entrants in specific regions may trigger price competition on loan and deposit. Meanwhile, interest



rate deregulation could have larger and more negative impacts on district banks' NIMs than big banks, especially on the deposit side

- Heavy reliance on interbank market and corporate deposit, given district banks' weaker retail franchises, may result in unstable deposit bases and higher funding costs.
- District banks are unlikely to develop effectively outside their original operational zones given the high regulatory requirements of opening non-core area branches; the lack of local government support and local expertise in new business regions
- District banks may be obligated to support local economies and local governments so as to maintain relationships and receive support from domestic corporates and SOEs
- Customers may prefer services and products offered by national banks, especially for customer who need national banking services support that district banks are unable to provide

The competition landscape

Financial institutions (FIs) in China could be divided into six categories: the large commercial banks (the "big five banks"), joint stock banks (JSB), city commercial banks, rural commercial banks, foreign banks, and other FIs. There are currently 144 city commercial banks. In fact, similar to the big five banks (ICBC, CCB, BOC, ABC, BoCom) and most JSBs, some city commercial banks have improved their capital bases, asset quality and profitability through private placements, public offerings and adoption of international practices.

Historically, city commercial banks were mainly formed by consolidating the domestic credit unions and credit co-operatives so that the local government and regulators can monitor these financial institutions more easily. In terms of shareholding structure, these FIs could be more diversified given the different owners in the credit unions and credit co-operatives prior to consolidation. More often than not, the government is the largest shareholder.

Exhibit 1: Market share of China's banks by category (2012)

	No.	Total assets			Shareholders' equity			Profit after tax	
		RMB bn	Market share (%)	CAGR (07-12) (%)	RMB bn	Market share (%)	CAGR (07-12) (%)	RMB bn	Market share (%)
Large commercial banks	5	60,040	44.9	16.1	3,952	45.6	20.1	755	49.9
Joint stock banks	12	23,527	17.6	26.5	1,314	15.2	31.1	253	16.7
City commercial banks	144	12,347	9.2	29.9	808	9.3	33.8	137	9.1
Rural commercial banks	2,411	15,512	11.6	22.0	996	11.5	30.1	161	10.6
Foreign banks	42	2,380	1.8	13.7	256	3.0	16.9	16	1.1
Other FIs	1,133	19,798	14.8	22.7	1,345	15.5	19.8	190	12.6
Total	3,747	133,604	100.0	20.3	8,671	100.0	23.3	1,512	100.0

Source(s): CBRC, ABCI Securities

As shown in Exhibit 1, the big five banks jointly hold a dominant market share in China in 2012: 44.9% by total assets, 45.6% by shareholders' equity and 49.9% by profit after tax, followed by 12 joint stock banks that jointly accounted for 17.6% of total assets. Meanwhile, the 144 city commercial banks owned around 9% market share of total assets, shareholders' equity and profit after tax in 2012.

Despite the limited market share of city commercial banks, they play an important role in maintaining regional financial stability, promoting market competition, facilitating financial services and easing SME funding pressures. Since 2005, city commercial banks were allowed to open branches outside its approved regions with CBRC's approval. In recent years, however, regulatory restrictions in business expansion in non-core business areas have been much tightened.



Fastest asset growth among the FIs

Leveraging on their strong local relationships and knowledge, city commercial banks are able to capture domestic business opportunities and react quickly to market changes. According to CBRC, city commercial banks achieved the fastest total asset growth among the six FI categories, expanding by 29.9% CAGR over 2007-12 as compared to 16.1% by large commercial banks, 26.5% by joint stock banks and 22% by rural commercial banks.

Exhibit 2: ROAs of China's banks by category (%)

	2007	2008	2009	2010	2011	2012
Large commercial banks	0.94	1.16	1.09	1.17	1.32	1.33
Joint stock banks	0.89	1.04	0.90	1.02	1.20	1.21
City commercial banks	0.84	1.09	1.01	1.14	1.21	1.22
Rural commercial banks	0.58	0.62	0.65	0.72	1.04	1.13
Foreign banks	0.56	0.92	0.48	0.50	0.86	0.72
Other FIs	1.26	0.65	0.68	0.77	0.94	1.05
Total	0.92	1.00	0.94	1.03	1.20	1.22

Source(s): CBRC, ABCI Securities

Improving profitability and asset quality

Profitability of city commercial banks has continuously trended up over the past six years; overall ROA increased from 0.84% in 2007 to 1.22% in 2012. In particular, their ROA surpassed joint stock banks in 2008 and ranked the second highest among the six FI categories, lower than large banks by only 11bps.

Meanwhile, asset quality of city commercial banks also improved, with NPL ratio falling from 3% in 2007 to 0.8% in 2012, comparable to joint stock banks and lower than the 1% among the large commercial banks. We believe this can be attributed to the better risk management system and disposal of problem assets.

Exhibit 3: NPL ratios of China's banks by category (%)

	2007	2008	2009	2010	2011	2012
Large commercial banks	8.0	2.8	1.8	1.3	1.1	1.0
Joint stock banks	2.1	1.3	1.0	0.7	0.6	0.7
City commercial banks	3.0	2.3	1.3	0.9	0.8	0.8
Rural commercial banks	4.0	3.9	2.8	1.9	1.6	1.8
Foreign banks	0.5	0.8	0.9	0.5	0.4	0.5
Total	6.1	2.4	1.6	1.1	1.0	1.0

Source(s): CBRC, ABCI Securities

Major characteristics of city commercial banks

Higher growth than national banks

By comparing the two recently listed city commercial banks with other H-share banks, we have identified several key characteristics of the former. Unlike the national large banks and joint stock banks, city commercial banks are still in their high-growth phase.

Exhibit 4: Growth comparisons of H-share banks (%)

Loan	ICBC	CCB	BOC	ABC	BoCom	CMB	MSB	CITICB	QRB	BoCQ	HB
2010	18.5	17.6	15.3	19.8	21.6	20.7	19.8	18.6	20.0	na	na
2011	14.7	14.6	12.1	13.8	14.5	14.6	14.0	13.4	18.2	20.9	17.4
2012	13.0	15.6	8.2	14.1	15.1	16.0	14.9	16.0	20.2	19.7	19.2
1H13 H-H	7.2	7.8	8.4	8.0	8.6	10.2	7.2	9.7	10.8	10.8	11.8
Deposit	ICBC	CCB	BOC	ABC	BoCom	CMB	MSB	CITICB	QRB	BoCQ	HB
2010	14.1	13.4	15.1	18.5	20.9	18.0	25.7	29.0	33.7	na	na
2011	10.0	10.1	14.0	8.3	14.5	17.0	16.0	13.7	19.7	20.9	27.6
2012	11.3	13.6	4.0	12.9	13.6	14.1	17.1	14.6	19.7	27.7	17.7
1H13 H-H	6.3	7.1	7.7	5.7	6.0	10.5	12.9	15.9	14.9	22.0	5.3

Source(s): Companies, ABCI Securities



Based on the growth in loan and deposit among H-share banks, city commercial banks (BoCQ and HB) and the rural commercial bank (CQRB) are able to maintain higher growth than that of the national players. Their loan growth was in the range of 10.8%-11.8% hoh in 1H13, compared to 7.2%-9.7% by others. Deposits of CQRB and BoCQ grew by 14.9% and 22%, vs. 5.7%-15.9% in other banks. Despite HB's deposit growth appeared to slow in 1H13 to only 5.3%; its yoy growth in 2012 was 17.7%, higher than all other H-share national banks.

High profitability

In terms of profitability, BoCQ and HB are at the high end of the China's H-share banks universe. E.g., their ROAs in 2012 were 1.4% and 1.5%, similar to market leaders such as ICBC and CCB, and outstanding mid-cap banks such as CMB and MSB. In terms of ROE, BOCQ and HB were 26.2% and 22.9% in 2012, higher than ICBC's 22.9% and CCB's 22%, and were comparable to CMB's 24.8% and MSB's 26.2%.

Exhibit 5: H-share banks profitability comparison (%)

(RMB mn)	ICBC	CCB	BOC	ABC	BoCom	CMB	MSB	CITICB	CQRB	BoCQ	HB
ROAA											
2010	1.3	1.3	1.1	1.0	1.1	1.2	1.1	1.1	1.3	1.2	1.5
2011	1.4	1.5	1.1	1.1	1.2	1.4	1.4	1.3	1.3	1.3	1.5
2012	1.4	1.5	1.1	1.1	1.2	1.5	1.4	1.1	1.4	1.4	1.5
ROAE											
2010	22.1	21.5	18.0	21.4	20.2	22.7	18.4	19.3	19.3	24.3	19.9
2011	23.4	22.4	18.2	20.5	20.5	24.2	24.3	20.7	16.9	25.9	22.2
2012	22.9	22.0	18.0	20.7	17.9	24.8	26.2	16.8	17.9	26.2	22.9

Source(s): Companies, ABCI Securities

Prior to the introduction of city commercial banks, China's H-share banks universe can be divided into two categories, namely, the big five and mid-cap banks (joint stock banks and CQRB). The big five banks tend to have slower growth given their already mammoth sizes. Except for BOC, the four other big banks also have ROEs of above 20% based on their extensive branch networks nationwide and diversified businesses.

Mid-cap banks based mainly in coastal areas generally have faster growth, driven by the expansion of business outside their base regions, while profitability generally are at high teens except for some players with outstanding edges, such as CMB's retail bank franchise and MSB's SME businesses.

City commercial banks, with their fast growth, high profitability, strong geographical focus and domestic expertise, introduce a new investment class into the current H-share Chinese banks universe.

A high operating efficiency model

Unlike large banks and joint stock banks, city commercial banks has a high regional focus and tend to operate intensively in the urban regions of their designated districts only with hundreds of outlets. E.g., BoCQ owns around 100 outlets in Chongqing and nearby cities, while HB owns about 200 outlets in Anhui with only six of them locating in Nanjing.

City commercial banks do not need an extensive network historically, as their core client bases were mainly corporates with local government background and domestic large corporates. This setup allows city commercial banks to enjoy high operating efficiency and react to domestic market changes more promptly than large players. On the negative side, due to a weaker retail franchise network, city commercial banks usually have lower mixes of retail deposit and demand deposit, which in turn may affect their deposit stability, increase their reliance on funding from interbank markets and drive up their funding costs.



The business model of city commercial banks has evolved over time. In order to cope with the rapidly changing competition landscape resulted from the entry of big banks into their operating regions and interest rate deregulation, city commercial banks have started to expand their retail businesses in recent years for more stable deposit bases and lower deposit costs to lower their reliance on corporate deposit and interbank funding sources.

In contrast, national level banks follow a risk diversification model with individual regions contributing to a portion of their businesses. Therefore economic downturn in a single region is unlikely to have material impacts on the banks' financials.

More aggressive in SME and MSE businesses

As city commercial banks are corporate-focused, aside from serving leading corporates and SOEs in their regions, they also extend their reaches to quality SMEs and MSEs, thanks to their expertise in local business environment and corporates. Most city commercial banks have started their SME business departments and small business loan centers since 2005-07.

We believe city commercial banks are more able to identify quality small business customers in the regions compared to their larger peers. They can capture the niche market with smaller, less-qualified clients whom the big banks are reluctant to work with. These smaller corporates usually have huge funding needs to support their businesses, yet they usually have limited funding support from the national banks.

National banks are often unwilling to spend additional costs in administration and risk management for the smaller clients as their loan sizes are often too small for them. However, for city commercial banks, these customers often are willing to pay higher yields, which in turn can offset their higher funding costs resulted from relatively weaker retail franchises. Aside from sustaining their large corporate client bases, city commercial banks have turned more aggressive to strengthen their business franchises to capture the SMEs and MSEs markets.

Outstanding asset quality from close monitoring

As small businesses usually entail higher risks, asset quality of city commercial banks therefore becomes a concern for many. NPL, however, are low among these banks. In 1H13, NPL ratio of H-share city commercial banks are actually much lower at 0.38%-0.64% versus other H-share banks at 0.71%-1.25%.

Exhibit 6: NPLs of H-share banks (as of June 2013)

(RMB mn)	ICBC	CCB	BOC	ABC	BoCom	CMB	MSB	CITICB	QORB	BoCQ	HB
NPL balance	81,768	80,310	69,356	86,697	31,667	14,925	11,554	16,370	1,407	322	1,165
Y-Y (%)	9	14	9	3	38	51	29	74	-28	na	na
Q-Q (%)	2	3	4	1	3	14	6	6	-2	na	na
NPL %	0.87	0.99	0.93	1.25	0.99	0.71	0.78	0.90	0.73	0.38	0.64
Y-Y (%)	-2.5	-0.5	-1.0	-14.2	17.4	15.6	8.9	28.5	-46.0	na	na
Q-Q (%)	0.0	0.3	2.6	-1.8	1.7	5.6	1.7	1.5	-5.2	na	na

Source(s): Companies, ABCI Securities

There are two reasons why NPL among city commercial banks is lower than the system NPL of 1%. First, the rise of NPL balance in recent quarters were mainly attributable to SMEs in eastern China coastal areas; geographic focuses of BoCQ and HB are in western and central China where domestic system NPL ratios were lower than the national level. Secondly, given their geographic focus and local expertise, city commercial banks are able to monitor changes in loan customers' businesses and domestic economies.

If asset quality worsens nationwide, we believe none of the banks can be exempted from the negative impacts. Yet, we believe the provisioning and



collateral positions of city commercial banks would provide a relatively strong buffer against an economic downturn.

Exhibit 7: Guaranteed and collateralized loan of H-share banks as % of total loan (Jun 2013)

(RMB mn)	ICBC	CCB	BOC	ABC	BoCom	CMB	MSB	CITICB	CQRB	BoCQ	HB
Guarantees	15	19	17	20	27	25	34	26	20	35	43
Collateral	54	53	53	58	46	54	52	53	71	58	50
Total	69	72	70	78	73	79	86	79	91	93	93

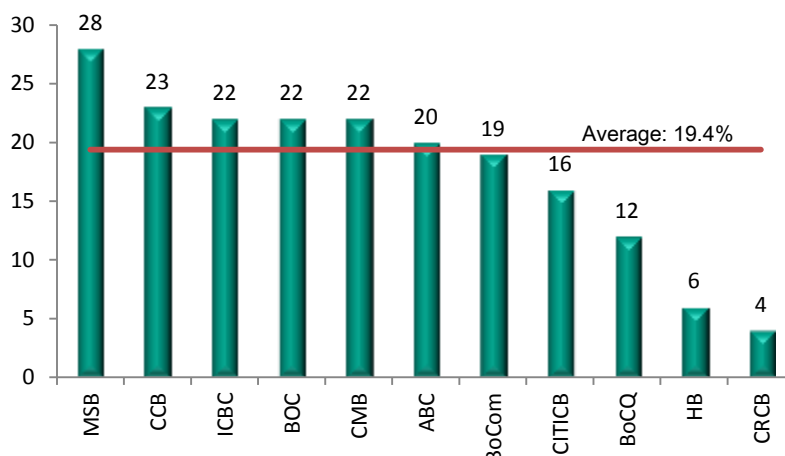
Source(s): Companies, ABCI Securities

BoCQ and HB had a provision coverage ratio of over 500% in 2012. We expect this to sustain at 400%-500% level over the next three years. Also, by comparing the collateral level across H-share banks, we find that BoCQ and HB's total coverage from guarantees and collaterals are above peers at over 90% (big five banks: 69%-78%; joint stock banks: 79%-86%).

Low revenue contribution from fee income

Facing the challenges from interest rate liberalization, innovative business has become a key growth driver of the Chinese banks in recent years. However, given the lack of innovative expertise and the traditional focus on credit business, city commercial banks have been conservative in expanding the fee income business and are usually late joiners.

Exhibit 8: Fee income as a percentage of topline revenue 1H13 (%)



Source(s): Companies, ABCI Securities

Therefore, fee income only accounted for single-digit/low-teen percentage of the top-line revenue among city commercial banks, compared to 16%-28% for the big banks. BoCQ's relatively higher fee income contribution (12%) was made possible by the synergy with its strategic investor, Dah Sing Bank (DSB, 2356 HK), which is a decent and conservative bank in Hong Kong (for Hong Kong banks, fee income to total income are generally in the range of 40%-60%).

We forecast the contribution of fee income among city commercial banks would rise in the future. This could improve the banks' business mix and reduce reliance on credit business. Given their relatively weak deposit franchise network, the inclusion of more wealth management products (WMP) will also help strengthen their funding bases.

We expect traditional fee income such as bank card and settlement fees will continue be the major fee contributor. Innovative fee income such as WMP, however, has shown exponential growth in recent quarters, partly due to its low base. Nevertheless, being the conservative market followers in innovative products, we believe city commercial banks would be relatively immune from

any policy risk and default risk compared to the mid-cap banks who have been expanding their fee income business aggressively.

Valuation and stock pick

Quality big banks, in particular, ICBC, CCB and ABC, are our sector top picks. We favor these banks based on their diversified businesses that render them more defensive against policy risk and competition from interest rate liberalization. We believe the addition of city commercial banks to the H-share universe would broaden investors' choices within the banking sector. We believe city commercial banks would continue to optimize their business mixes to include higher proportions of retail and demand deposit to expand their funding sources. More focus will be placed on business growth in the SME and MSE markets.

Based on the Gordon Growth Valuation, high profitability of city commercial banks' should lead to a higher P/B valuation. To factor in the smaller operation sizes and limitation in operation regions, however, a discount is applied to the sustainable ROE. We reiterate our **OVERWEIGHT** rating to the China banks sector, as we believe current valuations have already factored in most negative factors and further downside from the current level is now limited. We expect a sector re-rating to occur in 2Q14 after the annual results are announced and system statistics improve.

We initiate coverage on HB and BoCQ both with a **BUY** rating; HB's TP of HK\$ 4.21 and BoCQ's TP of HK\$ 5.72 reflect the targeted FY14E P/B of 0.97x and 0.77x and imply upsides of 18.59% and 17.21%. HB over BoCQ are currently trading at 0.82x and 0.66x 14E P/B. We prefer HB over BoCQ for its relatively larger operation size and domestic market share. Moreover, we believe industry migration would benefit central China sooner than the western part of the country.

Exhibit 9: Valuation table

Name	BBG code	Market cap (US\$m)	Price (HK\$)	Rating	TP (HK\$)	Upside (%)	P/B (x)		P/E (x)		ROE (%)		Div yield (%)	
							13E	14E	13E	14E	13E	14E	13E	14E
ICBC	1398 HK	204,073	4.82	BUY	6.91	43.36	1.04	0.91	4.94	4.59	21.5	21.2	6.74	7.52
CCB	939 HK	174,614	5.43	BUY	8.19	50.83	1.01	0.88	5.11	4.62	21.0	20.3	6.91	7.60
ABC	1288 HK	130,724	3.49	BUY	4.74	35.82	1.05	0.93	5.37	4.99	20.9	19.8	6.45	7.16
BOC	3988 HK	117,588	3.30	BUY	4.13	25.15	0.80	0.72	5.08	4.80	16.6	15.9	6.82	7.20
BoCom	3328 HK	48,097	5.09	BUY	6.60	29.67	0.71	0.63	4.85	4.38	15.4	15.2	5.16	5.65
CMB	3968 HK	44,262	14.36	BUY	17.80	23.96	1.04	0.89	5.25	4.63	21.5	20.7	5.75	6.44
MSB	1988 HK	34,827	7.94	BUY	11.94	50.38	0.91	0.77	4.10	3.78	22.9	20.8	4.09	4.57
CITICB	998 HK	31,501	4.02	HOLD	4.05	0.75	0.66	0.57	4.59	4.02	15.3	15.2	5.29	6.22
HB	3698 HK	5,058	3.55	BUY	4.21	18.59	0.97	0.82	4.90	5.36	18.6	16.5	3.87	4.58
BoCQ	1963 HK	1,702	4.88	BUY	5.72	17.21	0.80	0.66	3.49	3.87	21.5	18.6	5.38	6.40
Average						29.57	0.90	0.78	4.77	4.50	19.5	18.4	5.64	6.33

Source(s): Companies, Bloomberg, ABCI Securities estimates



February 13, 2014
Company Report
Rating: BUY
TP: HK\$ 4.21

H-Share price (HK\$)	3.55
Est. share price return	18.59%
Est. 14E dividend yield	4.58%
Est. total return	23.17%

Analyst: Johannes Au
Tel: (852) 2147 8802
Email: johannesau@abci.com.hk

Key Data

52Wk H/L(HK\$)	3.64/3.38
Issued shares (mn)	11,050
H-Shares (mn)	3,163
Domestic (mn)	7,887
Market cap	
H-shares (HK\$ mn)	11,227
Domestic (HK\$ mn)	28,000
3-mth avg daily turnover (HK\$ mn)	75.39
Major shareholder(s) (%):	
China Vanke	8.0
Anhui Energy Group	7.4
Anhui Credit Guaranty Group	7.3
Anhui Guoyuan Holding	6.2

Source(s): Company, Bloomberg, ABCI Securities

1H13 Revenue breakdown (%)

Corporate banking	58.7
Retail banking	27.4
Treasury operations	12.6
Others	1.3

Source(s): Company, ABCI Securities

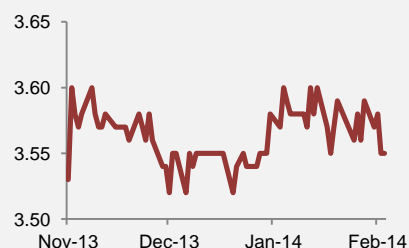
Share performance (%)

	Absolute	Relative*
1-mth	(1.39)	1.20
3-mth	(0.84)	2.84
6-mth	na	na

*Relative to HSI

Source(s): Bloomberg, ABCI Securities

1-Year stock performance (HK\$)



Source(s): Bloomberg, ABCI Securities

Huishang Bank (HB, 3698 HK)

A major beneficiary of industry migration

We believe Anhui will continue to benefit strongly from industry migration from coastal area, which fosters economic growth and banking demand in the province. We are impressed by HB's leading profitability and excellent asset quality made possible by its established domestic network and local expertise. We forecast HB's NPL ratio will remain stable despite the higher provision for regulatory requirement. HB's NIM would be at 2.5%-2.6% in 2013E-15E, assuming its loan yield could sustain at 6.8%-6.9% with a 15%-18% yoy loan growth to offset pressure from deposit cost and a high mix of interbank funding. HB is currently trading at 0.82x 14E P/B. We initiate coverage on the bank with a **BUY** rating. Our TP of HK\$ 4.21 implies an upside of 18.59%.

Core region to benefit from industry migration. We believe Anhui in central China will continue to benefit strongly from ongoing industry migration. Anhui's GDP grew by 18.5% CAGR in 2007-12, above the national rate at 14.3% CAGR. Continuous growth will be supported by government's urbanization targets of 50% by 2015 (47% in 2012) and national level by 2020. Loan and deposit growth in Anhui in 2012 were 3-4ppt higher than the system rate.

Leading local player with high profitability. Leveraging on its geographical advantage, leading position in Anhui and a relatively simple business structure, HB achieved the highest ROA of 1.48% in 2012; its CIR was the second lowest at 29.5% after BoCQ in 1H13. We forecast its ROE to sustain at 1.3% over 2013E-15E.

Clean asset quality track record. Despite its focus on SME business, HB has been able to maintain an outstanding asset quality, as supported by the fact that no disposals of NPL were made prior to its IPO. Meanwhile, its NPL ratio further improved to 0.58% in Sep 2013 from 0.64% in June 2013. Although LGFV exposure accounted for 12.9% of its total loans in June 2013, 99.7% of them were under full cashflow coverage. We expect NPL ratio to reach 0.62% by 2015E, although HB will increase provision to fulfill CBRC's requirement.

Growth in SME to offset funding cost pressure. HB's overall loan yield would stabilize at 6.8%-6.9% in 2013E-15E. Combined with a 15-18% loan growth, NIM pressure from stiffening deposit competition and the high mix of interbank funding should be offset. We forecast HB's NIM to sustain at 2.5%-2.6% in 2013E-15E

Initiate with BUY. Trading at 0.82x 14E P/B, we believe the Group's current valuation, which is at a discount to the bigger banks, has fairly reflected HB's regional nature. We like HB for its geographical advantage and leading local position. Moreover, its share price has outperformed other H-share Chinese banks since its IPO. We initiate coverage on HB with a **BUY** recommendation; our TP of HK\$ 4.21 reflects 0.97x FY14E P/B and a 18.59% upside.

Risk factors: 1) Asset quality deterioration in the region; 2) Pricing competition from big banks in domestic area; 3) Failure to optimize business mix in retail banking.

Results and Valuation

FY ended Dec 31	2011A	2012A	2013E	2014E	2015E
Revenue (RMB mn)	7,651	9,235	10,679	12,721	14,758
Chg (%.yoy)	22.0	20.7	15.6	19.1	16.0
Net profit (RMB mn)	3,493	4,306	4,912	5,812	6,680
Chg (%.yoy)	29.2	23.3	14.1	18.3	14.9
EPS (RMB)	0.43	0.53	0.58	0.53	0.60
Chg (%.yoy)	29.2	23.3	10.8	(9.9)	14.9
BVPS (RMB)	2.09	2.51	2.92	3.46	4.02
Chg (%.yoy)	19.0	19.9	16.6	18.4	16.3
P/E (x)	-	5.39	4.90	5.36	4.70
P/B (x)	-	1.13	0.97	0.82	0.71
ROE (%)	22.22	22.93	18.62	16.49	16.16
ROA (%)	1.51	1.48	1.32	1.29	1.31
DPS(RMB)	0.10	0.10	0.11	0.13	0.15
Yield (%)	-	3.52	3.87	4.58	4.63

Source(s): Bloomberg, ABCI Securities estimates

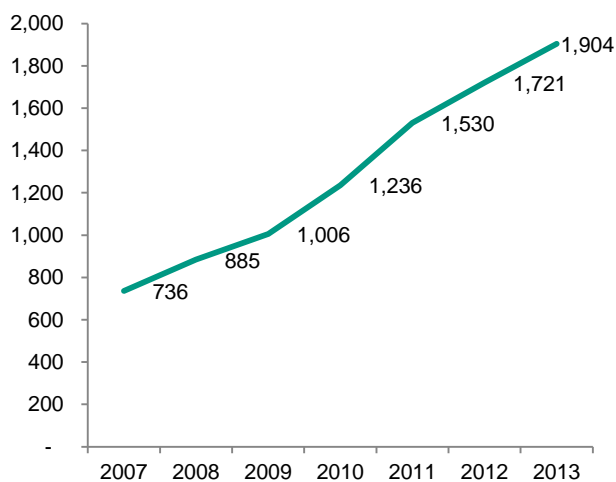
Anhui to benefit from industry migration

Fast economic growth driven by policy

Geographical location is the first and foremost important criterion in evaluating a district bank. Huishang Bank (HB). With its key business territory in Anhui province, HB has 193 outlets established in the region with only six of them locating in the none-core area in Nanjing.

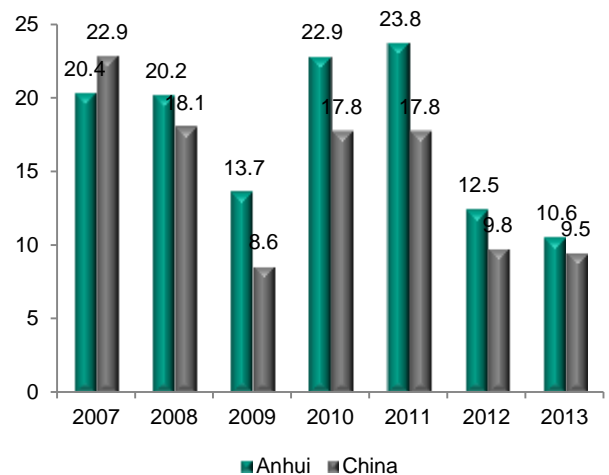
Anhui has been a fast-growing province with its GDP growing by a CAGR of 17.2% in 2007-13, above the national average at 14.1% CAGR. According to the Anhui Economic Work Conference in Dec 2012, Anhui's 2013 GDP target stated by Premier Li Keqiang was 10%, faster than the national GDP target of 7.5%. Since HB is the leading bank in the area, we believe it should benefit significantly from the ongoing industrialization and urbanization in the province.

Exhibit 1: Anhui's GDP (RMB bn)



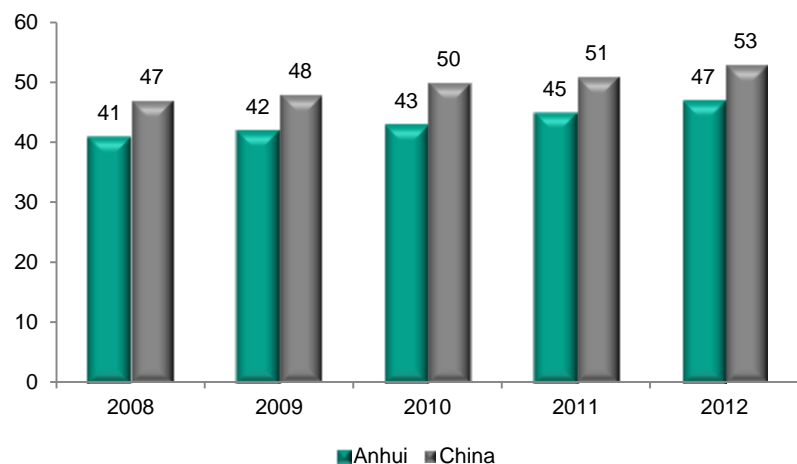
iiSource(s): Anhui Statistic Bureau, ABCI Securities

Exhibit 2: Nominal GDP growth in Anhui and China (yoy %)



Source(s): Anhui Statistic Bureau, ABCI Securities

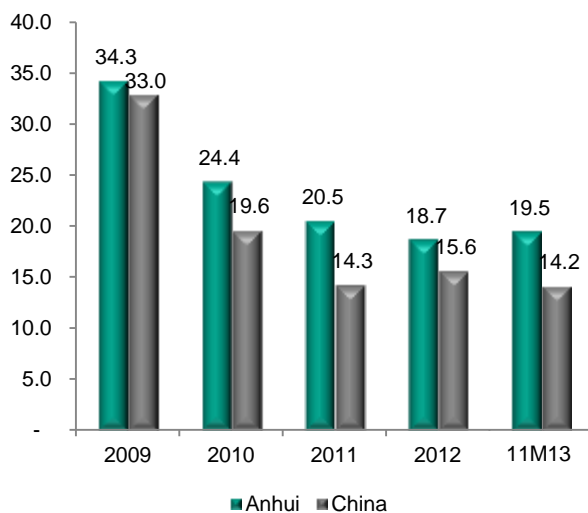
Exhibit 3: Urbanization rate in Anhui and China (%)



Source(s): Wind, ABCI Securities

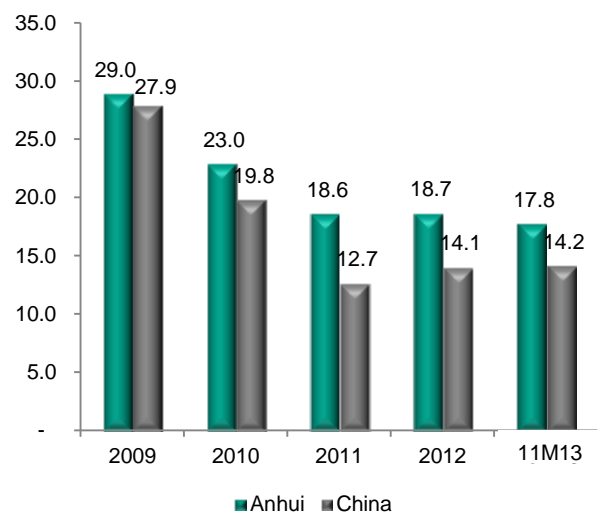
Among the six provinces including Hunan, Hubei, Jiangxi, Shanxi, Henan and Anhui, Anhui experienced the fastest GDP growth of over 2010-12 at 18% CAGR, versus the 13.6%-18% for the five remaining provinces. Being part of the “Rise of central China Plan”, the Anhui government targets to achieve an urbanization rate of 50% by 2015 (47% in 2012) and one that is on par with the national level by 2020.

Exhibit 4: Loan growth in Anhui and China (yoy %)



Source(s): Wind, ABCI Securities

Exhibit 5: Deposit growth in Anhui and China (yoy %)



Source(s): Wind, ABCI Securities

Nevertheless, Anhui’s loan penetration is still low at 97%, compared to the national level of 127%. Its loan and deposit growth, however, was 3ppt-4ppt higher than the systemic level. Going forward, we believe a low loan penetration and fast economic growth would accelerate the provincial loan and deposit growth, and demand for banking service will increase significantly.

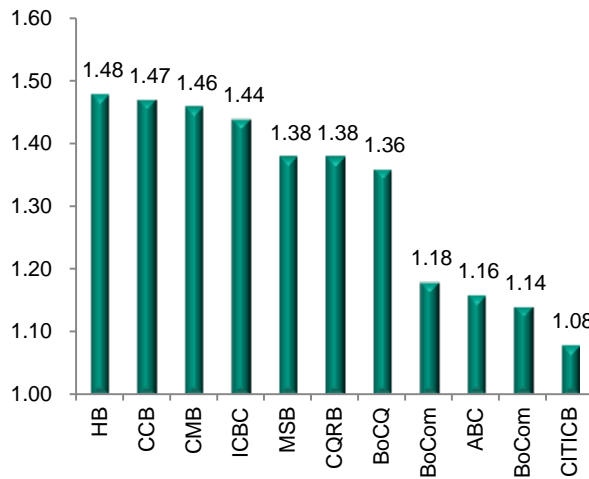
Geographical advantage arising from industry migration

With continuous increases in wealth along the coastal regions, labor cost and other production overheads have been rising significantly over the past decade. The government therefore has been encouraging enterprises to relocate their manufacturing plants to western and central China. Anhui province, with its close proximity to eastern China, therefore becomes one of the first relocation spots under the progressive migration to central and western China.

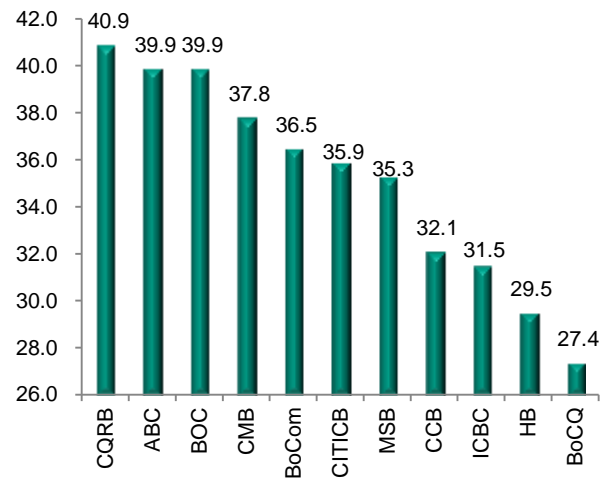
The Chinese government has introduced new initiatives such as a reformed tax regime to rebalance the national economy and reduce its reliance on eastern China. With the strengthening supply chain and the continuous industrial migration from Yangtze River Delta (YRD), Pearl River Delta (PRD) and Bohai Rim (BR), personal wealth growth in Anhui has grown rapidly over the past few years. Disposable income per capita among the urban population increased by a CAGR of 13.9% over 2005-12, higher than the national level of 12.9%.

High operating efficiency enhances profitability

High operating efficiency has been a typical characteristic of district banks. With a focused business strategy and regional exposure, HB achieved the highest ROA among other H-shares peers at 1.5% in 2012. Meanwhile, HB’s cost-to-income ratio (CIR) was the second lowest among the H-share banks at 29.5% in 1H13, thanks to its relatively simple business structure and a relatively low labor cost in the region.

Exhibit 6: ROA of H-share banks in 2012 (%)


Source(s): Companies, ABCI Securities

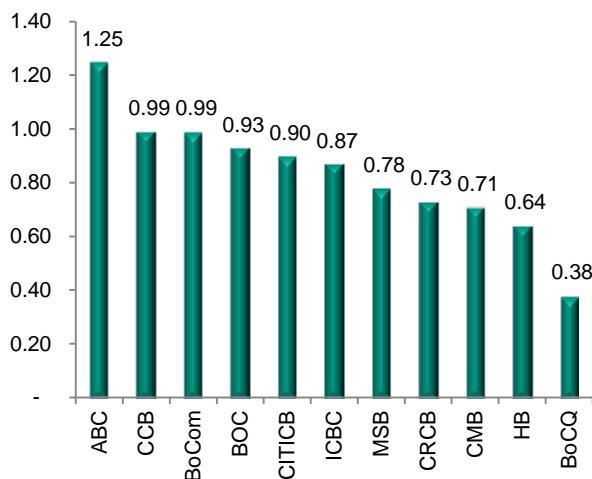
Exhibit 7: CIR of H-share bank in 1H13 (%)


Source(s): Companies, ABCI Securities

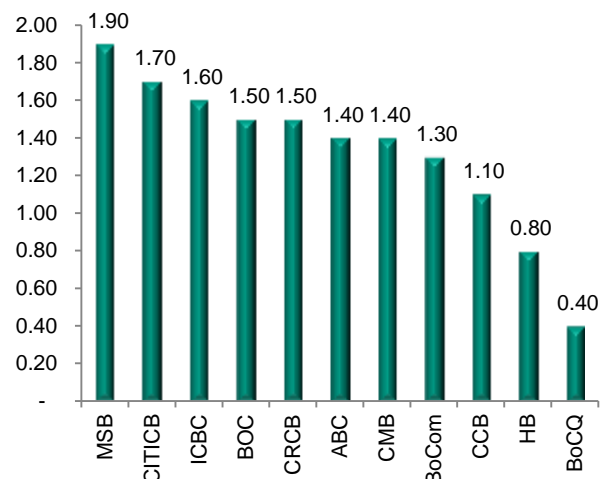
Sound risk management

A strong SME focus

Similar to other district banks, corporate banking has been an important business segment of HB, accounting for 62% of the bank's top-line revenue or 50% of profit before tax in 1H13. HB deliberately places its business focus on SMEs to tap on growing banking demand, avoid direct competition with big banks, and enjoy higher loan yields. Among HB's corporate loans, 75.3% was attributed to SMEs while 33.2% of retail loans were personal business loans.

Exhibit 8: NPL of H-share banks in 1H13 (%)


Source(s): Companies, ABCI Securities

Exhibit 9: Overdue in H-share banks in 1H13 (%)


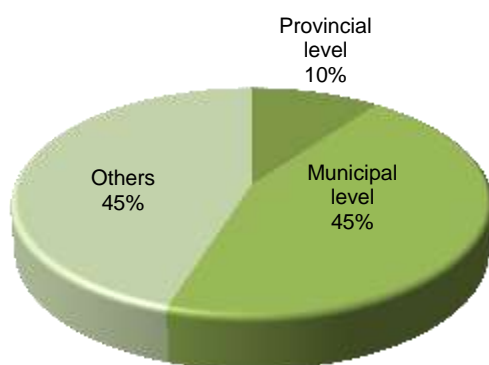
Source(s): Companies, ABCI Securities

Excellent asset quality

Despite the bank's high exposure to SMEs, HB's 1H13 NPL was only at 0.64%, the second lowest NPL ratio among H-share banks and was slightly higher than BoCQ (Bank of Chongqing, 1963 HK). The figure further improved to 0.58% in Sep 2013. While the NPL classification may vary among different banks, the overdue ratio of HB still ranked the second lowest among H-share banks at 0.8% in 1H13.

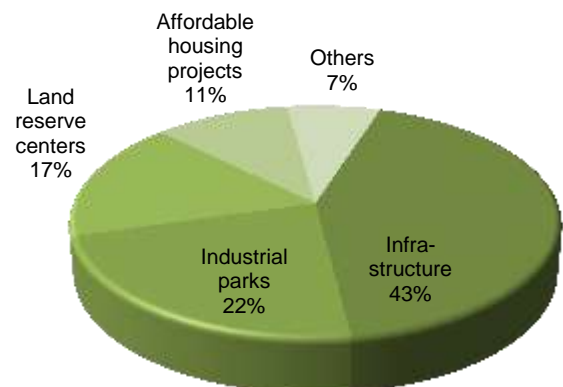
Furthermore, HB's LGFV exposure totaling RMB 24bn accounted for 12.9% of its total loan in June 2013, of which 99.7% of them were under full cashflow coverage. Among its exposure in LGFV, 55% was aggregated to provincial and municipal levels, while the rest was below the municipal level. By sector, about 43% could be attributed to infrastructure, 22% to industrial parks, 17% to land reserve centers, and 11% to affordable housing projects.

Exhibit 10: HB's LGFV by level



Source(s): Company, ABCI Securities

Exhibit 11: HB's LGFV by sector



Source(s): Company, ABCI Securities

Unlike the city commercial bank such as BoCQ or other banks prior to their IPOs, no significant disposals of bad debt portfolio were made by HB since numerous provincial FIs have been consolidated prior to its listing. This implies that risk management system of the bank has been prudent and we believe HB's asset quality would stay benign.

With HB's excellent asset quality and positive momentum in the provincial economy, we forecast its overall NPL ratio to rise gently in the next three years and reach 0.62% by 2015E. To fulfill CBRC's requirement in provision ratio, HB shall increase its credit cost gradually to 2.5% by 2015E. HB's provision coverage ratio should remain at the 400% level over 2013E-15E - a strong buffer against any major economic downturn in the region in our view.

SME focus to protect NIM

Corporate relationship crucial to defend NIM

With HB's 193 outlets in the province, HB had ~7,500 and 92,300 corporate loan and deposit customers as of June 2013, accounting for 10.4% of the market share for loans - the second largest among commercial banks in the province. Meanwhile, HB's established domestic relationship allows the bank to rank top in terms of corporate deposits for five consecutive years in 2008-12.

On the deposit side, 63.9% of HB's corporate deposits were demand deposits in June 2013, compared to an average of 55% among peers. About 46% of HB's retail deposits were demand deposits, compared to the peer average at ~40%. HB's deposit cost structure is therefore better than peers in our view.

HB has started its small business banking department back in 2005. SME loans accounted for 54% of total loans for HB, compared to the national average at 40%. In terms of loan pricing, HB is charging a premium no less than 20% above the benchmark rate for SME loans. As a result, its corporate loan yield hit 7.23% in 1H13, the highest among H-share banks.

Yet, competition in SME business will only intensify overtime, especially when mid-cap banks including Minsheng Bank (1988 HK, MSB) may expand to central China. Loan yield therefore would face a certain amount of downside pressure in the future, but we expect HB's overall loan yield to stabilize at 6.8-6.9% level in 2013E-15E.

We believe SME business will continue to be the major growth driver of district banks. District banks tend to have better domestic relationship and knowledge; they could react more swiftly to market changes and tailor their products to meet the needs of local customers. Regional SME business is often a small niche market in the eyes of the national banks and is therefore overlooked. As of Sep 2013, HB has 10 small-business branches and 43 small-business oriented sub-branches.

Third lowest retail deposit cost

On the retail side, HB has 7mn of customers as of June 2013, which was equivalent to 25% of Anhui's urban population. Among which, 165,500 were loan customers. About 46% of its retail deposits were demand deposits - a relatively high percentage in the sector, only next to ABC and CMB that are known for their strong retail franchises. HB therefore enjoyed the third lowest retail deposit cost in 1H13. With the expectation of increased deposit competition under interest rate deregulation, we expect HB's deposit cost to increase by 7-10bps each year in 2013-15E and reach 2.25% by 2015E.

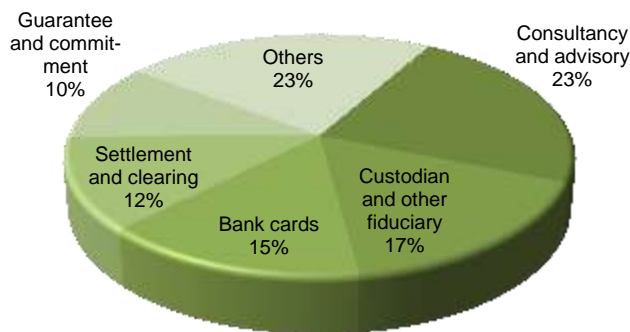
Stiffening deposit competition

HB's deposit growth has slowed to 5% in 1H13, compared to the 6%-16% growth among peers; demand deposits contributed 4ppt less hoh to the deposit mix in 1H13. This reflects the fact that a district bank like HB could be under enormous pressure of the stiff deposit competition. The bank's NIM narrowed (HB's funding cost rose by 3bps H-H in 1H13), yet we believe HB's strong domestic franchise, continuous improvement in balance sheet mix and stable loan pricing could help sustain the bank's NIM at 2.5%-2.6% over 2013E-15E.

Enhancing fee income base

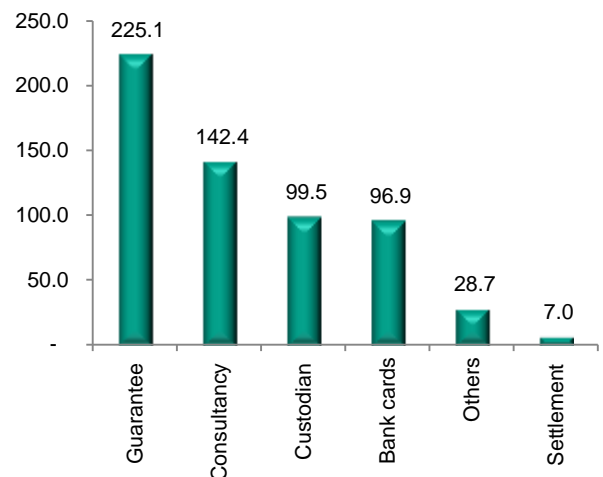
HB's fee income only accounted for 5.7% of HB's top-line revenue in 1H13, the second lowest among peers. HB only started to underwrite debt financing instruments for non-FIs in 2008 and received its license and launched its first credit card in 2009. It only started the derivatives trading business and RMB cross border settlement services in 2012. Despite its late start, HB's fee income grew rapidly in recent years - guarantee and commitment fee, consultancy and advisory fee, custodian and other fiduciary fee, and bank cards fee grew by 225.1%, 142.4%, 99.5% and 96.9%, respectively.

Exhibit 12: HB's fee income mix in 1H13



Source(s): Company, ABCI Securities

Exhibit 13: HB's fee income growth in 1H13 (yoy, %)



Source(s): Company, ABCI Securities

In terms of fee income mix, consultancy and advisory fee, custodian and other fiduciary fee, and bank cards fee accounted for 23%, 17% and 15%, respectively, in 1H13. We expect total net fee income to grow by 30-60% each year in 2013-15E and account for 7.5% of top-line revenue by 2015E.

Prudent liquidity management

Interbank assets and liabilities to total interest-earning assets and interest-bearing liabilities were 21% and 28% as of June 2013. However, HB's interbank balance duration were relatively long, hence the actual liquidity risk is lower than perceived. E.g., as at June 2013, only 1.5% and 0.2% of HB's interbank assets and liabilities were due immediately, the lowest and second lowest among peers.

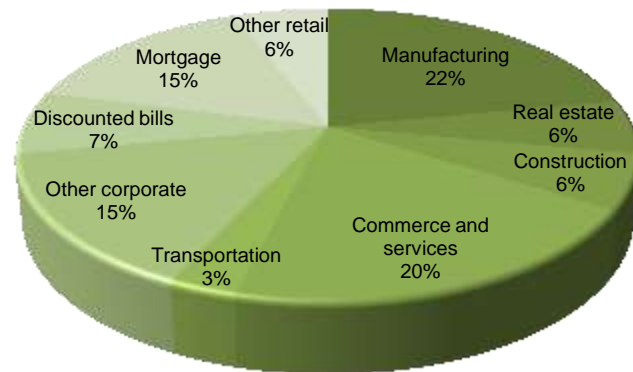
Heavy reliance on interbank balances is one of the main characteristics of district banks. Although this could result in more volatile funding yield as evidenced by HB's 1H13 result, HB's management has indicated their intention to reduce repo balance back to the 2012 level under the tightened regulatory requirements for interbank assets. In 3Q13, HB's interbank reverse repo balance fell 47.1% hoh.

Risk factors

Sustainability of asset quality

HB's dedication to SME business implies potential asset quality risk going forward - 54% of loans were allocated to riskier sectors such as manufacturing, commerce and services, and property-related ones in 2012. Although system new NPL in the past few quarters were mainly attributable to clients in coastal area, Anhui, locating next to eastern China, could be similarly impacted as well.

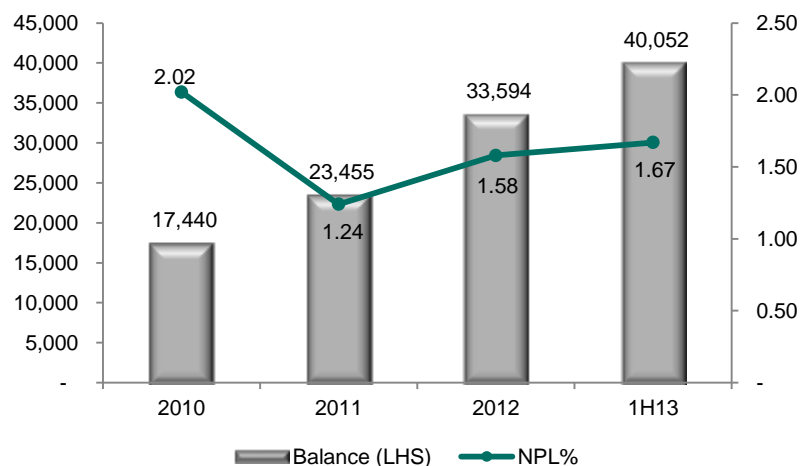
Exhibit 14: HB loan mix (2012)



Source(s): Company, ABCI Securities

Meanwhile HB 's commerce and services loans grew rapidly over the past few years, expanding by 34% and 43% yoy in 2011 and 2012 and by another 19% hoh in 1H13. The rapid growth, however, also resulted in rising NPL whose ratio edged up from 1.24% in 2011 to 1.67% in June 2013 within the specific loan category. At the same time, HB's total overdue loan also rose by 57% hoh in 1H13.

Exhibit 15: HB commerce and services loan (RMB mn)



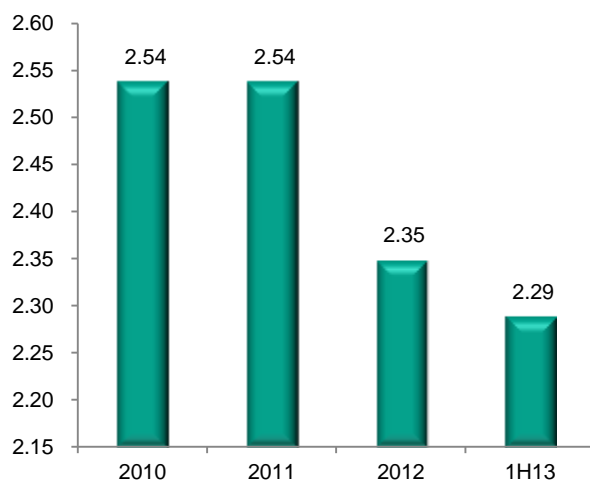
Source(s): Company, ABCI Securities

Nevertheless, we believe HB is following a stringent NPL classification standard, as hinted by its high NPL-to-overdue ratio of 81% in June 2013, comparable to 89% in CCB, which is known for its outstanding asset quality. Considering the national and provincial economic environment, we are confident that HB's NPL ratio should stay benign at 0.58%-0.62% over 2013E-15E, much lower than the systemic level of 1%.

Declining provisioning ratio since 2012

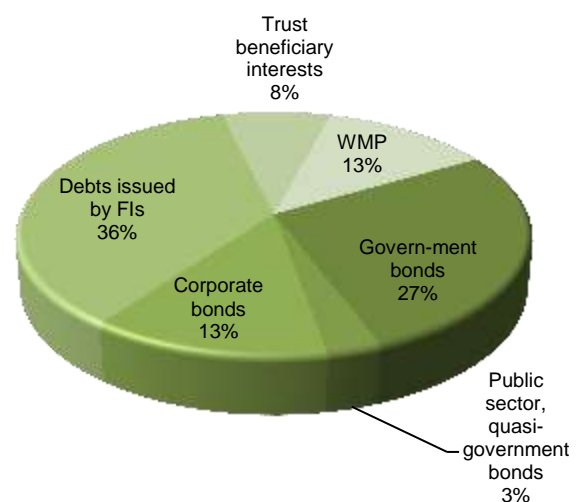
Although the CBRC requires banks to fulfill their provisioning ratio at 2.5% by 2016, HB's provisioning ratio has been declining since 2012 from 2.54% in 2011 to 2.29% in June 2013. Our base case scenario assumes that HB's provisioning ratio would increase from the current level to 2.5% by 2015E, equivalent to a 16%-36% yoy growth in loan loss provision in its P&L.

Exhibit 16: HB's provisioning ratio (%)



Source(s): Company, ABCI Securities

Exhibit 17: HB's investment portfolio (1H13)



Source(s): Company, ABCI Securities

Risk in investment portfolio

We consider 21% of HB's investment portfolio as high-risk investments, which include 8% of trust beneficiary interests and 13% of WMP issued by other FIs. Comparing the investment yields of HB and Chongqing Rural Commercial Bank (CQRB) in 1H13 (HB: 3.94%, CQRB: 5.85%), we estimate that the risk involved in HB should be much lower, as a riskier portfolio should entail a higher yield.

Valuation

In our base case scenario, we forecast HB's net profit to grow at 15.8% CAGR over 2012-15E, with its ROE at 16%-19%. We adopt the Gordon Growth Model ($P/B = (ROE-g)/(COE-g)$) to calculate the theoretical P/B of HB, which is a conventional method to value banks, and apply a discount factor of 15% for the smaller size and district-focus nature.

Our sustainable ROE of 16.4% reflects the simple average of ROE in 2010-15E, and a discretionary reduction of 1ppt is applied to reflect the intensified price competition. We assume a long-term growth of 6%, in line with other H-share Chinese banks in our coverage. The COE of 14.8% is calculated by a risk-free rate of 4%, a beta of 1.2 and an equity risk premium of 9%.

Currently HB is trading at 0.82x FY14E P/B, which we believe is at a discount to quality big banks whose average valuation is at 0.9x 14E P/B. This fairly reflects HB's nature as a district bank. We initiate coverage on HB with a **BUY**

recommendation. Our target price of HK\$ 4.21 implies 0.97x FY14E P/B and a 18.59% upside. HB's share price has stayed above its IPO price of HK\$ 3.53, outperforming the sector despite the flurry of negative news in Dec 2013 and Jan 2014. This reflects investors' confidence in HB as a quality district bank.

Exhibit 18: Valuation table of China's H-share banks

Name	BBG code	Market cap (US\$m)	Price (HK\$)		TP (HK\$)	Upside (%)	P/B (x)		P/E (x)		ROE (%)		Div yield (%)	
			Rating				13E	14E	13E	14E	13E	14E	13E	14E
ICBC	1398 HK	204,073	4.82	BUY	6.91	43.36	1.04	0.91	4.94	4.59	21.5	21.2	6.74	7.52
CCB	939 HK	174,614	5.43	BUY	8.19	50.83	1.01	0.88	5.11	4.62	21.0	20.3	6.91	7.60
ABC	1288 HK	130,724	3.49	BUY	4.74	35.82	1.05	0.93	5.37	4.99	20.9	19.8	6.45	7.16
BOC	3988 HK	117,588	3.30	BUY	4.13	25.15	0.80	0.72	5.08	4.80	16.6	15.9	6.82	7.20
BoCom	3328 HK	48,097	5.09	BUY	6.60	29.67	0.71	0.63	4.85	4.38	15.4	15.2	5.16	5.65
CMB	3968 HK	44,262	14.36	BUY	17.80	23.96	1.04	0.89	5.25	4.63	21.5	20.7	5.75	6.44
MSB	1988 HK	34,827	7.94	BUY	11.94	50.38	0.91	0.77	4.10	3.78	22.9	20.8	4.09	4.57
CITICB	998 HK	31,501	4.02	HOLD	4.05	0.75	0.66	0.57	4.59	4.02	15.3	15.2	5.29	6.22
HB	3698 HK	5,058	3.55	BUY	4.21	18.59	0.97	0.82	4.90	5.36	18.6	16.5	3.87	4.58
BoCQ	1963 HK	1,702	4.88	BUY	5.72	17.21	0.80	0.66	3.49	3.87	21.5	18.6	5.38	6.40
Average						29.57	0.90	0.78	4.77	4.50	19.5	18.4	5.64	6.33

Source(s): Companies, Bloomberg, ABCI Securities estimates

Company background

HB was established in 2005 by merging Hefei City Commercial Bank with five other city commercial banks and seven city credit cooperatives in Anhui Province. It is the only city commercial bank headquartered in Anhui. The bank is the largest city commercial bank in the Anhui province in terms of total assets, loan and deposit in 2012, and is the fourth largest city commercial bank in China by total loan and deposit next to ICBC, CCB and ABC. The bank's 199 outlets are highly focused in Anhui, with only six of them operating in Nanjing. As a result, about 93.5% and 97.1% of loans and operating income were generated from Anhui in 2012.

Exhibit 19: Bank's market share in Anhui Province (2012)

RMB bn	Total assets		Loans		Deposits	
	Amount	Market share (%)	Amount	Market share (%)	Amount	Market share (%)
ICBC	329	18.7	216	21.3	320	20.2
HB	314	17.8	167	16.5	242	15.3
ABC	285	16.2	128	12.6	273	17.2
CCB	280	15.9	174	17.2	267	16.8
BOC	223	12.6	144	14.2	214	13.5
BoCom	131	7.4	72	7.1	122	7.7
CEB	51	2.9	27	2.7	34	2.2
CITICB	50	2.9	33	3.2	41	2.6
CMB	46	2.6	33	3.2	41	2.6

Source(s): Companies, PBOC, ABCI Securities

In 2007, HB increased its share capital to RMB 3.175bn by issuing bonus share of 0.5 shares for every 10 shares to existing shareholders and a private placement of 630mn of new shares at RMB 1.09/share to five shareholders (one existing and four new shareholders). In 2008, HB issued another 5bn of new shares at RMB 1.35/share to 25 parties (two existing and 23 new shareholders) and increased the total share capital to RMB 8.175bn.

The bank has a diversified shareholding structure with no dominant shareholder. After its IPO, stated-owned corporate shareholders hold a 45.4% stake, while private enterprises, individuals and H-share shareholders hold 26.5%, 2.1% and 26% stakes in HB. Major shareholders include China Vanke (8.0%), Anhui Energy Group (7.4%), Anhui Credit Guaranty Group (7.3%), Anhui Guoyuan Holding (6.2%), Anhui Highway Holding (4.5%), Zhongjiang Sihai Company (4%), Hefei Xingtai Holding (3.3%), Wuhu Construction Investment (2.6%), and CCB Trust (2%).

Exhibit 20: HB's NIM model in 2012-13E

RMB mn	Growth (%)	Balance	2012			2013E				
			Average balance	Yield (%)	Interest inc/exp	Average balance	Yield (%)	Interest inc/exp		
Corporate loans	16.42	116,808				16.0	135,497			
Retail loans	14.58	35,080				15.0	40,342			
Discounted bills	84.32	11,907				40.0	16,670			
Total loans	19.20	163,795	149,322	7.16	10,697	17.53	192,509	178,152	6.90	12,292
L&R	(52.45)	1,814				500.0	10,885			
AFS	39.35	25,581				25.0	31,976			
HTM	26.49	26,063				15.0	29,972			
Held for trading	(28.54)	3,599				8.0	3,887			
Investment	19.33	57,056	54,536	4.08	2,225	34.46	76,720	66,888	3.80	2,542
Cash	3.26	57,649	42,616	1.52	647	20.0	69,179	63,414	1.54	977
Deposit with FIs	180.73	44,845	36,431	4.37	1,592	82.0	81,618	63,232	4.00	2,529
Total IEAs	25.80	323,346	282,905	5.36	15,161	29.90	420,026	371,686	4.93	18,340
Other assets	37.44	4,732				15.0	5,442			
Provision	10.41	(3,854)				14.90	(4,428)			
Total assets	26.17	324,224				29.86	421,040			
Deposits	17.67	239,543	205,210	1.98	4,061	17.0	280,265	259,904	2.05	5,328
Deposit with FIs	88.50	54,747	56,430	4.02	2,269	65.0	90,332	72,540	4.2	3,047
Bonds	0.01	3,992	3,992	6.55	262	110.0	8,383	6,187	5.9	365
Total ILBs	26.06	298,282	265,632	2.48	6,592	27.05	378,981	338,631	2.58	8,740
Other liabilities	66.32	5,462				79.00	9,777			
Total liabilities	26.61	303,743				27.99	388,757			
NIS					2.88					2.35
NIM					3.03					2.58

Source(s): Company, ABCI Securities estimates

Exhibit 21: HB's NIM model 2014E-15E

RMB mn	Growth (%)	Balance	2014E			2015E				
			Average balance	Yield (%)	Interest inc/exp	Average balance	Yield (%)	Interest inc/exp		
Corporate loans	15.0	155,822				15.0	179,195			
Retail loans	14.0	45,990				13.0	51,969			
Discounted bills	30.0	21,671				25.0	27,088			
Total loans	16.09	223,482	207,996	6.85	14,248	15.56	258,252	240,867	6.90	16,620
L&R	5.0	11,429				5.0	12,001			
AFS	20.0	38,371				15.0	44,127			
HTM	15.0	34,468				12.0	38,604			
Held for trading	8.0	4,198				8.0	4,533			
Investment	15.31	88,466	82,593	3.85	3,180	12.21	99,265	93,865	3.90	3,661
Cash	12.0	77,481	73,330	1.54	1,129	8.0	83,679	80,580	1.54	1,241
Deposit with FIs	12.0	91,412	86,515	4.05	3,504	9.0	99,639	95,526	4.10	3,917
Total IEAs	14.48	480,841	450,434	4.90	22,061	12.48	540,836	510,839	4.98	25,438
Other assets	15.0	6,258				20.0	7,510			
Provision	21.14	(5,364)				20.37	(6,456)			
Total assets	14.42	481,736				12.49	541,889			
Deposits	15.0	322,305	301,285	2.15	6,478	13.0	364,205	343,255	2.25	7,723
Deposit with FIs	12.0	101,172	95,752	4.00	3,830	10.0	111,290	106,231	4.10	4,355
Bonds	5.0	8,802	8,592	5.95	511	5.0	9,242	9,022	6.15	555
Total ILBs	14.06	432,279	405,630	2.67	10,819	12.13	484,736	458,508	2.76	12,634
Other liabilities	14.98	11,242				13.17	12,722			
Total liabilities	14.09	443,521				12.16	497,459			
NIS					2.23					2.22
NIM					2.50					2.51

Source(s): Company, ABCI Securities estimates

Consolidated income statement (2011A-2015E)

FY Ended Dec 31 (RMB mn)	2011A	2012A	2013E	2014E	2015E
Interest income	11,253	15,161	18,340	22,061	25,438
Interest expense	(4,164)	(6,592)	(8,740)	(10,819)	(12,634)
Net interest income	7,089	8,569	9,600	11,242	12,805
Net fee and commission	413	396	633	855	1,111
Other operating income	149	270	446	624	843
Operating income	7,651	9,235	10,679	12,721	14,758
Operating expenses	(2,500)	(3,132)	(3,633)	(4,287)	(5,059)
Impairment losses	(579)	(458)	(624)	(832)	(963)
Investment in associates	32	35	40	46	53
Profit before tax	4,604	5,680	6,463	7,648	8,789
Income tax expenses	(1,111)	(1,374)	(1,551)	(1,835)	(2,109)
Net profit	3,493	4,306	4,912	5,812	6,680
Growth (%)					
Interest income	36.3	34.7	21.0	20.3	15.3
Interest expense	86.0	58.3	32.6	23.8	16.8
Net interest income	17.8	20.9	12.0	17.1	13.9
Net fee and commission	64.3	(4.1)	60.0	35.0	30.0
Other operating income	6,408.2	80.9	65.0	40.0	35.0
Operating income	22.0	20.7	15.6	19.1	16.0
Operating expenses	13.5	25.3	16.0	18.0	18.0
Impairment losses	0.1	(20.9)	36.2	33.4	15.8
Investment in associates	136.2	10.4	15.0	15.0	15.0
Profit before tax	31.4	23.4	13.8	18.3	14.9
Income tax expenses	38.9	23.6	12.9	18.3	14.9
Net profit	29.2	23.3	14.1	18.3	14.9
Per share data					
BVPS	2.09	2.51	2.92	3.46	4.02
EPS	0.43	0.53	0.58	0.53	0.60
DPS	0.10	0.10	0.11	0.13	0.15
Key ratios (%)					
Net interest margin	3.17	3.03	2.58	2.50	2.51
Net interest spread	3.00	2.88	2.35	2.23	2.22
CIR	32.68	33.92	34.02	33.70	34.28
Net fee to topline	5.39	4.29	5.93	6.72	7.53
Credit cost	0.31	0.34	0.35	0.40	0.40
ROA	1.52	1.50	1.33	1.30	1.32
ROE	22.22	22.93	18.62	16.49	16.16
Dividend payout	23.41	18.98	25.00	25.00	25.00
Core CAR	10.87	10.30	13.11	13.47	13.86
Total CAR	14.68	13.54	15.42	15.73	15.98
LDR	67.50	68.38	68.69	69.34	70.91
Provision coverage	526.70	537.70	396.55	400.00	403.23
Provisioning ratio	2.54	2.35	2.30	2.40	2.50
NPL ratio	0.48	0.58	0.58	0.60	0.62
Effective tax rate	24.13	24.18	24.00	24.00	24.00

Source(s): Company, ABCI Securities estimates

Consolidated balance sheet (2011A-2015E)

As of Dec 31 (RMB mn)	2011A	2012A	2013E	2014E	2015E
Cash and bank	55,829	57,649	69,179	77,481	83,679
Due from bank and FIs	15,975	44,845	81,618	91,412	99,639
Total loans	137,413	163,795	192,509	223,482	258,252
- loan provision	(3,490)	(3,854)	(4,428)	(5,364)	(6,456)
Net loans	133,923	159,941	188,081	218,119	251,796
Investment securities	42,777	53,458	72,833	84,268	94,732
- L&R	3,815	1,814	10,885	11,429	12,001
- AFS	18,357	25,581	31,976	38,371	44,127
- HTM	20,605	26,063	29,972	34,468	38,604
- Held for trading	5,036	3,599	3,887	4,198	4,533
Total IEA	253,539	319,492	415,598	475,478	534,379
Other assets	3,443	4,732	5,442	6,258	7,510
Total assets	256,982	324,224	421,040	481,736	541,889
Customer deposits	203,580	239,543	280,265	322,305	364,205
Due to bank and FIs	29,043	54,747	90,332	101,172	111,290
Subordinated debt	3,991	3,992	8,383	8,802	9,242
Total IBL	236,614	298,282	378,981	432,279	484,736
Other liabilities	3,284	5,462	9,777	11,242	12,722
Total liabilities	239,898	303,743	388,757	443,521	497,459
Net assets	17,084	20,481	32,283	38,215	44,431
Share capital	8,175	8,175	11,050	11,050	11,050
Retained earnings	4,550	7,064	10,748	15,107	20,117
Reserves	4,358	5,242	10,485	12,058	13,264
Total equity	17,084	20,481	32,283	38,215	44,431
Growth (%)					
Cash and bank	61.4	3.3	20.0	12.0	8.0
Due from bank and FIs	20.3	180.7	82.0	12.0	9.0
Total loans	17.4	19.2	17.5	16.1	15.6
- loan provision	17.3	10.4	14.9	21.1	20.4
Net loans	17.4	19.4	17.6	16.0	15.4
Investment securities	16.8	19.3	34.5	15.3	12.2
- L&R	(44.6)	(52.4)	500.0	5.0	5.0
- AFS	(12.0)	39.4	25.0	20.0	15.0
- HTM	56.2	26.5	15.0	15.0	12.0
- Held for trading	na	(28.5)	8.0	8.0	8.0
Total IEA	25.0	26.0	30.1	14.4	12.4
Other assets	1.3	37.4	15.0	15.0	20.0
Total assets	24.6	26.2	29.9	14.4	12.5
Customer deposits	27.6	17.7	17.0	15.0	13.0
Due to bank and FIs	(8.9)	88.5	65.0	12.0	10.0
Subordinated debt	na	0.0	110.0	5.0	5.0
Total IBL	23.6	26.1	27.1	14.1	12.1
Other liabilities	4.1	66.3	79.0	15.0	13.2
Total liabilities	23.3	26.6	28.0	14.1	12.2
Net assets	46.8	19.9	57.6	18.4	16.3
Share capital	0.0	0.0	35.2	0.0	0.0
Retained earnings	68.9	55.2	52.1	40.6	33.2
Reserves	25.0	20.3	100.0	15.0	10.0
Total equity	19.0	19.9	57.6	18.4	16.3

Source(s): Company, ABCI Securities estimates

February 13, 2014 Company Report Rating: BUY TP: HK\$ 5.72

H-Share price (HK\$)	4.88
Est. share price return	17.21%
Est. 14E dividend yield	6.40%
Est. total return	23.61%

Analyst: Johannes Au
 Tel: (852) 2147 8802
 Email: johannesau@abci.com.hk

Key Data

52Wk H/L(HK\$)	6.03/4.65
Issued shares (mn)	2,705
H-Shares (mn)	1,157
Domestic (mn)	1,548
Market cap	
H-shares (HK\$ mn)	5,534
Domestic (HK\$ mn)	7,585
3-mth avg daily turnover (HK\$ mn)	11.05
Major shareholder(s) (%):	
Yufu	17.1
DSB	17.0

Source(s): Company, Bloomberg, ABCI Securities

FY12 Revenue breakdown (%)

Corporate banking	66.5
Retail banking	18.7
Treasury operations	14.8

Source(s): Company, ABCI Securities

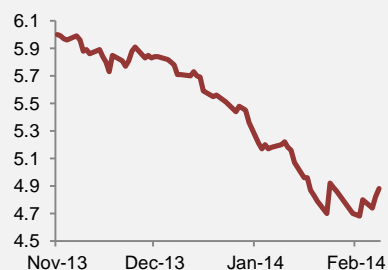
Share performance (%)

	Absolute	Relative*
1-mth	(6.51)	(4.05)
3-mth	(16.72)	(13.62)
6-mth	na	na

*Relative to HSI

Source(s): Bloomberg, ABCI Securities

1-Year stock performance (HK\$)



Source(s): Bloomberg, ABCI Securities

Bank of Chongqing (BoCQ, 1963 HK) A prospering west side story; initiate BUY

In addition to its fast growth over the past few years, BoCQ has successfully expanded its SMEs and MSEs businesses by capturing the high-yield niche market often overlooked by national banks. Meanwhile, its fee income and asset quality also benefit from synergy with its strategic investor, DSB. BoCQ enjoys the highest fee income-to-operating income ratio among city commercial peers while having the lowest NPL ratio among the H-share banks. As provision will increase on regulatory requirement, we believe its coverage ratio of over 400% should render the bank more defensive against future headwinds. BoCQ is currently trading at 0.66x FY14E P/B. We initiate our coverage on BoCQ with a **BUY** rating with TP at HK\$ 5.72, reflecting a 17.21% upside.

Decent balance sheet growth. Chongqing's GDP grew faster than national rate by 3%-8% in the past five years, supported by the continuous industrialization and urbanization. BoCQ's loan and deposit in 2012 grew 19.9% and 22.7%, higher than the systemic level of 15.6% and 13.4%.

Rapid growth in niche SME business. BoCQ has started its SME business back in 2007 and opened its first small-enterprise loan center in 2009. Micro lending grew rapidly, with small enterprise loan accounting for 29.9% of total corporate loan in 2012, as opposed to 10% in 2010. Strong demand and better yield from small enterprise loan should help defend NIM especially when interest rate is liberalized in the future.

Early bird advantage in fee income business. Percentage of fee income to total revenue was only 12.4% in 1H13 for BoCQ, which was low among the H-share banks but high when compared to other city commercial banks. Fee income from WMPs and trust would remain as the swing factors, while traditional fee income would continue to grow. We estimate fee income would grow by 50.7% CAGR over 2012-15E, while its percentage to top-line revenue would reach 14.4% by 2015E.

Prudent risk management as core value. Thanks to its strategic investor, DSB, BoCQ possesses a much better asset quality than peers with a NPL ratio of 0.38% in June 2013. Synergy has helped BoCQ to adopt a prudent risk management standard. Despite provision level will increase on regulatory requirement, its provision coverage of above 400% should defend the bank should risks arise.

Initiate with BUY. BoCQ's share price, in line with the China banks sector, has fallen by 19% since IPO. Its share performance has been weaker than its recently listed district bank peer Huishang Bank (HB), and we believe this can be attributed to its smaller size and local market share compared to HB. BoCQ is now trading at 0.66x FY14E P/B, the sector risk has been overdone in our view. We initiate our coverage on BoCQ with a **BUY** recommendation with a TP of HK\$ 5.72, which implies a 17.21% upside.

Risk factors: 1) Asset quality deterioration in the region; 2) Pricing competition from big banks to local regions; 3) Failure to optimize business mix of retail banking.

Results and Valuation

FY ended Dec 31	2011A	2012A	2013E	2014E	2015E
Revenue (RMB mn)	3,571	4,658	5,828	7,187	8,751
Chg (%.yoy)	28.7	30.4	25.1	23.3	21.8
Net profit (RMB mn)	1,488	1,925	2,328	2,752	3,164
Chg (%.yoy)	35.0	29.4	20.9	18.2	14.9
EPS (RMB)	0.74	0.95	1.12	1.01	1.16
Chg (%.yoy)	35.0	29.4	17.5	(9.9)	14.9
BVPS (RMB)	3.2	4.1	4.9	5.9	7.0
Chg (%.yoy)	28.3	28.0	20.2	20.3	17.8
P/E (x)	-	4.11	3.49	3.87	3.37
P/B (x)	-	0.96	0.80	0.66	0.56
ROE (%)	25.92	26.17	21.49	18.64	18.01
ROA (%)	1.26	1.36	1.30	1.22	1.17
DPS(RMB)	0.05	0.05	0.21	0.25	0.29
Yield (%)	-	1.28	5.38	6.33	7.42

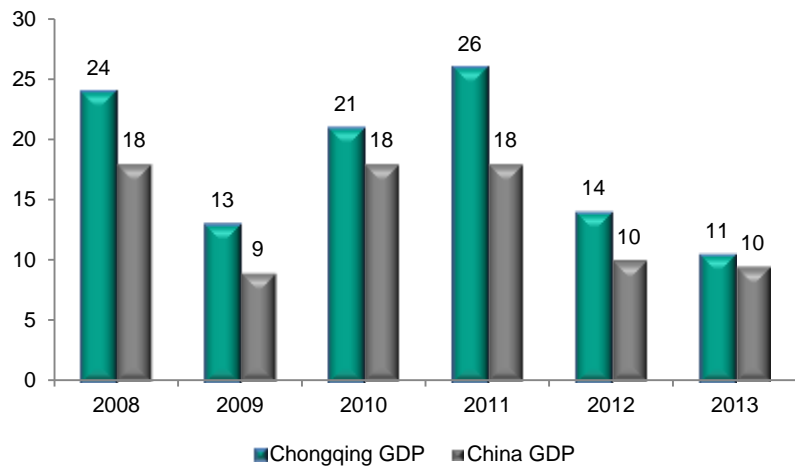
Source(s): Bloomberg, ABCI Securities estimates

Decent balance sheet growth

Above-average GDP growth supportive to domestic bank

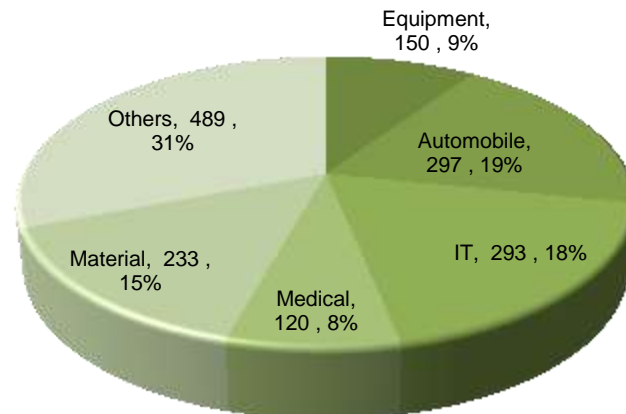
Fast economic growth was seen in Chongqing under continuous industrialization and urbanization. Its GDP has grown faster than the national rate by 3ppt-8ppt for the past five years. In 2008-12, Chongqing's demonstrated the highest CAGR growth of 17.5% among municipalities whose growth was in the range of 6.2%-12.2% for the same period. A district bank like Bank of Chongqing (BoCQ) has benefited immensely under such positive economic momentum.

Exhibit 22: Nominal GDP growth of Chongqing and China (yoy %)



Source(s): Wind, NBSC Chongqing, ABCI Securities

Exhibit 23: Chongqing's industrial output in 2013 (RMB bn)



Source(s): NBSC Chongqing, ABCI Securities

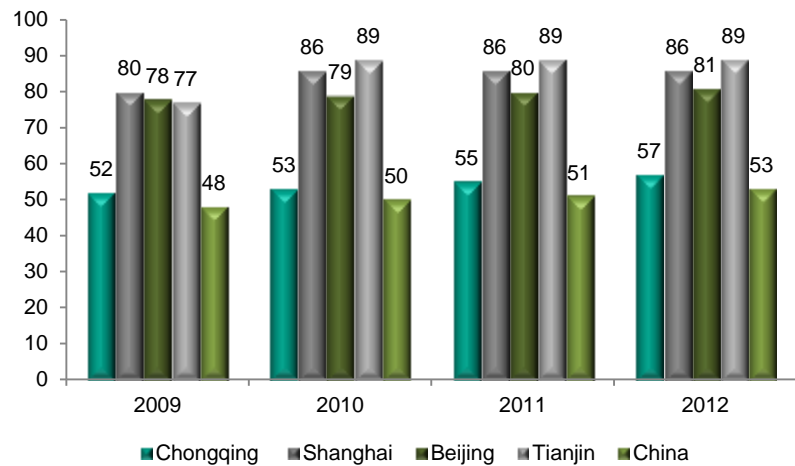
As one of the directly supervised municipalities (DSM), Chongqing has been experiencing rapid growth in the past decade under the "Go West" Policy that was first introduced in 2000. Rebalancing economic growth between coastal and less developed regions has been one of priorities of China. Hence, we believe Chongqing will continue to develop briskly, supported by its relatively low labor cost, government-supported infrastructure upgrade, migration of factories from coastal to western China, and beneficial tax rate.

Upon the establishment of Liangjiang new development zone in Chongqing, the third national economic zone after Shanghai's Pudong New Area and Tianjin's Binhai New Area, information technology, automotive, high-value equipment, aeronautics and biochemical have become the key industries in the region. Among which, automobile and IT accounted for the largest share of industrial output in 2013. We believe industry such as automobiles, technology, electronic and consumer-related manufacturing will become its core economic drivers in the medium/long term.

Lowest urbanization rate among DSM

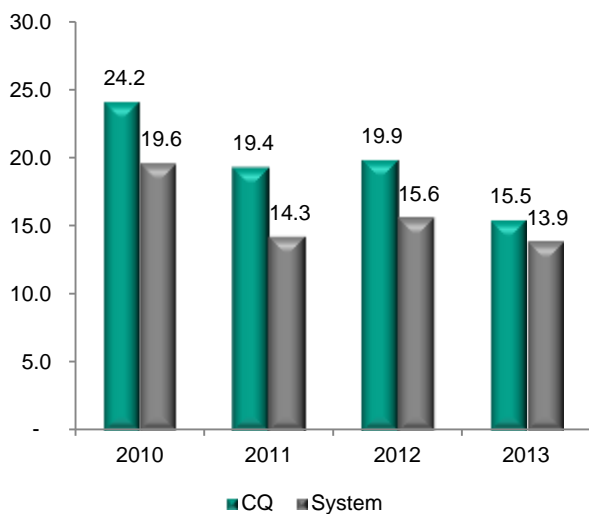
Nevertheless, Chongqing's urbanization rate of 57% is comparable to the national level of 53% but is the lowest compared to three other directly supervised municipalities whose rates exceed 80%. On the back of favorable policies and its geographical location, Chongqing Development and Reform Commission aims to raise Chongqing's urbanization to 70% by 2020. We forecast the region to achieve a above-average profit growth in the medium /long term.

Exhibit 24: Urbanization rate of the four directly supervised municipalities in China (%)



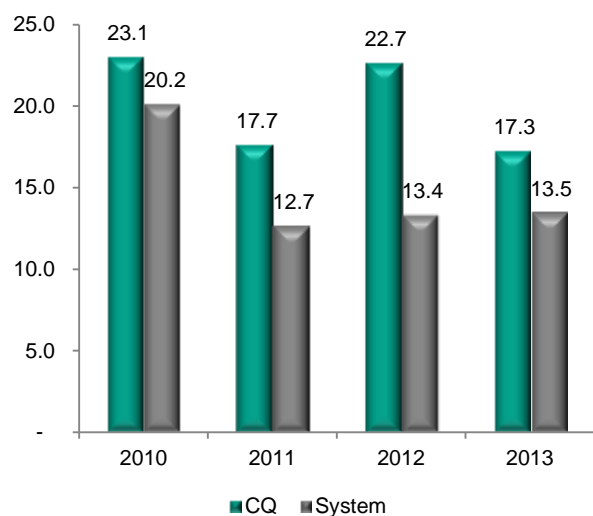
Source(s): Wind, ABCI Securities

Exhibit 25: Loan growth in Chongqing and system (yoy %)



Source(s): Wind, PBOC, NBSC Chongqing, ABCI Securities

Exhibit 26: Deposit growth in Chongqing and system (yoy %)

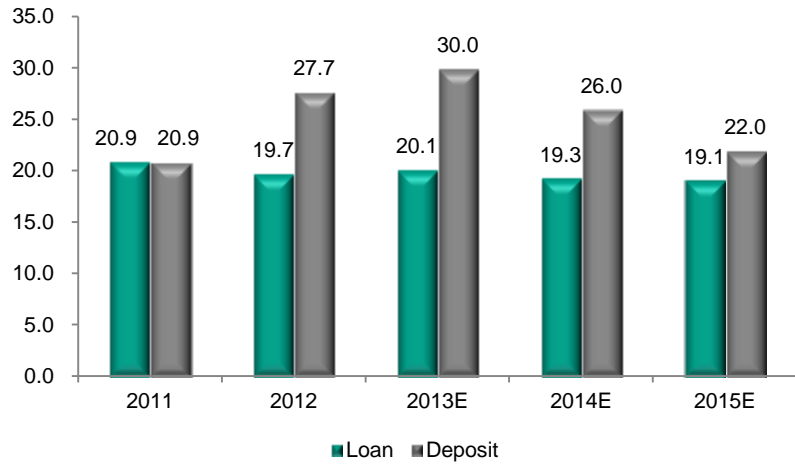


Source(s): Wind, PBOC, NBSC Chongqing, ABCI Securities

Fast-growing loan and deposit size

Robust economic growth usually means strong banking demand by local enterprises. Chongqing's loan and deposit growth has surpassed the system rate by 4.3ppt and 9.3ppt at 19.7% and 27.7% yoy in 2012. BoCQ, as a top player in Chongqing, also reported impressive loan and deposit growth of 19.7% and 30% in 2012. Taken together, BoCQ took up 3.6% and 4.9% of the domestic loan and deposit market shares.

Exhibit 27: BoCQ loan and deposit growth (%)



Source(s): Company, ABCI Securities estimates

Corporate banking as emphasis

Like other city commercial bank, corporate banking has been the key business segment of BoCQ supported by the local government and its established relationship with domestic corporates. About 61% of BoCQ's profit before tax was contributed by corporate banking in 1H13, compare to 59% in 2010. Meanwhile, we believe the increased contribution of retail banking up to 17% of total profit before tax was also supported by small business loans.

Exhibit 28: BoCQ's PBT mix in 2010



Exhibit 29: BoCQ's PBT mix in 1H13



Source(s): Company, ABCI Securities

Source(s): Company, ABCI Securities

Extending business to nearby regions

Bigger banks have set up their franchises in Chongqing to capture the rising banking demand. As competition intensifies, we believe it would be difficult for BoCQ to significantly raise its market share from its current level in the region. The bank has turned more aggressive to expand its business to nearby provinces such as Shaanxi, Sichuan and Guizhou in recent years. As of June 2013, these areas aggregated one-fourth of BoCQ's loan and deposit balance, compared to only 17.8% and 10.1% in 2010 respectively. Still, we would be cautious on the bank's expansion outside Chongqing as support from local government could be limited, and the bank may face fierce competition from regional players and need higher levels of risk management.

Although we expect BoCQ's market share in Chongqing to stay similar in coming years, robust economy growth in the province is likely to spur balance sheet growth. We believe enterprises in Chongqing would enjoy sustainable profit growth with the low production cost (labor, land, utilities) and a preferential tax regime that entails a rate as low as 15%. In our base case scenario, we forecast BoCQ's loan and deposit growth to sustain at 19%-20% and 22%-30% in 2013E-15E.

Robust top-line growth on low base

A different business model from CQRB's

Investors tend to compare BoCQ with Chongqing Rural Commercial Bank (CQRB) as their distribution franchises are mostly in Chongqing. Yet, the business models of the two are rather different. BoCQ is mostly an urban play with outlets concentrating in cities, while 52% of CQRB's outlets are in county areas (non-urban regions). This results in a significantly higher operating efficiency for BoCQ.

Exhibit 30: Business outlook of BoCQ and CQRB

	BoCQ	CQRB
Business focus	Urban	48% Urban, 52% county
Market share in CQ	5.9	15.6
No. of outlets	103	1,767
No. of employees	3000	15000
Total assets (RMB bn)	188	487
Total loans (RMB bn)	85	192
Total deposits (RMB bn)	140	339
ROE (%)	29.6	18.8
LDR (%)	61	57
NPL (%)	0.38	0.73

Source(s): Companies, ABCI Securities

With BoCQ's number of outlets and staff amounting to only 5.8% and 20% of CQRB's, BoCQ's total assets, total loan and total deposit were 38.6%, 44.3% and 41.3%, respectively, of CQRB. High efficiency allowed BoCQ to achieve a better ROE at 29.6% compared to 18.8% for CQRB in 1H13. BoCQ also had a lower LDR at 61% and a better NPL ratio at 0.38%, compared to CQRB's LDR of 57% and NPL ratio of 0.73%.

We believe BoCQ's smaller size means it has more growth potential in the future than CQRB and city commercial banks in other regions. Its strategic focus will be on key financial centers of western China and neighboring cities.

Niche focus on SMEs

BoCQ has setup its micro-loan department back in 2007 to capture opportunities in SME business, while its first small-enterprise loan center started in 2009. BoCQ demonstrated its ability to increase the operating efficiency through its in-depth knowledge of the local environment and the establishment of a value-chain business model to extend business opportunities and risk management to their upstream and downstream customers.

SME lending has been soaring over the past three years, in which percentage of small- and micro-enterprise loans to total corporate loans increased from 10% in 2010 to 29.9% in 2012; enterprises of medium size or below accounted for 68.9% of total corporate loans by 2012. We believe the rising proportion of SMEs and MSEs in its customer mix would render BoCQ's NIM more defensive against the pressure exerted by the ongoing interest rate liberalization; the resulting growth in asset size and enhanced yield may also present upside surprises to the bank's earnings.

Exhibit 31: BoCQ's corporate loan mix in 2010

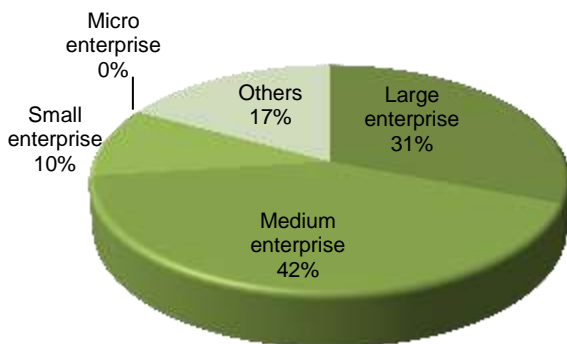
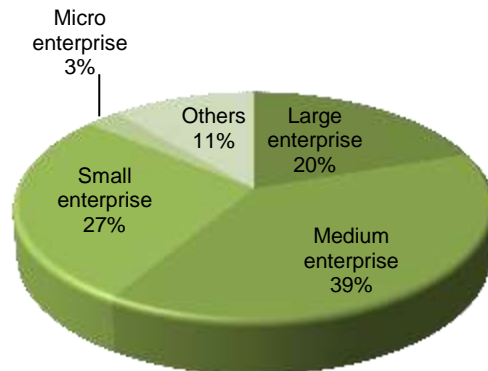


Exhibit 32: BoCQ's corporate loan mix in 2012



Source(s): Company, ABCI Securities

Source(s): Company, ABCI Securities

In our base case scenario, we forecast BoCQ's NIM to narrow by 6bps in 2013 to 2.79% mainly on the re-pricing from two rate cuts in 2012; its NIM would stabilize at 2.69% over 2014E-15E, based on the higher funding cost driven by the stiffening competition in the deposit market and BoCQ's reliance on interbank funding, although asset yield would be supported by the improved asset mix. We forecast BoCQ's net interest income will increase by 20% CAGR over 2012-15E.

Early bird advantage in fee income business

The percentage of fee income to operating income was 12.4% in 1H13 for BoCQ, which was low compared to other H-share Chinese banks but high among the city commercial banks. As city commercial banks tend to focus on credit business historically, most of them have only started to expand fee business in recent years. As a result, percentage of fee income to total income in most city commercial banks are usually below 10%.

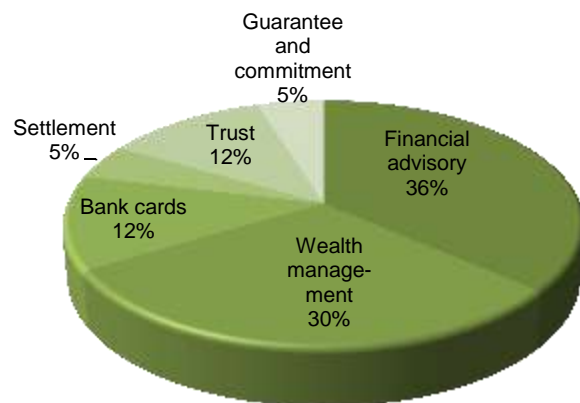
However, the figure in BoCQ has been boosted by synergy with DSB, its strategic investor and a reputable bank in Hong Kong. In Hong Kong, fee income usually account for 40%-60% of total income in banks, which also possess more sophisticated knowledge in fee structure as well.

Fee income from wealth management and trust have been the major driver in recent years, whose mix increased from 15% in 2010 to 30% in 1H13 and trust fee to account for 12% of total fee income in 1H13; traditional fee income such as bank cards also expanded from 4% in 2010 to 12% in 1H13 of total fee. Still, we believe room for growth is still ample and we forecast BoCQ's net fee income to grow at 50% CAGR over 2012-15E, while the proportion of fee income to total income should increase to 14.4% by 2015E.

Exhibit 33: BoCQ's fee income mix in 2010



Exhibit 34: BoCQ's fee income mix in 1H13



Source(s): Company, ABCI Securities

Source(s): Company, ABCI Securities

As net interest and net fee incomes are expected to rise, we expect BoCQ's top-line revenue to rise at a 23.4% CAGR over 2012-15E; net profit would grow at 18% CAGR while ROE CAGR would be in the range of 18%-21.5% for the same period.

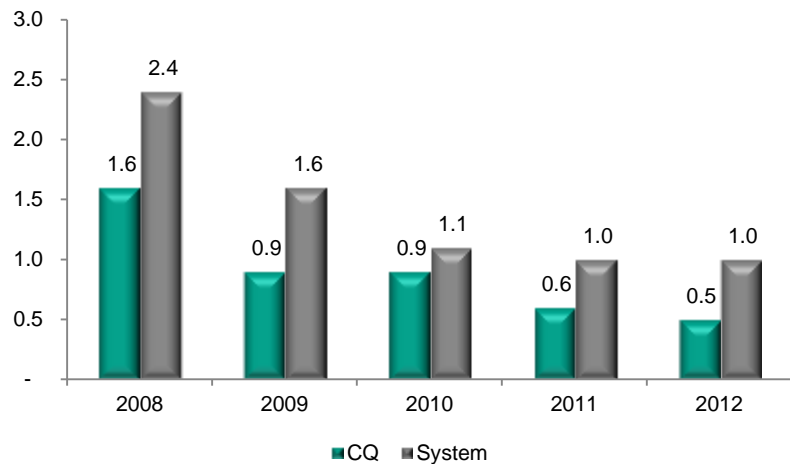
Prudent risk management as core value

An excellent track record of asset quality

BoCQ has an outstanding asset quality with its NPL ratio at 0.38% in June 2013, compared to the provincial level of 0.5% and systemic level of 1%. We believe this is one of the synergistic effects with DSB who has a high risk management standard and a prudent mentality. DSB has nominated the vice president and the chief risk officer for BoCQ, and shared its risk management experience with the bank.

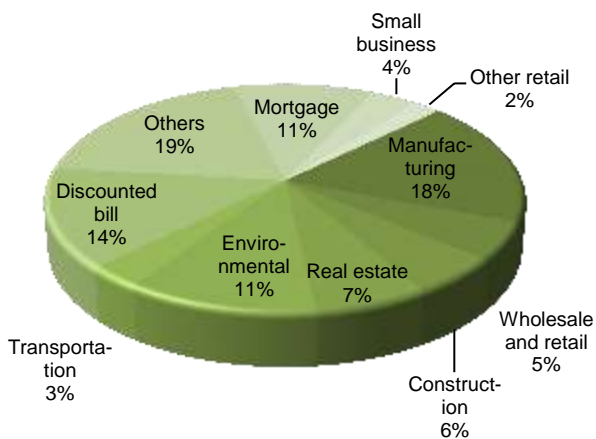
The recent system NPL trend shows that new NPLs were mainly from eastern China; by sector, manufacturing, wholesale/ retail were the major contributors. With a SME/MSE business focus, BoCQ has the largest exposure to these sectors - manufacturing accounted for 18% and wholesale/ retail took up 11% of total loans in 1H13. Meanwhile, real estate and construction loans made up 12%-13% of total loan. The level of exposure to risky sectors, however, was lower than that of other H-share Chinese banks, thus asset quality risk in BoCQ is no higher than its peers.

Exhibit 35: NPL ratio in Chongqing and system (%)



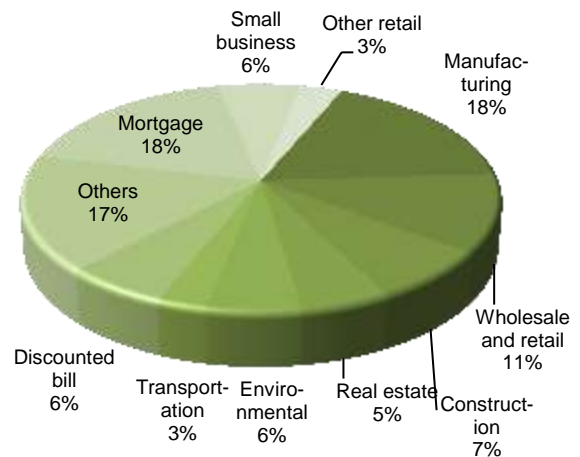
Source(s): Wind, ABCI Securities

Exhibit 36: BoCQ's loan mix by sector (2010)



Source(s): Company, ABCI Securities

Exhibit 37: BoCQ's loan mix by sector (1H13)

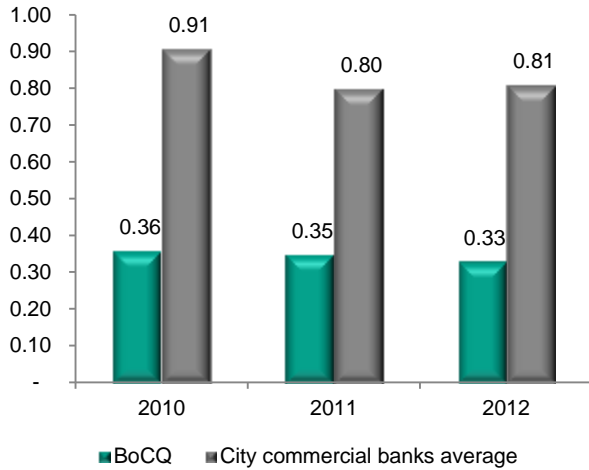


Source(s): Company, ABCI Securities

Among BoCQ's NPL balance of RMB 322mn as of June 2013, manufacturing and wholesale/retail accounted for 48% and 20% of total, followed by information technology's 17%. Two largest NPLs were from a manufacturing company and a technology company, which added up to over 44% (RMB 98mn and RMB 44mn) of the total NPL. Nonetheless, BoCQ's asset quality is one of the finest among city commercial bank. By end-2012, BOCQ's NPL ratio was 0.33% versus the city commercial banks' average of 0.81%.

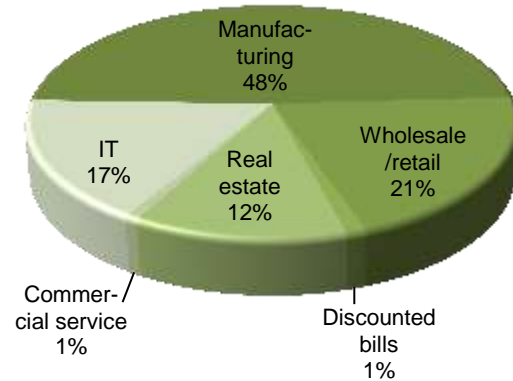
Total overdue loan has been well maintained at 0.3%-0.4% level since 2010. As of June 2013, loan overdue more than 90 days was at 0.2% of total overdue balance. BoCQ adopts a strict NPL classification system based on overdue period and collateral. For unsecured loans, those that are overdue for 1-90 days will be classified as special mention; those with an overdue period of 91 days or more will be classified into one of the NPL categories. Depending on the collateral and guarantee statuses, loans overdue for 91 days or 181 days will be classified as NPL.

Exhibit 38: NPL ratios of BoCQ and city commercial banks average (%)



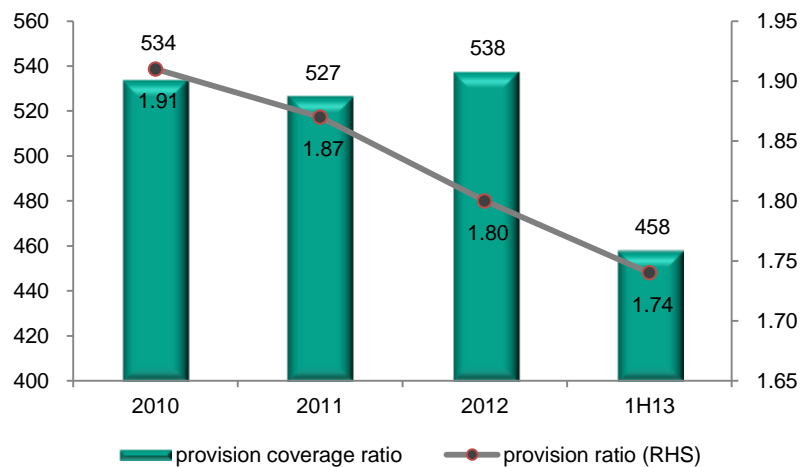
Source(s): Company, PBOC, ABCI Securities

Exhibit 39: BoCQ's NPL by sector in 1H13



Source(s): Company, ABCI Securities

Exhibit 40: BoCQ's provision ratio (%) and coverage ratio (%)



Source(s): Company, ABCI Securities

Strong buffer against economic downturn

BoCQ has maintained its provision coverage ratio at above 500% over 2010-12 and at 458% by end-June 2013. This provides the bank with sufficient buffer against any future increases in NPL. However, BoCQ's loan provisioning ratio was only at 1.74% in June 2013, meaning the bank will need to increase its provisions in the coming years to comply with CBRC's standard at 2.5% by 2016. Indeed, management indicated the bank would strengthen provisions in coming quarters.

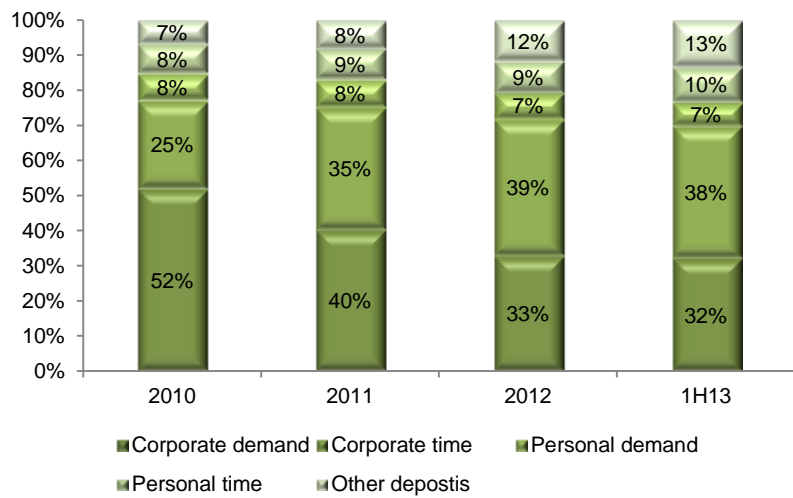
In the coming quarters, we expect provision would go up while overall asset quality would stay benign. We have assumed in our base case scenario that BoCQ's provision ratio will reach 2.4% by end-2015E. This would lead to a decline in net profit growth over 2013E-15E, even though we expect its top-line revenue to expand at a 23.4% CAGR over 2013E-15E.

Risk factors

Deposit mix may result in deposit cost fluctuation

BOCQ's corporate deposit accounted for 70% of total deposit in June 2013 (2010: 77%), s higher than the peer average of 64%. A high mix in corporate deposit usually means a less stable deposit base, especially when we believe BoCQ's corporate deposit base is highly concentrated on a small number of large domestic corporates. Withdrawal from a few corporates could result in a sizeable drop in BoCQ's total deposit. To maintain a stable deposit base, BoCQ may have to increase it deposit cost significantly.

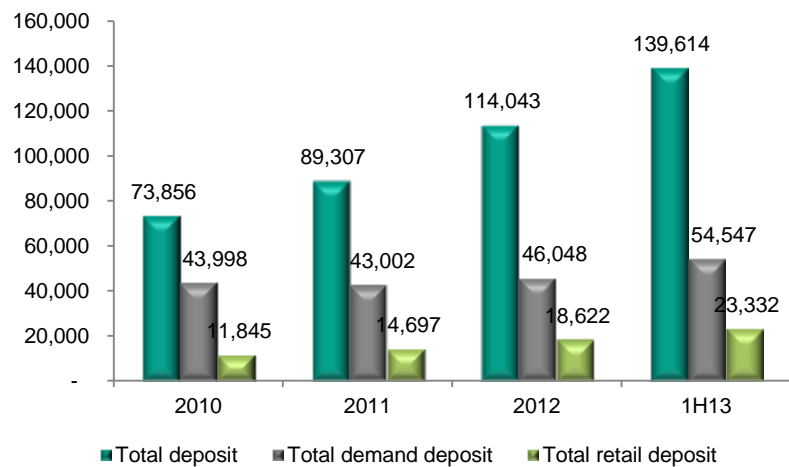
Exhibit 41: BoCQ's deposit mix (%)



Source(s): Company, ABCI Securities

Demand deposit is regarded as the cheapest funding source of a bank. Percentage of demand deposit to total deposit is relatively low in BoCQ at 39% in June 2013, compared to the peer average of 44%. To optimize its deposit structure, BoCQ would need to increase retail and demand deposits in the mix.

Exhibit 42: BoCQ's deposit (RMB mn)



Source(s): Company, ABCI Securities

BOCQ is well aware of the need to improve its deposit mix and has increased its effort to expand its retail business. Retail deposit growth in 2011, 2012 and 1H13 was 24% yoy, 27% yoy, and 25% hoh, respectively, in 1H13, outpacing the total deposit growth at 21%, 28% and 22% in the corresponding period.

High mix of interbank funding

City commercial banks typically follow a high efficiency model. They usually have fewer outlets than the national and rural banks, although most of these outlets are strategically located in key economic urban areas. The less extensive retail network would become a barrier for a city commercial bank like BoCQ to grow its deposit base effectively, in particular from the retail sources. District banks often have to rely on interbank funding and 19.3% of BoCQ's IBL was from the interbank market in 2012, compared to high single-digit or low-teen percentage for big banks.

Exhibit 43: BoCQ's IEA mix in 2012

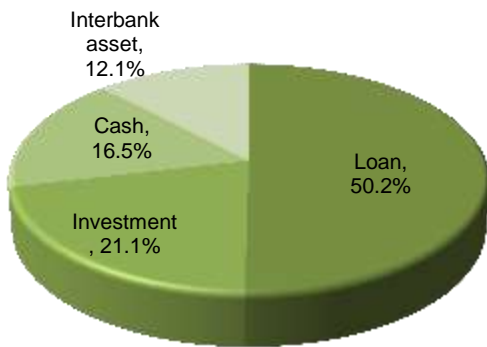
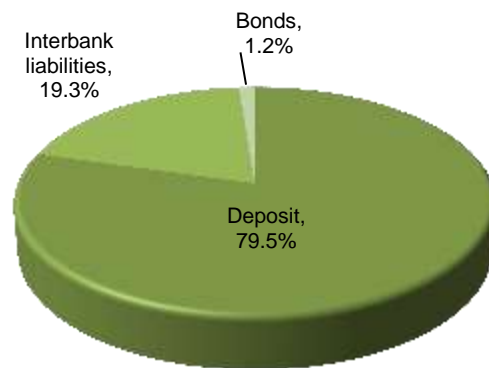


Exhibit 44: BoCQ's IBL mix in 2012



Source(s): Company, ABCI Securities

Source(s): Company, ABCI Securities

Liquidity concerns have repeatedly dragged down China banks' share prices since the SHIBOR increased sharply in June 2013. Market has turned highly sensitive to signals that may suggest a shrinking liquidity, especially during the end of each quarter if the PBOC suspends the use of repo tools. The high mix of interbank assets and liabilities in BoCQ would pose additional uncertainty to the bank's share price. We believe the bank will continue to adjust its funding sources by expanding its retail deposit base, and expect the interbank liabilities-to-total interest-bearing liabilities ratio would gradually reduce to 13.3% in 2015E.

The development of local government debts

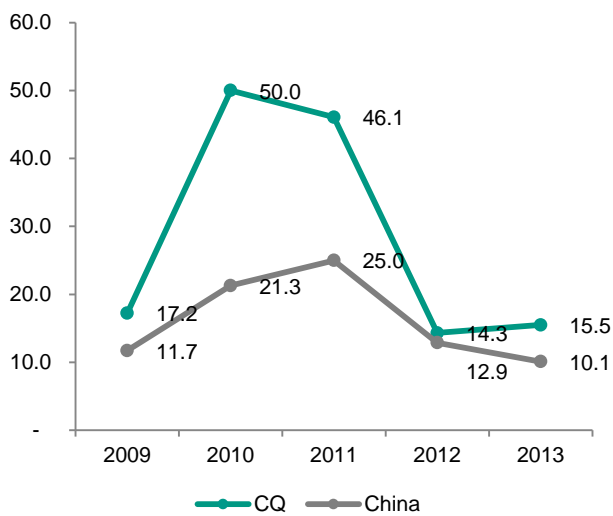
Despite BOCQ's outstanding asset quality, its exposure to local government financing vehicle (LGFV) has been another concern in recent years. We notice that banks have been reducing their overall exposure to LGFV except for the quality ones with sufficient cashflow coverage.

However, BoCQ's LGFV exposure increased from RMB 13.8bn in Dec 2010 to RMB 20.1bn in June 2013, even the percentage to total assets decreased from 12.74% in Dec 2010 to 10.67% in June 2013. The absolute increment was mainly attributable to investment in trust beneficiary rights which amounted to RMB 6.9bn in June 2013.

Nevertheless, we are comfortable with the size of such exposure and is confident the repayment ability of the LGFVs. Chongqing's LGFV exposure in 2012 was 20% and 26% of total loans and GDP, compared to 14% and 18% nationwide. We believe the default risk from Chongqing's LGFV loans are manageable, as reflected by the above-national growth in government revenue (excluding transfer income from central government) of 14.3%-50% in 2009-13.

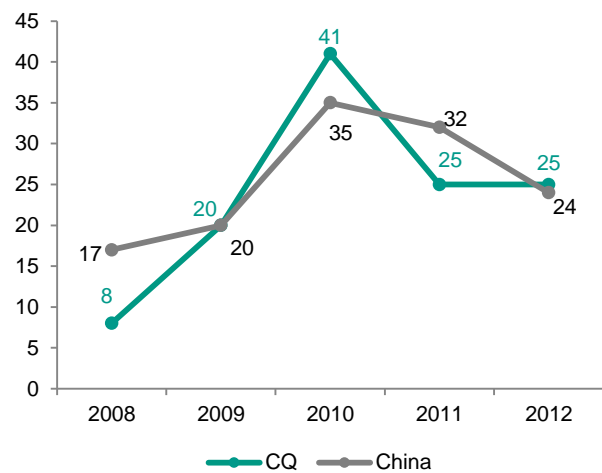
Furthermore, land sales premium (property sale price/initiate cost -1) has accounted for 25% of the government revenue in 2012. We believe such premium would be a strong funding source for the local governments in the future.

Exhibit 45: Government revenue growth (%)



Source(s): Wind, ABCI Securities

Exhibit 46: Percentage of land sales premium to government revenue (%)



Source(s): Wind, ABCI Securities

Valuation

We forecast BoCQ's net profit to grow by 18% CAGR over 2012-15E and an ROE of 18%-21%. We adopt the Gordon Growth Model ($P/B = (ROE-g)/(COE-g)$), which is a commonly used method for bank valuation, to calculate the theoretical P/B of BoCQ. Our TP incorporates a 20% discount to reflect the small business scale and limited geographical exposure of BoCQ.

Our sustainable ROE of 15.4% reflected the simple average of ROEs between 2010 and 2015E; a discretionary reduction of 4ppt is applied to reflect keen price competition faced by district banks and the relatively small size of BoCQ. We assume a long-term growth of 6%, which is in line with other H-share Chinese banks under our coverage. The COE of 15.7% is calculated by a risk free rate of 4%, a beta of 1.3 and an equity risk premium of 9%.

BoCQ's share price has fallen by 19% from its IPO price of HK\$ 6. Its share performance is in line with the sector but weaker than its recently listed district bank peer, Huishang Bank (HB). We believe this can be attributed to BoCQ's smaller size and the fact that it was not the largest player in its major operating zone. Nonetheless, we believe the sector and individual risks of the stock have been overdone. With its current valuation at 0.66x FY14E P/B, we recommend investors to **BUY** with TP set at HK\$ 5.72, implying a 17.21% upside.



Exhibit 47: Valuation table

Name	BBG code	Market cap (US\$m)	Price (HK\$)	Rating	TP (HK\$)	Upside (%)	P/B (x)		P/E (x)		ROE (%)		Div yield (%)	
							13E	14E	13E	14E	13E	14E	13E	14E
ICBC	1398 HK	204,073	4.82	BUY	6.91	43.36	1.04	0.91	4.94	4.59	21.5	21.2	6.74	7.52
CCB	939 HK	174,614	5.43	BUY	8.19	50.83	1.01	0.88	5.11	4.62	21.0	20.3	6.91	7.60
ABC	1288 HK	130,724	3.49	BUY	4.74	35.82	1.05	0.93	5.37	4.99	20.9	19.8	6.45	7.16
BOC	3988 HK	117,588	3.30	BUY	4.13	25.15	0.80	0.72	5.08	4.80	16.6	15.9	6.82	7.20
BoCom	3328 HK	48,097	5.09	BUY	6.60	29.67	0.71	0.63	4.85	4.38	15.4	15.2	5.16	5.65
CMB	3968 HK	44,262	14.36	BUY	17.80	23.96	1.04	0.89	5.25	4.63	21.5	20.7	5.75	6.44
MSB	1988 HK	34,827	7.94	BUY	11.94	50.38	0.91	0.77	4.10	3.78	22.9	20.8	4.09	4.57
CITICB	998 HK	31,501	4.02	HOLD	4.05	0.75	0.66	0.57	4.59	4.02	15.3	15.2	5.29	6.22
HB	3698 HK	5,058	3.55	BUY	4.21	18.59	0.97	0.82	4.90	5.36	18.6	16.5	3.87	4.58
BoCQ	1963 HK	1,702	4.88	BUY	5.72	17.21	0.80	0.66	3.49	3.87	21.5	18.6	5.38	6.40
Average						29.57	0.90	0.78	4.77	4.50	19.5	18.4	5.64	6.33

Source(s): Companies, Bloomberg, ABCI Securities estimates

Company background

BoCQ was established in 1996 by consolidating 37 urban credit cooperatives and one urban credit union. It is a city commercial bank with its headquarter in Chongqing, the only municipality in western China (report directly to the central government). BoCQ mainly operates in the urban area of Chongqing, as well as the neighboring regions in western China including Sichuan, Guizhou and Shaanxi. With 106 branches, BoCQ has been the second largest local player in Chongqing after CQRB and has 4% and 5% market share of the loan and deposit in the province. As of June 2013, non-Chongqing area contributed to 26% and 23% of BoCQ's total loan and deposit.

Exhibit 48: Market share of banks in Chongqing (2012)

RMB bn	Total assets		Deposits		Loans	
	Amount	Market share (%)	Amount	Market share (%)	Amount	Market share (%)
CQRB	485.5	18.7	336.1	16.9	188.3	13.3
ICBC	280.7	18.8	253.4	12.7	217	15.4
ABC	269	10.4	256.8	12.9	207.4	14.7
CCB	249.9	9.6	231.9	11.7	192.4	13.6
BoCQ	158.5	6.1	108.1	5.4	62.7	4.4
MSB	137.1	5.3	118.7	6	90	6.4
BOC	125.7	4.8	61.6	3.1	56.8	4
IB	111.4	4.3	73.1	3.7	38.4	2.7
CITICB	88.2	3.4	74.1	3.7	48.9	3.5

Source(s): Companies, PBOC, ABCI Securities

With 27 years of operating history, BoCQ developed sound relationships with the local government and corporates, which allowed the bank to establish long-term banking relationship with 67 out of the 100 most profitable corporates in the region. The bank had a total of 36,900 corporate and 2.2mn retail customers as of Dec 2012.

The bank disposed its NPL portfolio amounting to RMB 1.25bn and RMB 1bn in 2004 and 2006 to Chongqing Yufu Asset Management, a wholly owned company by Chongqing government. Besides, the bank wrote off RMB 400mn in NPL after a capital injection from SOEs in 2004.

Capital position of BoCQ is strengthened after a total of RMB 1.6bn of capital were injected to the bank in 2003-06, and sub-debts totaling RMB 1.8bn were issued in 2009 and 2012. Later in 2007, Dah Sing Bank has become its strategic shareholder through the acquisition of 404mn shares (20% stake) at an average of RMB2.11 per share from Yufu.

Upon the completion of IPO, Yufu and DSB remained as the major shareholders of BoCQ with 17.1% and 17% stakes. We believe these major shareholders are unlikely to divest their shares in near future. In particular, DSB firmly believes that BoCQ will continue to be its key profit contributor.



Exhibit 49: BoCQ's NIM model 2012-13E

RMB mn	Growth (%)	2012				2013E				
		Balance	Average balance	Yield (%)	Interest inc/exp	Growth (%)	Balance	Average balance	Yield (%)	Interest inc/exp
Corporate loans	14.49	57,134				15.0	65,704			
Retail loans	38.09	19,500				35.0	26,325			
Total loans	19.70	76,634	70,798	7.21	5,101	20.09	92,029	84,332	7.00	5,903
L&R	268.04	21,232				55.0	32,910			
AFS	102.62	3,244				15.0	3,731			
HTM	(21.24)	7,656				-5.0	7,273			
Investment	88.01	32,132	27,310	5.27	1,439	36.67	43,913	38,023	5.90	2,243
Cash	30.52	25,243	21,253	1.52	322	35.0	34,078	29,661	1.50	445
Deposit with FIs	(23.86)	18,532	26,408	5.48	1,447	55.0	28,725	23,628	4.60	1,087
Total IEAs	22.24	152,541	145,769	5.70	8,309	30.29	198,745	175,643	5.51	9,678
Other assets	33.52	4,999				15.0	5,749			
Provision	15.04	(1,377)				33.67	(1,841)			
Total assets	22.63	156,163				29.77	202,653			
Deposits	27.70	114,043	102,738	2.24	2,303	30.0	148,256	131,149	2.40	3,148
Deposit with FIs	(2.77)	27,659	32,299	5.45	1,760	10.0	30,425	29,042	4.95	1,438
Bonds	79.90	1,790	1,594	6.02	96	170.0	4,833	3,312	6.02	199
Total ILBs	20.84	143,492	136,631	3.04	4,159	27.89	183,514	163,503	2.93	4,785
Other liabilities	106.21	4,413				29.97	5,736			
Total liabilities	22.35	147,905				27.95	189,249			
NIS				2.66					2.58	
NIM				2.85					2.79	

Source(s): Company, ABCI Securities estimates

Exhibit 50: BoCQ's NIM model 2014E-15E

RMB mn	Growth (%)	2014E				2015E				
		Balance	Average balance	Yield (%)	Interest inc/exp	Growth (%)	Balance	Average balance	Yield (%)	Interest inc/exp
Corporate loans	15.0	75,560				15.0	86,894			
Retail loans	30.0	34,223				28.0	43,805			
Total loans	19.29	109,782	100,906	7.05	7,114	19.05	130,698	120,240	7.10	8,537
L&R	25.0	41,137				20.0	49,364			
AFS	12.0	4,178				10.0	4,596			
HTM	-3.0	7,055				5.0	7,408			
Investment	19.26	52,370	48,142	5.95	2,864	17.18	61,368	56,869	6.05	3,441
Cash	20.0	40,894	37,486	1.50	562	18.0	48,255	44,574	1.50	669
Deposit with FIs	40.0	40,214	34,470	4.65	1,603	25.0	50,268	45,241	4.70	2,126
Total IEAs	22.40	243,261	221,003	5.49	12,143	19.46	290,589	266,925	5.53	14,773
Other assets	15.0	6,611				20.0	7,933			
Provision	31.22	(2,415)				29.88	(3,137)			
Total assets	22.11	247,457				19.37	295,386			
Deposits	26.0	186,802	167,529	2.55	4,272	22.0	227,899	207,351	2.65	5,495
Deposit with FIs	9.0	33,163	31,794	5.15	1,637	8.0	35,816	34,490	5.20	1,793
Bonds	5.0	5,075	4,954	6.02	298	5.0	5,328	5,202	6.10	317
Total ILBs	22.63	225,040	204,277	3.04	6,208	19.55	269,044	247,042	3.08	7,606
Other liabilities	9.70	6,292				16.69	7,342			
Total liabilities	22.24	231,332				19.48	276,386			
NIS				2.46					2.46	
NIM				2.69					2.69	

Source(s): Company, ABCI Securities estimates



Consolidated income statement (2011A-2015E)

FY Ended Dec 31 (RMB mn)	2011A	2012A	2013E	2014E	2015E
Interest income	6,107	8,309	9,678	12,143	14,773
Interest expense	(2,786)	(4,159)	(4,785)	(6,208)	(7,606)
Net interest income	3,321	4,150	4,894	5,936	7,167
Net fee and commission	290	368	718	969	1,259
Other operating income	(40)	140	217	282	324
Operating income	3,571	4,658	5,828	7,187	8,751
Operating expenses	(1,451)	(1,901)	(2,471)	(3,163)	(4,049)
Impairment losses	(184)	(240)	(295)	(404)	(541)
Investment in associates	0	1	1	1	2
Profit before tax	1,936	2,518	3,063	3,621	4,163
Income tax expenses	(448)	(593)	(735)	(869)	(999)
Net profit	1,488	1,925	2,328	2,752	3,164
Growth (%)					
Interest income	54.5	36.1	16.5	25.5	21.7
Interest expense	97.9	49.3	15.0	29.7	22.5
Net interest income	30.5	25.0	17.9	21.3	20.7
Net fee and commission	46.5	26.9	95.0	35.0	30.0
Other operating income	(225.0)	(450.0)	55.0	30.0	15.0
Operating income	28.7	30.4	25.1	23.3	21.8
Operating expenses	31.0	31.0	30.0	28.0	28.0
Impairment losses	(27.3)	30.4	23.0	36.7	34.1
Investment in associates	na	na	20.0	20.0	20.0
Profit before tax	36.9	30.1	21.7	18.2	14.9
Income tax expenses	43.6	32.4	24.0	18.2	14.9
Net profit	35.0	29.4	20.9	18.2	14.9
Per share data					
BVPS	3.2	4.1	4.9	5.9	7.0
EPS	0.74	0.95	1.12	1.01	1.16
DPS	0.05	0.05	0.21	0.25	0.29
Key ratios (%)					
Net interest margin	2.92	2.85	2.79	2.69	2.69
Net interest spread	2.77	2.66	2.58	2.46	2.46
CIR	40.6	40.8	42.4	44.0	46.3
Net fee to topline	8.1	7.9	12.3	13.5	14.4
Credit cost	0.31	0.34	0.35	0.40	0.45
ROA	1.26	1.36	1.30	1.22	1.17
ROE	25.92	26.17	21.49	18.64	18.01
Dividend payout	6.79	5.25	25.0	25.0	25.0
Core CAR	9.26	9.39	11.09	10.78	10.50
Total CAR	12.11	12.83	13.64	12.97	12.44
LDR	71.7	67.2	62.1	58.8	57.3
Provision coverage	526.7	537.7	476.2	488.9	480.0
Provisioning ratio	1.87	1.80	2.00	2.20	2.40
NPL ratio	0.35	0.33	0.42	0.45	0.50
Effective tax rate	23.1	23.6	24.0	24.0	24.0

Source(s): Company, ABCI Securities estimates



Consolidated balance sheet (2011A-2015E)

As of Dec 31 (RMB mn)	2011A	2012A	2013E	2014E	2015E
Cash and bank	19,340	25,243	34,078	40,894	48,255
Due from bank and FIs	24,340	18,532	28,725	40,214	50,268
Total loans	64,022	76,634	92,029	109,782	130,698
- loan provision	(1,197)	(1,377)	(1,841)	(2,415)	(3,137)
Net loans	62,825	75,257	90,189	107,367	127,562
Investment securities	17,091	32,132	43,913	52,370	61,368
- L&R	5,769	21,232	32,910	41,137	49,364
- AFS	1,601	3,244	3,731	4,178	4,596
- HTM	9,721	7,656	7,273	7,055	7,408
Total IEA	123,596	151,164	196,905	240,845	287,453
Other assets	3,744	4,999	5,749	6,611	7,933
Total assets	127,340	156,163	202,653	247,457	295,386
Customer deposits	89,307	114,043	148,256	186,802	227,899
Due to bank and FIs	28,446	27,659	30,425	33,163	35,816
Subordinated debt	995	1,790	4,833	5,075	5,328
Total IBL	118,748	143,492	183,514	225,040	269,044
Other liabilities	2,140	4,413	5,736	6,292	7,342
Total liabilities	120,888	147,905	189,249	231,332	276,386
Net assets	6,452	8,258	13,404	16,124	19,000
Share capital	2,021	2,021	2,729	2,729	2,729
Retained earnings	3,122	4,554	6,300	8,364	10,737
Reserves	1,309	1,683	4,375	5,032	5,535
Total equity	6,452	8,258	13,404	16,124	19,000
Growth (%)					
Cash and bank	28.4	30.5	35.0	20.0	18.0
Due from bank and FIs	35.0	(23.9)	55.0	40.0	25.0
Total loans	20.9	19.7	20.1	19.3	19.1
- loan provision	18.2	15.0	33.7	31.2	29.9
Net loans	20.9	19.8	19.8	19.0	18.8
Investment securities	(18.9)	88.0	36.7	19.3	17.2
- L&R	(5.2)	268.0	55.0	25.0	20.0
- AFS	(68.5)	102.6	15.0	12.0	10.0
- HTM	(2.0)	(21.2)	(5.0)	(3.0)	5.0
Total IEA	16.4	22.3	30.3	22.3	19.4
Other assets	71.2	33.5	15.0	15.0	20.0
Total assets	17.6	22.6	29.8	22.1	19.4
Customer deposits	20.9	27.7	30.0	26.0	22.0
Due to bank and FIs	6.0	(2.8)	10.0	9.0	8.0
Subordinated debt	0.1	79.9	170.0	5.0	5.0
Total IBL	16.8	20.8	27.9	22.6	19.6
Other liabilities	33.2	106.2	30.0	9.7	16.7
Total liabilities	17.0	22.3	28.0	22.2	19.5
Net assets	28.3	28.0	62.3	20.3	17.8
Share capital	0.0	0.0	35.0	0.0	0.0
Retained earnings	49.1	45.9	38.3	32.8	28.4
Reserves	43.2	28.6	160.0	15.0	10.0
Total equity	28.3	28.0	62.3	20.3	17.8

Source(s): Company, ABCI Securities estimates



Disclosures

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Definition of equity rating

Rating	Definition
Buy	Stock return \geq Market return rate
Hold	Market return $- 6\% \leq$ Stock return $<$ Market return rate
Sell	Stock return $<$ Market return $- 6\%$

Stock return is defined as the expected % change of share price plus gross dividend yield over the next 12 months

Market return: 5-year average market return rate from 2009-2013

Time horizon of share price target: 12-month

Definition of share price risk

Rating	Definition
Very high	$2.6 \leq$ 180 day volatility/180 day benchmark index volatility
High	$1.5 \leq$ 180 day volatility/180 day benchmark index volatility $<$ 2.6
Medium	$1.0 \leq$ 180 day volatility/180 day benchmark index volatility $<$ 1.5
Low	180 day volatility/180 day benchmark index volatility $<$ 1.0

We measure share price risk by its volatility relative to volatility of benchmark index. Benchmark index: Hang Seng Index.

Volatility is calculated from the standard deviation of day to day logarithmic historic price change. The 180-day price volatility equals the annualized standard deviation of the relative price change for the 180 most recent trading days closing price.

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**Office address: ABCI Securities Company Limited, 13/F Fairmont House,
8 Cotton Tree Drive, Central, Hong Kong.**

Tel: (852) 2868 2183