



Company Report

BOCHK (2388 HK) – Buy Diversified Banks Industry Initiation (2013E TP: HK\$33.61)

Key data

Share price (HK\$)	26.15
Target price (HK\$)	33.61
Upside potential (%)	28.5
52Wk H/L(HK\$)	26.15/20.25
Issued shares (mn)	10,573
Market cap (HK\$mn)	276,478
30-day avg vol (HK\$mn)	289
Major shareholder (%)	
BOC	66.1

Source: Company & Bloomberg

Revenue breakdown by segment (1H12) (%)

Personal banking	25.6
Corporate banking	30.5
Treasury	24.1
Insurance	19.7
Others	0.1

Source: Company

Share performance (%)

	Absolute	Relative*
1-mth	8.3	3.4
3-mth	8.3	(0.4)
6-mth	10.9	(10.5)

*Relative to Hang Seng Index

Source: Bloomberg

1 year price performance



Source: Bloomberg

Analyst

Report Date: 23 January 2013

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Monetizing CNH development

A leading position in CNH business allows BOCHK to outperform peers through improving Rmb LDR and Rmb NIM. NIM rises on the back of stable funding cost and better asset yields, which will drive BOCHK's NII to grow at a CAGR of 13% during 2012-14E. Generous dividend policy and strong CAR position justify the bank as our sector core holding. We initiate coverage on BOCHK with a BUY rating and a 29% upside.

Competitive edges in CNH businesses. Rmb internationalization is on the path of acceleration by the setup of Qianhai Financial Pilot Zone. New Rmb loan channel allows HK banks to mitigate structure issues of low Rmb LDR and Rmb NIM. In addition, CNH deposits have gained growth momentum since October 2012. With our estimated BOCHK's 30% and 50% market shares in CNH deposits and loans respectively, we think the bank will outperform peers with increased CNH deployment which started to reflect from 1H12 results.

NIM bottomed in 1H11. With stable HKD and USD funding cost under liquidity inflow and low interest rate environment, and limited upside of Rmb deposit cost approaching to China rates, we expect HK banks' NIM to rise mildly for better loan pricing and improving Rmb asset yields. BOCHK's NIM therefore could expand by 5bps and 6bps in 2013E and 2014E respectively after a 29bps jump in 2012E, resulting in a NII CAGR of 13% and a net profit CARG of 7% during 2012-14E.

Defensive dividend policy and CAR positions. BOCHK's management is dedicated to maintain a generous dividend policy even in a bad year, with a 60-70% payout ratio. Strong Tier 1 capital at 13% and total CAR at 17.4% lifted dividend cut concerns on Basel III implementation. The high-end payout ratio and strong CAR positions constitute solid defensive factors to justify BOCHK as the sector core holding.

Our GGM target price of HKD33.61 implying 2.43x 2013E P/B. Currently BOCHK trades at 1.89x 2013E P/B. Taken into account BOCHK's top notch ROE, unique CNH clearing position and leading HK market share, we think the bank deserves to trade at a premium to peers. **We initiate coverage on BOCHK with a BUY recommendation and a 29% upside.**

Risk factors: Slowdown of RMB internationalization, sharp deterioration of China asset quality and macro environment.

Results and valuation

(FY ended Dec 31)	FY10A	FY11A	FY12E	FY13E	FY14E
Operating income (HKD mn)	27,508	30,846	36,495	39,991	44,581
Y-Y Chg (%)	5.6	12.1	18.3	9.6	11.5
Net profit (HKD mn)	16,196	20,430	20,859	22,727	24,968
Y-Y Chg (%)	16.3	26.1	2.1	9.0	9.9
EPS (HKD)	1.53	1.93	1.97	2.15	2.36
BVPS (HKD)	10.89	12.27	13.06	13.84	14.65
PE (x)	--	13.5	13.3	12.2	11.1
PB (x)	--	2.13	2.00	1.89	1.79
Dividend yield (%)	--	4.6	4.6	5.2	5.9
ROAE (%)	14.8	16.7	15.6	16.0	16.6

Source: Company, ABCI Securities estimates



農銀國際

ABC INTERNATIONAL

ABCI SECURITIES COMPANY LIMITED

BOC Hong Kong (Holdings) Limited

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Executive Summary

We are initiating coverage on BOC Hong Kong (Holdings) Limited (BOCHK, 2388 HK) with a BUY recommendation, by using Gordon Growth Model (GGM) to calculate our HKD33.61 target price, which implied 2.43x 2013E P/B. We like BOCHK for its leading position among the Hong Kong banking sector with a top-notch ROE and a unique offshore Rmb (CNH) clearing role, which allow the bank to outperform peers amid acceleration of Rmb internationalization post the 18th Congress. Despite we expect both HK loans and deposits growth to remain calm, NIM improvement will be driven by better Rmb assets yields and stable funding cost. In addition, BOCHK's stable dividend and CAR position serve as solid defensive factors. We initiate coverage on BOCHK with a BUY recommendation and a 29% upside.

Set to outperform in Rmb internationalization

BOCHK has leading CNH edge given its unique clearing bank position and holding company relationship. Due to the lack of CNH deposits investment channels, HK banks historically have low Rmb LDR and deteriorating NIM from high Rmb funding cost. However we believe the situation is going to improve after the 18th Congress as RMB internationalization shows signs of acceleration. Qianhai Financial Pilot Zone opens up new CNH loan channel for HK banks, which would gradually increase their Rmb LDR and NIM. Besides, continuous Rmb appreciation will resume CNH deposits growth momentum. We are convinced that BOCHK will be the outperformer and market leader of CNH loans and deposits. This has been started to reflect from the bank's better-than-peers 1H12 NIM.

Time for NIM improvement

We are of the view that HK banks' funding costs are turning stable. We expect stable HKD and USD funding cost amid continuous liquidity inflow and low interest rate environment. Rmb funding costs should have limited upside as the current interest rate level is approaching the onshore level. Meanwhile we believe there are still rooms for higher Rmb asset yields. Despite we forecast both system loans and deposits to grow mildly by 6-8% per year, net-net HK banks' NIM should improve in a gentle manner. We forecast BOCHK's NIM to expand by 5bps and 6bps in 2013E and 2014E respectively, resulting in a net interest income CARG of 13% and a net profit CARG of 7% during 2012-14E.

Defensive with high dividend yield

The generous dividend policy and high-end CAR position constitute a solid defensive outlook for BOCHK. Sufficient CAR in the HK banking sector rules out the risk of dividend cut, and lifts concerns on CAR enhancement regarding the implementation of Basel III. BOCHK has 13% Tier 1 CAR and 17.4% total CAR, the highest in the sector. We feel comfortable that BOCHK could sustain its payout ratio at 60-65% during 2012-14E, which implies 4-6% dividend yield at current price.



Monetizing CNH development

Acceleration of Rmb internationalization

The pace of Rmb internationalization has been resumed after the 18th Congress. On 27 December 2012, the PBOC approved and kicked off the Qianhai Financial Pilot Zone (QFPZ) operations by allowing designated companies to borrow CNH loans from HK banks, with sole purpose to develop Qianhai projects. We think the launch of QFPZ not only serves as an experimental spot of CNH inflow/outflow circuit, but also provides a new channel for HK banks to use their CNH funding, which will improve their Rmb NIM. Among the HK banks, BOCHK with its unique clearing house position, strong institutional clients and regulator network could leverage itself as the major beneficiary of Rmb internationalization.

The QFPZ was created in 2010 by the State Council with a national strategic intention to develop pilot measures in taxation, legal, human resources, education, medicine and telecommunications, besides the financial sector. Qianhai is located in the west side of Shenzhen with 15 km sq area and is designated as a core component in the circular flow of CNH by serving as a connection between HK and China. On 27 June 2012, the government approved the preferential policies including low tax rate and legal regime and started to attract investor to the pilot zone.

NIM potential from low Rmb LDR

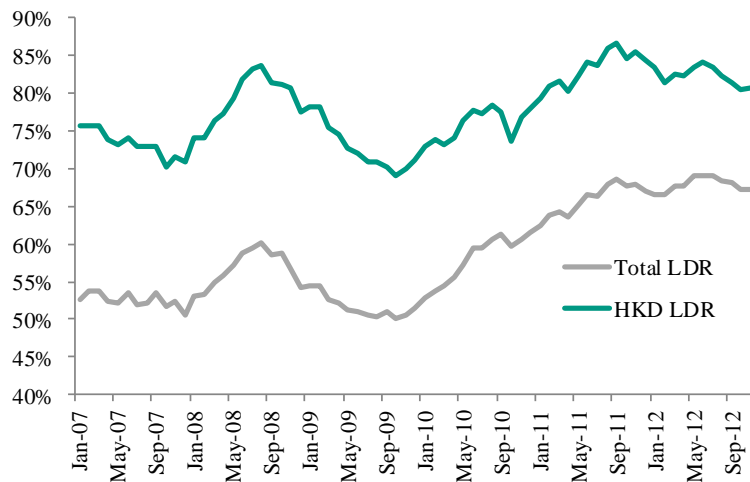
Despite the CNH market in HK has started to develop since 2004, the structural problem facing HK banking sector was the lack of investment channels for their Rmb deposits. In order to capture potential China's business opportunities, banks were keen to compete for CNH deposits with high funding cost even with low visibility of exit channels. Banks soon found that it was hard to grow their Rmb loan book given fast Rmb appreciation and regulatory limitations. Without alternatives, banks parked majority of their Rmb funds in the interbank market together and Rmb bonds, which depressed their Rmb NIM to a low level.

BOCHK, as a sole CNH clearing bank in HK, was allowed by the PBOC to accept CNH deposits from other financial institutions through trust accounts at 0.629% interest rate, while the Shenzhen PBOC will pay BOCHK at 0.72% for any excess CNH parking with them. Although this appears that BOCHK could earn some 10bps spread from its CNH deposits base, we believe the size of such trust accounts is not significant, given that CNH deposit costs under keen competition created a negative spread to participating banks if they stayed their funds with BOCHK's trust account.

HKMA does not apply strict LDR control to HK banks and system LDR was maintained at low level of 65%. However if we analyze the LDR by currency, divergence appears. HKD LDR was over 80% while we estimate Rmb LDR was only 25-35%. By the end of June 2012, BOCHK's LDR by currency for Rmb, USD and HKD was 31.5%, 83.1% and 76.8% respectively. This implies plenty of room for HK banks to extend their Rmb loan book, given the acceleration of Rmb internationalization process and the development of QFPZ experimental spot. We could reasonably expect Rmb LDR to increase gradually and improve assets yield for HK banks through more Rmb investment alternatives. We forecast BOCHK's LDR to reach 70% by end 2014E from 65% in 2012E.



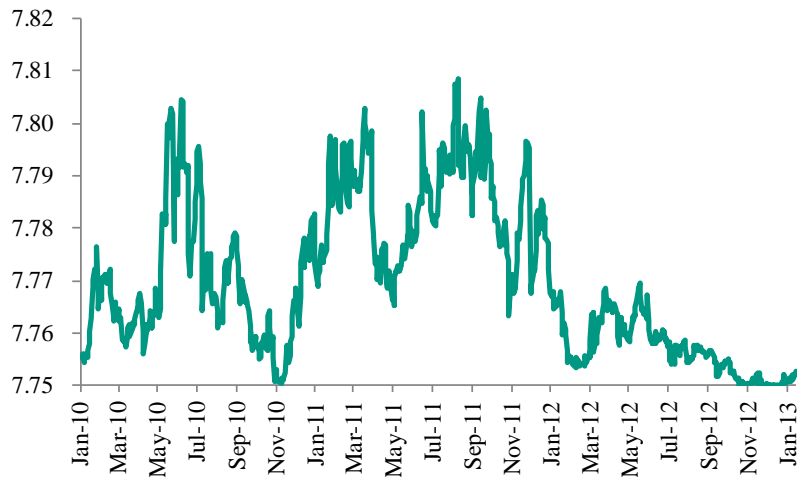
Exhibit 1: HK system LDR



Source: HKMA, ABCI Securities estimates

On the other hand, we believe banks' funding costs have peaked. Given the HKD/USD exchange rate floating at 7.75 (lower range of linked rate) since 2H12, sufficient liquidity inflow cooled down HKD funding needs, thus reducing deposit competitions. Even though we still saw keen CNH deposit competitions in the previous quarters, one-year CNH time deposit rates surged from 1% to 3% in 2012 and CNH deposit rates has been slightly lowered in 2013 according to our channel checks. This implies that further upside of CNH deposit cost is limited on the assumption that current deposit rate are closely matched with the China onshore benchmark rates.

Exhibit 2: HKD/USD exchange rate



Source: Bloomberg, ABCI Securities estimates

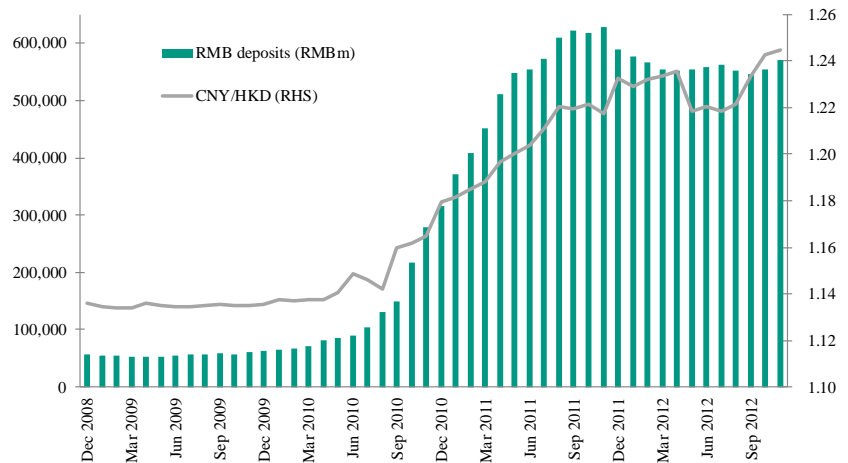
CNH deposits growth momentum to resume

After 87% YoY growth in 2011, system CNH deposits base was dropped by 9% YoY as of November 2012. We noticed that the growth of CNH deposits base in HK is highly correlated with the trend of Rmb appreciation. The exchange rate between Rmb and HKD was appreciated in late 2010 from 1.14 to 1.22 in mid-2011 while CNH deposits balance grew as much as 500% YoY in line with such appreciation trend until 2H11, partly due to low base effect. The



exchange rate of Rmb/HKD was then stable at 1.22 from August 2011, followed by a slight dip in November 2011, which at that time the CNH deposit balance was also peaked and flat at Rmb600bn level.

Exhibit 3: Offshore RMB deposit base and RMB exchange rate



Source: HKMA, ABCI Securities estimates

Later in 2012, with relatively stable Rmb/HKD ranged at 1.22-1.24, the CNH deposits balance was flat throughout the year. Six out of the first eleven months in 2012 recorded low-single-digit negative MoM growth. Nevertheless, despite the negative growth was partly due to fund distraction by other Rmb investment channels such as Rmb-denominated funds, bonds and equity, the rebound of exchange rate from July 2012 resumed the growth momentum of Rmb deposits since October 2012. HKMA estimated the CNH deposits balance in HK to reach Rmb700bn by December 2012. Surging back above 1.24 level and given our macro assumption of 1-2% appreciation each in 2013-14E, we forecast 3-4% YoY growth in CNH deposits base in 2013-14E. Being the market leader of CNH businesses, we estimate BOCHK to hold 30-35% market share in CNH deposits and 40-50% market share in CNH loans. The solid Rmb funding channels allows BOCHK to quickly capture any new Rmb investment opportunities.

Competitive edges started to show

The magic of BOCHK's CNH leadership has been started to reflect in 1H12 results. BOCHK led its peers with 20bps HoH NIM expansion and 43bps YoY expansion, driven mainly by its Rmb assets yield, both from HK and China. HK banks on average recorded only 4bps expansion HoH and 9bps YoY. Although we expect BOCHK's NIM has bottomed out in 1H11, we conservatively forecast the bank's 2012E NIM to stay at 1.62% (1.64% for 1H12), and mildly improve by 5bps and 6bps to 1.67% and 1.73% in 2013E and 2014E respectively. Benefiting from the market leader position, further acceleration of Rmb internationalization and new Rmb business opportunities, BOCHK is our top choice among the HK banks universe.

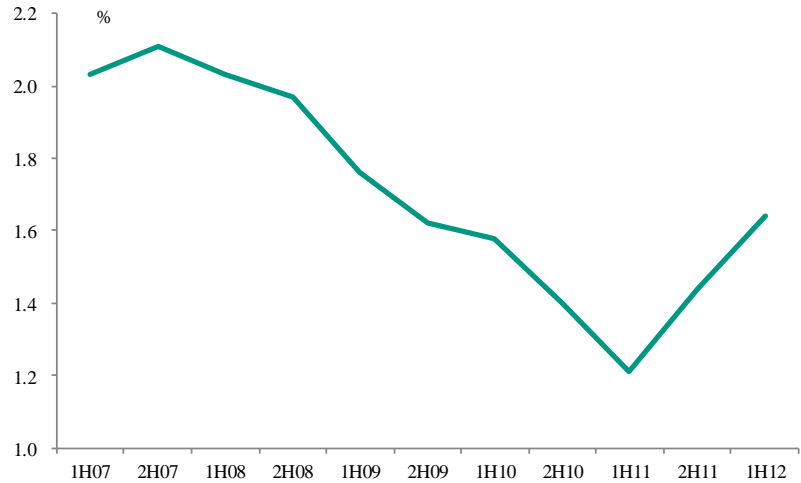


Exhibit 4: HK banks NIM comparison

(%)	1H11	2H11	1H12	YoY (bps)	HoH (bps)
BOCHK	1.21	1.44	1.64	43	20
HSB	1.75	1.80	1.85	10	5
BEA	1.84	1.90	1.86	2	(4)
WHB	1.71	1.64	1.67	(4)	3
DSB	1.52	1.30	1.47	(5)	17
CHB	1.06	1.28	1.11	5	(17)

Source: Companies, ABCI Securities estimates

Exhibit 5: BOCHK NIM trend



Source: Company, ABCI Securities estimates

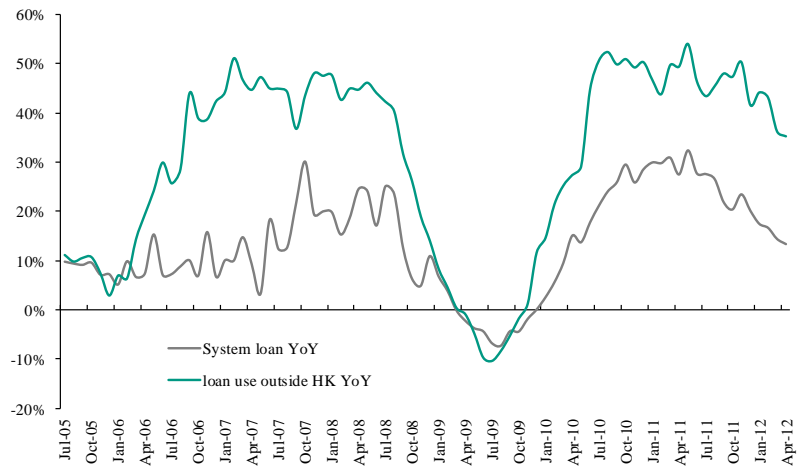


NIM outlook mildly positive

Domestic loan growth remains calm

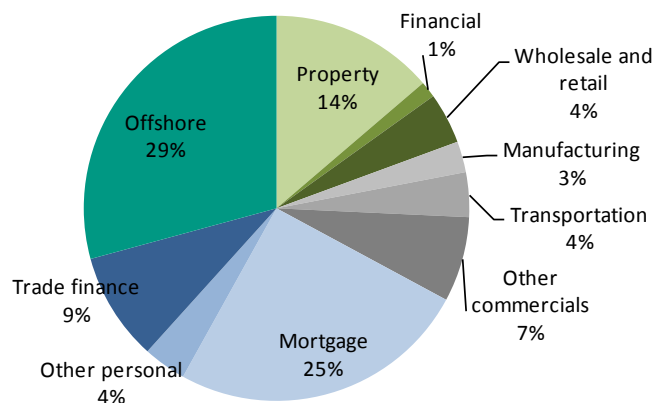
System loan growth in HK has slowed down since mid-2011, from as much as 30% YoY to only 7.3% YoY in November 2012. Domestic loan growth was shadowed by macro uncertainty and weak export and loan growth was mainly sustained by the use of loans outside HK, which accounted for 28% of system loan. In view of the bottoming of China macro environment in 3Q12, we expect HK banks' concern towards China credit quality will be lifted. Together with the huge loan demand from the China enterprises, we forecast HK system loan growth to sustain at 6-8% each year in 2013 and 2014.

Exhibit 6: HK system loan YoY vs loan use outside HK YoY



Source: HKMA, ABCI Securities estimates

Exhibit 7: BOCHK loan mix (1H12)

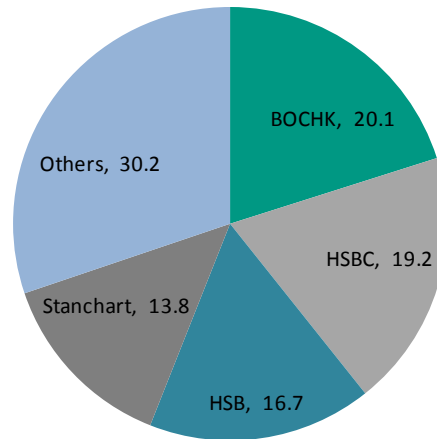


Source: Company, ABCI Securities estimates



Looking at BOCHK's loan book, 77% of loans and 18.7% were granted to HK customers and China customers respectively, while 29.2% of total loans were for the use outside HK. Taken into account business potential from Rmb loans and China customers as a result of Rmb internationalization, we expect BOCHK's loan growth to stay faster than system loan growth at 12% YoY each in 2013E and 2014E.

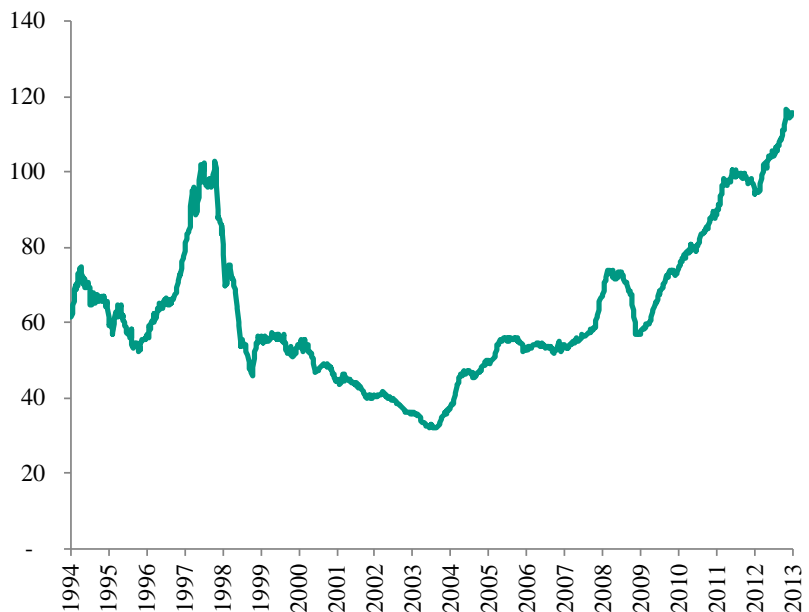
Exhibit 8: HK December 2012 new mortgage market share (%)



Source: Mreferral.com, ABCI Securities estimates

BOCHK is the market leader of HK mortgage market, with 20.1% market share in December 2012, slightly higher than 19.2% by HSBC (5 HK) and 16.7% by HSB (11 HK). Property related loans including property developer and personal mortgage accounted for 39% of BOCHK's loan book.

Exhibit 9: Centaline leading index



Source: Centaline, ABCI Securities estimates

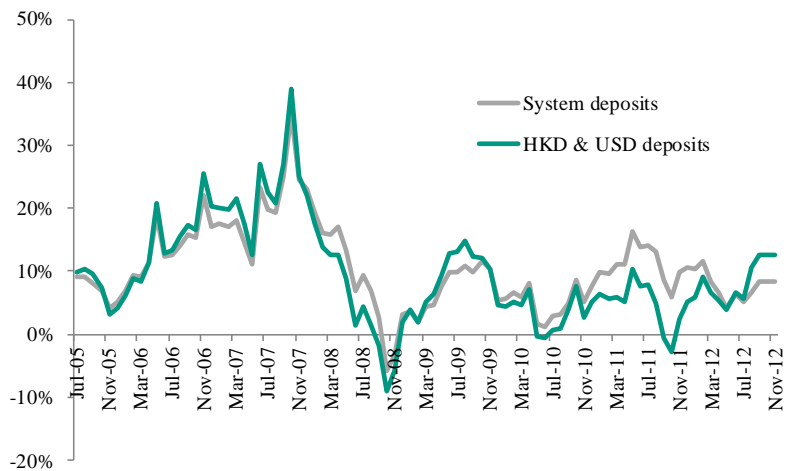


According to the Centaline’s city leading index, HK property prices has started to surge since 2009 and recently exceed the previous peak in 1997 with 20% YoY property price growth in 2012. The HKSAR government showed its dedication to a healthy property market by enforcing certain property tightening measures such as the special stamp duty (SSD), and the buyer stamp duty (BSD). We are of the view that the HK property market will remain stable and mortgage loan growth will slow to 4-6% YoY each year in 2013E and 2014E. There are no signs of credit quality deterioration in HK. In order to cope with the government’s policy direction to increase housing supply, we expect property developer loans growth will speed up at 9-11% YoY each year in 2013E and 2014E.

Deposit growth stays resilient

System deposit grew by 8.3% YoY as of November 2012, slowly picking up from the dip in mid-2012 with more liquidity inflow to HK close to the end of 2012. Both HKD and USD deposit grew faster than system deposits YoY at 10.3% and 16.4% respectively, reversing the weak growth trend from 4Q11 caused by the low interest rate environment and weak USD exchange rate with other currencies. This has been offset by the weakening Rmb deposits balance of 9% drop YoY, which was due to funds switched to alternative Rmb-denominated investments and fast growth in 2011.

Exhibit 10: HK system deposits YoY

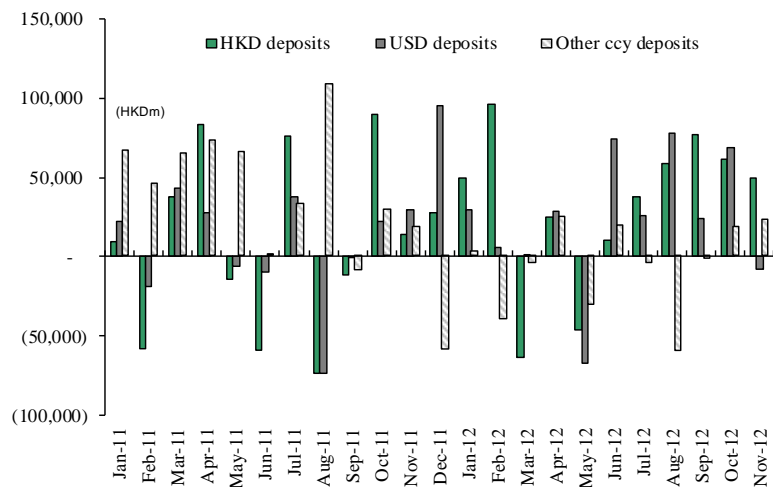


Source: HKMA, ABCI Securities estimates

However, on the back of stronger Rmb/HKD exchange rate, we noticed a reverse trend of positive MoM growth in October and November 2012. Since we do not expect to see a significant interest rate hike in HKD and USD, or a dramatic appreciation in USD, we forecast system deposit growth to grow at 6-7% YoY each year in 2013E and 2014E. BOCHK’s deposit growth could see 8.1% and 7.4% in 2013E and 2014E respectively given its leading market share and strong CNH platform.



Exhibit 11: HK deposit MoM change by currency



Source: HKMA, ABCI Securities estimates

Better asset yields and stable funding costs

We expect interest rate in HK to stay calm until 2015E as we believe the US interest rates are unlikely to change prior to 2015. Our base case assumption assumes 3-month HIBOR to remain at the range of 0.35-0.4% over 2013-14E, and the prime rate to stick at current level. Combined with the development of CNH loan market and better domestic loan pricing from strong offshore use loan demand, we factored into 10-14bps improvement in loan spread in 2013E and 2014E. Other asset classes such as interbank placements and treasuries will also see better yields, benefiting from improving Rmb assets return.

For liabilities side, despite we only factored into minor interbank cost increment of 5-7bps each in 2013E and 2014E, customer deposits costs should be under control. As discussed earlier, we believe CNH funding costs to have limited upside unless the PBOC raises the deposit benchmark rates or allows the banks to offer more premiums above the benchmarks. Together with the assumption that there will be no interest hike in the US and HK prior to 2015, we conservatively assume customer deposits cost to rise by 6bps and 11bps in 2013E and 2014E respectively, after 13bps rise in 2012E.

In general, based on our NIM model, we forecast to see mild improvement in BOCHK's NIM. After the reported NIM of 1.64% in 1H12, we conservatively expect its NIM to reach 1.62% for 2012E. We project BOCHK's NIM to expand by another 5bps and 6bps to 1.67% and 1.73% in 2013E and 2014E respectively. With 2-7% average interest earning assets (AIEAs) growth per year during 2012-14E, our base case scenario expects BOCHK's net interest income to grow by 13% CAGR and net profit to grow by 7% CAGR during 2012-14E.



Exhibit 12: BOCHK NIM model 2011-12E

(HKDmn) Assets	2011				2012E			
	Asset Growth%	Balance	Interest yield%	Interest Income	Asset Growth%	Balance	Interest yield%	Interest Income
ST funds	-9.1%	445,385	1.48%	8,459	-16.0%	373,984	2.30%	10,692
RMB	-16.5%	315,666	1.48%	6,319	-25.0%	236,750	2.52%	8,005
USD & others	31.1%	109,138	1.67%	1,926	5.0%	114,595	2.02%	2,485
HKD	-27.4%	20,581	0.73%	214	10.0%	22,639	0.85%	202
Treasuries	-0.3%	452,387	2.33%	10,132	7.0%	483,853	2.28%	10,665
RMB	112.7%	50,076	2.30%	830	50.0%	75,114	2.50%	1,565
USD & others	-2.8%	281,690	2.76%	7,604	-2.0%	276,056	2.65%	7,390
HKD	-14.1%	120,621	1.37%	1,699	10.0%	132,683	1.35%	1,710
Loans:	14.1%	699,379	2.04%	13,339	11.2%	777,699	2.27%	16,742
Corporate	4.2%	30,788	1.23%	371	-8.0%	28,325	1.55%	458
Commercial	14.4%	461,608	2.25%	9,733	14.6%	528,822	2.50%	12,380
Residential mortgages	13.2%	180,767	0.95%	1,603	6.5%	192,432	1.00%	1,866
Unsecured	28.4%	26,216	7.00%	1,632	7.3%	28,120	7.50%	2,038
Fix assets and others	31.8%	78,299			7.0%	83,780		
HKG cert of indebtedness	40.2%	65,890			2.0%	67,208		
LLR	22.5%	-2,830			26.5%	-3,581		
Total assets	4.7%	1,738,510	1.92%	31,931	2.6%	1,782,942	2.28%	38,099
Total AIEA		1,597,151				1,635,535		

Liabilities	2011				2012E			
	Growth%	Dec-11	Int cost%	Int cost	Growth%	Dec-12	Int cost %	Int cost
Interbank deposits	-27.4%	261,573	0.76%	3,179	-1.9%	256,699	0.72%	2,053
RMB	-35.6%	155,582	0.84%	2,231	2.0%	158,694	0.73%	1,260
USD & others	-23.6%	48,545	0.78%	590	-20.0%	38,836	0.85%	409
HKD	3.9%	57,446	0.47%	358	3.0%	59,169	0.60%	385
Customer deposits	11.6%	1,146,590	0.61%	6,211	5.4%	1,208,307	0.74%	8,456
Current & demand	9.9%	77,440	0.16%	114	2.0%	78,989	0.21%	155
Savings	-4.4%	504,868	0.22%	1,083	4.0%	525,160	0.27%	1,332
Time	31.6%	564,282	1.07%	5,014	7.1%	604,159	1.23%	6,970
RMB:	56.9%	245,375	0.60%	1,101	4.7%	256,908	0.88%	2,101
Current & demand	56.9%	24,538	0.32%	59	2.0%	25,028	0.40%	94
Savings	56.9%	73,613	0.48%	266	5.0%	77,293	0.60%	430
Time	56.9%	147,225	0.70%	776	5.0%	154,586	1.10%	1,577
USD & others:	17.9%	304,907	0.85%	2,246	10.1%	335,652	1.17%	3,671
Current & demand	-10.8%	5,198	0.18%	9	2.0%	5,302	0.21%	11
Savings	-23.9%	133,102	0.27%	387	8.0%	143,750	0.32%	434
Time	114.3%	166,608	1.59%	1,850	12.0%	186,601	1.86%	3,226
HKD:	-2.6%	596,308	0.50%	2,864	3.3%	615,748	0.46%	2,684
Current & demand	-2.6%	47,705	0.10%	46	2.0%	48,659	0.11%	50
Savings	-2.6%	298,154	0.15%	431	2.0%	304,117	0.16%	467
Time	-2.6%	250,449	0.99%	2,387	5.0%	262,972	0.87%	2,166
Sub-debt (Tier two)	6.6%	28,656	2.02%	562	1.0%	28,943	2.00%	576
Others	26.3%	102,618			-20.1%	81,944		
HK currency note	40.2%	65,890			2.0%	67,208		
Equity	12.6%	133,183			5.0%	139,842		
Total	4.7%	1,738,510	0.68%	9,952	2.6%	1,782,942	0.78%	11,086
Total AIBL		1,436,819				1,493,949		
Net interest income/spread			1.24%	21,979			1.50%	27,013
NIM%			1.32%				1.62%	
LDR %		61.0%				64.4%		
Loans/AEA%		43.8%				47.6%		

Source: Company, ABCI Securities estimates



Exhibit 13: BOCHK NIM model 2013-14E

(HKDmn) Assets	Asset Growth%	2013E			2014E			
		Balance	Interest yield%	Interest Income	Asset Growth%	Balance	Interest yield%	Interest Income
ST funds	4.5%	390,797	2.43%	10,068	0.3%	391,856	2.52%	10,352
RMB	10.0%	260,424	2.72%	7,438	5.0%	273,446	2.80%	7,848
USD & others	-5.0%	108,865	2.07%	2,433	-10.0%	97,979	2.12%	2,306
HKD	-5.0%	21,507	0.85%	197	-5.0%	20,432	0.90%	198
Treasuries	2.0%	493,408	2.38%	11,532	0.7%	496,728	2.49%	12,244
RMB	10.0%	82,625	2.60%	2,051	20.0%	99,150	2.70%	2,454
USD & others	0.5%	277,436	2.75%	7,611	-5.0%	263,565	2.90%	7,845
HKD	0.5%	133,347	1.45%	1,871	0.5%	134,013	1.50%	1,945
Loans:	12.0%	871,299	2.44%	20,081	12.0%	975,640	2.68%	24,737
Corporate	12.0%	31,724	1.55%	465	15.0%	36,483	1.80%	614
Commercial	14.6%	606,013	2.60%	14,753	14.4%	693,462	2.80%	18,193
Residential mortgages	5.6%	203,116	1.20%	2,373	4.6%	212,534	1.40%	2,910
Unsecured	8.3%	30,446	8.50%	2,489	8.9%	33,162	9.50%	3,021
Fix assets and others	6.0%	88,807			6.0%	94,135		
HKG cert of indebtedness	2.0%	68,552			2.0%	69,923		
LLR	20.0%	-4,297			19.7%	-5,141		
Total assets	7.0%	1,908,566	2.42%	41,681	6.0%	2,023,142	2.59%	47,333
Total AIEA		1,755,504				1,864,225		

Liabilities	Growth%	2013E			2014F			
		Dec-11	Int cost%	Int cost	Dec-12	Int cost %	Int cost	
Interbank deposits	8.1%	277,469	0.79%	2,286	4.0%	288,663	0.84%	2,555
RMB	10.0%	174,563	0.83%	1,492	5.0%	183,291	0.88%	1,651
USD & others	5.0%	40,778	0.90%	394	3.0%	42,001	1.00%	455
HKD	5.0%	62,128	0.60%	400	2.0%	63,370	0.65%	449
Customer deposits	8.1%	1,305,808	0.80%	9,892	7.4%	1,402,437	0.91%	12,093
Current & demand	5.7%	83,482	0.21%	166	7.1%	89,406	0.23%	196
Savings	5.7%	555,282	0.28%	1,481	4.6%	580,634	0.34%	1,880
Time	10.4%	667,044	1.32%	8,246	9.8%	732,396	1.46%	10,017
RMB:	13.0%	290,328	0.89%	2,434	19.9%	348,099	0.97%	3,089
Current & demand	10.0%	27,531	0.35%	93	15.0%	31,661	0.37%	109
Savings	10.0%	85,022	0.53%	430	15.0%	97,776	0.55%	503
Time	15.0%	177,774	1.15%	1,911	23.0%	218,662	1.25%	2,478
USD & others:	7.9%	362,030	1.27%	4,356	3.7%	375,603	1.52%	5,507
Current & demand	10.0%	5,832	0.22%	12	5.0%	6,124	0.32%	19
Savings	5.0%	150,937	0.33%	477	2.0%	153,956	0.48%	717
Time	10.0%	205,261	2.01%	3,868	5.0%	215,524	2.31%	4,772
HKD:	6.1%	653,451	0.50%	3,102	3.9%	678,735	0.54%	3,497
Current & demand	3.0%	50,118	0.13%	61	3.0%	51,622	0.14%	69
Savings	5.0%	319,323	0.19%	574	3.0%	328,903	0.21%	660
Time	8.0%	284,010	0.93%	2,467	5.0%	298,210	0.98%	2,767
Sub-debt (Tier two)	0.5%	29,087	2.50%	725	0.5%	29,233	3.50%	1,021
Others	-3.1%	79,417			-8.3%	72,795		
HK currency note	2.0%	68,552			2.0%	69,923		
Equity	6.0%	148,233			8.0%	160,091		
Total	7.0%	1,908,566	0.85%	12,904	6.0%	2,023,142	0.96%	15,669
Total AIBL		1,612,364				1,720,332		

Net interest income/spread			1.57%	28,777			1.63%	31,664
NIM%			1.67%				1.73%	
LDR %		66.7%				69.6%		
Loans/AEA%		49.6%				52.3%		

Source: Company, ABCI Securities estimates

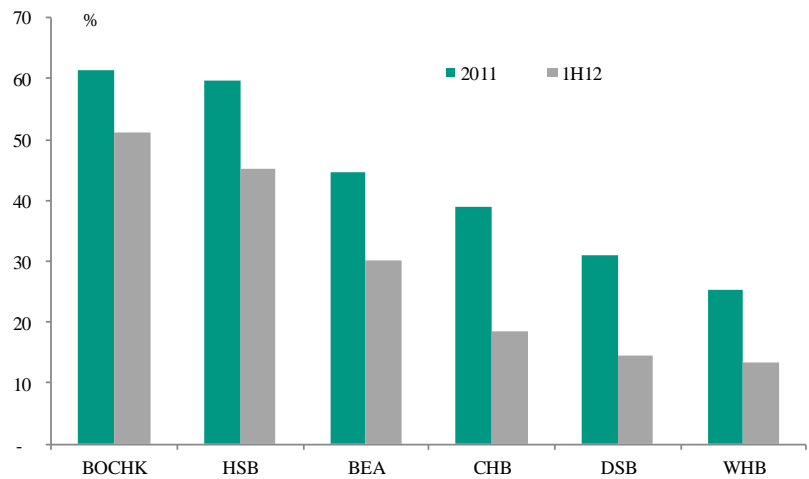


Defensive core holding with high yield

Stable dividend payout policy

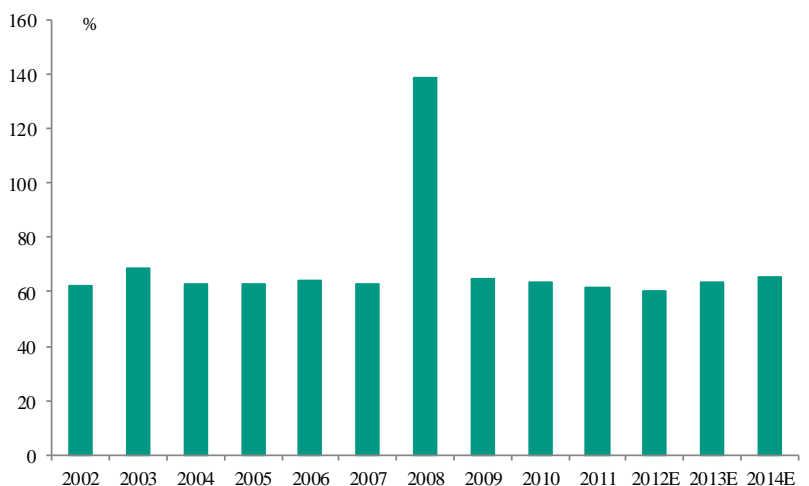
In our opinion, BOCHK's stable and high dividend payout track record formulate a solid defensive factor as a core holding in the HK banks universe. BOCHK is the bank with the highest payout ratio among the peers, with 61% in 2011 and 51% in 1H12, compare to the sector average of 43% and 29% respectively. Besides, BOCHK possesses a stable dividend policy since its IPO. Even for a bad year like 2008 when BOCHK's earning was hammered by massive write-offs, the bank's management dedicated to maintain their dividend by absolute amount through increasing the dividend payout ratio to over 100%.

Exhibit 14: HK banks payout ratio



Source: Companies, ABCI Securities estimates

Exhibit 15: BOCHK historical payout ratio trend



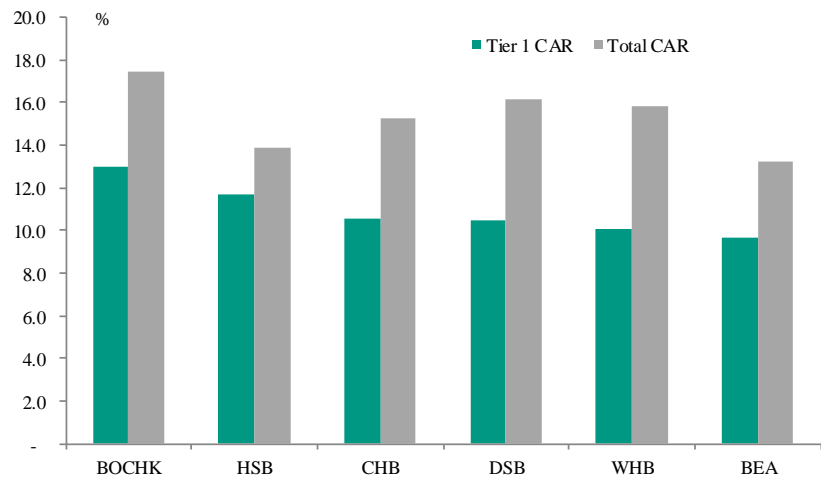
Source: Company, ABCI Securities estimates



Strong CAR position rules out dividend cut concerns

Some investors hesitated on a dividend cut scenario triggered by higher capital requirement from Basel III. We think the current HK banks CAR positions have proven their ability to fulfill all new requirements. Sector average Tier 1 CAR and total CAR well sustained at 10.9% and 15.3% respectively. While BOCHK has the highest rank of 13% Tier 1 CAR and 17.4% total CAR, we feel comfortable that BOCHK could sustain its payout ratio at 60-65% during 2012-14E, implying 4-6% dividend yield at current price.

Exhibit 16: HK banks CAR positions (1H12)



Source: Companies, ABCI Securities estimates



Trading at fair value, but deserves a premium

Gordon Growth Model

We use Gordon Growth Model ($P/B = (ROE-g)/(COE-g)$) to calculate the target P/B of BOCHK, which is a traditional methodology to value banks. Our target price of HKD33.61 was calculated by 2.43x target P/B and the 2013E BPS of HKD13.84. Our sustainable ROE of 15.3% was calculated by the simple average of BOCHK's historical ROE since 2002. We assume long term growth at 4% (similar to long term GDP growth) and calculate the 8.7% COE based on the assumptions of 0.8% risk free rate (HK 10Y government bond), 0.98 beta and 8% equity risk premium.

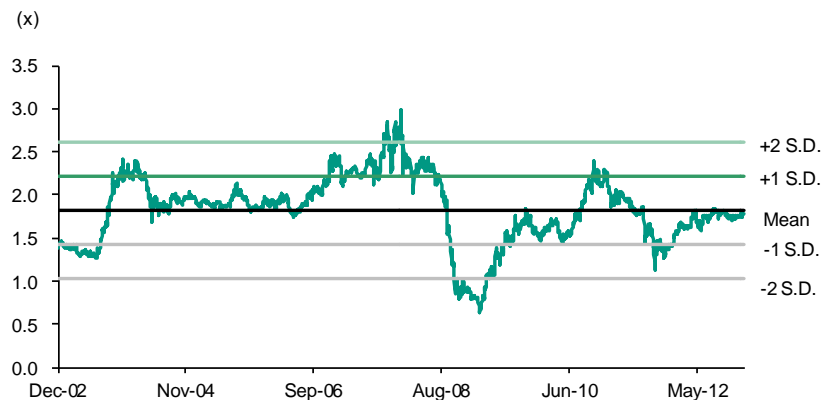
Exhibit 17: BOCHK ROE trend



Source: Company, ABCI Securities estimates

BOCHK is currently trading at 1.89x 2013E P/B, at mean historical P/B. Our target P/B of 2.43x points to +1 s.d. from the mean. Although BOCHK is trading at higher-than-peers P/B (sector average 1.34x 2013E P/B), we believe BOCHK deserves to trade at a premium to peers by taking into account its higher-than-peers ROE, sole CNH clearing position and leading market shares in Hong Kong. We initiate coverage on BOCHK with a BUY recommendation and our target price of HKD 33.61 implies 29% upside.

Exhibit 18: BOCHK PB band chart



Source: Bloomberg, ABCI Securities estimates



Exhibit 19: China and HK banks valuation table

	Ticker	Market cap (HKDmn)	Price (HKD)	2013 ROE (%)	2013 PB (x)	2013 PE (x)	2013 div. yield (%)
China							
	ICBC	1,910,363	5.97	21.0	1.55	7.32	4.42
	CCB	1,659,185	6.67	20.9	1.29	6.54	5.40
	ABC	1,156,822	4.13	20.2	1.27	6.75	4.36
	MSB	311,126	10.58	21.6	1.35	6.39	3.74
	BOC	1,040,636	3.76	15.3	0.96	6.67	4.79
	BoCom	471,128	6.40	17.8	0.94	5.56	5.81
	CMB	381,933	18.84	20.3	1.43	7.58	3.31
	CITICB	266,765	5.42	15.4	0.89	6.19	3.99
			Average	19.1	1.21	6.62	4.48
Hong Kong							
	BOCHK	276,478	26.15	16.0	1.89	12.16	5.24
	HSB*	229,039	119.80	20.7	2.40	12.92	4.40
	BEA*	69,374	31.15	8.3	1.20	15.42	3.08
	WHB*	24,415	80.80	9.8	1.20	13.01	2.34
	DSB*	11,209	37.80	7.0	0.66	9.59	3.33
	CHB*	7,291	16.76	5.2	0.99	19.72	2.03
			Average	11.2	1.36	12.78	3.56

Source: Bloomberg, ABCI Securities estimates

*Being Bloomberg consensus data

Company background

BOCHK is a local incorporated licensed bank established on 1 October 2001 by consolidating ten of the twelve banks originally owned by Bank of China Group (BOC, 3988 HK – Hold). The ten banks included Bank of China Hong Kong Branch, The Kwangtung Provincial Bank, Sin Hua Bank Limited, The China & South Sea Bank Limited, Kincheng Banking Corporation, The China State Bank Limited, The National Commercial Bank Limited, The Yien Yieh Commercial Bank Limited, Hua Chiao Commercial Bank and Po Sang Bank Limited. Meanwhile BOCHK also holds stakes in Nanyang Commercial Bank Limited, Chiyu Banking Corporation Limited and BOC Credit Card (International) Limited. Besides being one of the note issuing bank and the sole CNH clearing bank in Hong Kong, BOCHK provides wide range of financial products and services through over 260 branches and over 570 ATMs in Hong Kong, and over 30 branches and sub-branches in China.



Income statement forecast

(HKD mn)	2010A	2011A	2012E	2013E	2014E
Interest income	23,449	31,931	38,099	41,681	47,333
Interest expense	(4,715)	(9,952)	(11,086)	(12,904)	(15,669)
Net interest income	18,734	21,979	27,013	28,777	31,664
Non-interest income	8,774	8,867	9,481	11,214	12,917
Of which: Fees and commissions	7,044	7,833	8,119	9,273	10,604
Operating income (Top line)	27,508	30,846	36,495	39,991	44,581
Operating expenses	(9,584)	(7,862)	(11,677)	(12,911)	(14,279)
Pre-prov. oper. profit (PPOP)	17,924	22,984	24,817	27,080	30,302
Impairment loans losses	315	(506)	(681)	(588)	(683)
Operating profit	18,239	22,478	24,136	26,491	29,619
Non-operating income	1,503	2,202	1,025	928	531
Profit before tax	19,742	24,680	25,162	27,419	30,150
Tax	(3,052)	(3,867)	(3,900)	(4,250)	(4,673)
Minority interests	(494)	(383)	(402)	(442)	(509)
Net profit	16,196	20,430	20,859	22,727	24,968
Growth (%)					
Interest income	8	36	19	9	14
Interest expense	26	111	11	16	21
Net interest income	4	17	23	7	10
Non-interest income	8	1	7	18	15
Of which: Fees and commissions	8	11	4	14	14
Operating income (Top line)	6	12	18	10	11
Operating expenses	(21)	(18)	49	11	11
Pre-prov. oper. profit (PPOP)	29	28	8	9	12
Impairment loans losses	(74)	(261)	35	(14)	16
Operating profit	21	23	7	10	12
Non-operating income	(7)	47	(53)	(10)	(43)
Profit before tax	18	25	2	9	10
Tax	23	27	1	9	10
Minority interests	54	(22)	5	10	15
Net profit	16	26	2	9	10
Per share					
EPS	1.53	1.93	1.97	2.15	2.36
BVPS	10.89	12.27	13.06	13.84	14.65
DPS	0.97	1.19	1.19	1.37	1.55
Key ratio (%)					
Net interest margin	1.49	1.32	1.62	1.67	1.73
Net interest spread	1.47	1.21	1.50	1.56	1.63
Cost to income ratio	34.8	25.5	32.0	32.3	32.0
Return on average assets	1.13	1.20	1.18	1.23	1.27
Return on average equity	14.8	16.7	15.6	16.0	16.6
Effective tax rate	15.5	15.7	15.5	15.5	15.5
Dividend payout	63.5	61.5	60.3	63.7	65.6

Source: Company, ABCI Securities estimates



Balance sheet forecast

(HKD mn)	2010A	2011A	2012E	2013E	2014E
Assets					
Cash & balances with central banks	415,812	278,795	234,100	244,625	245,288
Dues from banks & non-bank FI	39,499	107,910	139,883	146,172	146,568
Investment securities	488,430	511,067	542,533	552,088	555,408
Net loans and advances	610,908	696,549	774,118	867,003	975,640
Total interest earning assets	1,554,649	1,594,321	1,690,635	1,809,888	1,922,905
Property and equipment	41,391	52,091	55,737	59,082	62,627
Other non-int. earn assets	65,000	92,098	36,570	39,597	37,611
Total assets	1,661,040	1,738,510	1,782,942	1,908,566	2,023,142
Liabilities					
Customer deposits	1,027,267	1,146,590	1,208,307	1,305,808	1,402,437
Demand deposits	598,488	582,308	604,149	638,764	670,041
Time deposits	428,779	564,282	604,159	667,044	732,396
Due to other banks & FIs	313,784	236,694	232,284	251,078	261,207
Subordinated term debt	26,877	28,656	28,943	29,087	29,233
Total interest bearing liabilities	1,367,928	1,411,940	1,469,533	1,585,973	1,692,876
Other liabilities	174,823	193,387	173,567	174,360	170,174
Total liabilities	1,542,751	1,605,327	1,643,100	1,760,334	1,863,050
Share capital					
Reserves	62,317	76,901	85,179	93,421	102,001
Investment revaluation reserve	15,750	23,150	24,308	25,523	26,799
General reserve	8,158	9,428	8,271	7,055	5,779
Retained earnings	38,409	44,323	52,601	60,843	69,423
Minorities	3,108	3,418	1,799	1,948	5,227
Shareholders equity excludes MI	115,181	129,765	138,043	146,285	154,865
Growth (%)					
Assets					
Cash & balances with central banks	159	(33)	(16)	4	0
Dues from banks & non-bank FI	(34)	173	30	4	0
Investment securities	25	5	6	2	1
Net loans and advances	19	14	11	12	13
Total interest earning assets	38	3	6	7	6
Property and equipment	16	26	7	6	6
Other non-int. earn assets	23	42	(60)	8	(5)
Total assets	37	5	3	7	6
Liabilities					
Customer deposits	22	12	5	8	7
Demand deposits	7	(3)	4	6	5
Time deposits	51	32	7	10	10
Due to other banks & FIs	215	(25)	(2)	8	4
Subordinated term debt	0	7	1	0	0
Total interest bearing liabilities	41	3	4	8	7
Other liabilities	29	11	(10)	0	(2)
Total liabilities	40	4	2	7	6
Share capital					
Reserves	21	23	11	10	9
Investment revaluation reserve	36	47	5	5	5
General reserve	10	16	(12)	(15)	(18)
Retained earnings	19	15	19	16	14
Minorities	14	10	(47)	8	168
Shareholders equity excludes MI	11	13	6	6	6
Key ratio (%)					
Loan to deposits	59.7	61.0	64.4	66.7	69.6
Core CAR	11.3	12.5	12.7	12.7	12.6
Total CAR	16.1	16.9	16.8	16.5	16.1
NPL ratio	0.1	0.1	0.1	0.2	0.2
NPL growth	(51.0)	(18.1)	23.4	82.6	33.4
Net bad debt charge ratio	0.0	0.1	0.1	0.1	0.1
Provision to total loans	0.4	0.4	0.5	0.5	0.5
Provision coverage	266.6	398.6	408.8	268.6	241.0

Source: 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 2007-2011

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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