



July 29, 2014
Company Report
Rating: BUY
TP: HK\$ 31.50

Share price (HK\$)	24.25
Est. share price return	29.90%
Est. FY14E dividend yield	4.83%
Est. total return	34.73%

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Key Data

52Wk H/L(HK\$)	26.6/21.5
Issued shares (mn)	10,572.8
Market cap (HK\$ mn)	256,390
3-mth avg daily turnover (HK\$ mn)	225.63
Major shareholder(s) (%):	
BOC Group	65.65

Source(s): Company, Bloomberg, ABCI Securities

FY13 Revenue breakdown (%)

Personal banking	27.6
Corporate banking	31.9
Treasury	19.2
Insurance	17.9
Others	3.4

Source(s): Company, ABCI Securities

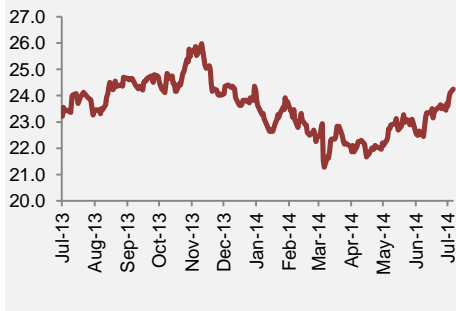
Share performance (%)

	Absolute	Relative*
1-mth	7.3	2.0
3-mth	9.0	0.2
6-mth	3.7	(6.7)

Relative to HSI

Source(s): Bloomberg, ABCI Securities

1-Year stock performance (HK\$)



Source(s): Bloomberg, ABCI Securities

BOCHK (2388 HK)

Sustainable NIM and solid fundamentals

For the upcoming interim results to be announced starting from early-Aug, we expect Hong Kong banks to achieve: (1) an average earnings growth of 6%-10% YoY in 1H14; (2) a mid-single digit loan growth; (3) a stable system NIM at 1.4%. China-related business will continue to be the major growth driver, while the mild increase in China's NPL should not cause major compromises in overall asset quality. BOCHK's NIM is well defended by improving asset yield through reallocation of CNH fund and a high CASA mix. While the counter has underperformed YTD on slashed payout ratio, further dividend cut is unlikely and we deem its valuation at 1.49x 14E P/B as attractive. Our TP of HK\$31.5 implies a 29.9% upside; reiterate **BUY**.

Sector fundamentals remain solid. With the reporting season arriving in early Aug, we expect average earnings growth of Hong Kong banks to sustain at 6%-10% YoY in 1H14, supported by a mid-single digit loan growth and a stable NIM on sustainable economic growth. China-related business will continue be the key growth driver of the sector through increased RMB asset channels for banks' CNH pool and high demand for cross-border financing and services. Given the low base of NPL, we are not overly concerned about the risks posed by the rising NPL in China on overall asset quality.

A stable NIM outlook despite rising deposit costs. According to HKMA, system deposit costs edged up 15bps to 47bps YoY in June 2014, while system NIM has been stable at 1.4% since 2Q13. This implies the negative impacts of deposit competition have been largely offset by banks' improving asset yield. Although BOCHK's historical NIM was lower than peers due to its higher market share in CNH deposits, the banks may raise its NIM by directing its CNH funds into asset class with high returns.

A high CASA mix helps buffer against deposit cost competition. Even though the composite interest rate is rising, we believe big banks are less sensitive to deposit competition given their high CASA ratios and extensive branch networks. CASA deposits in HSB and BOCHK accounted for 70% and 56% of total in 2013 compared to the industry average of 54%.

Negatives are priced in; reiterate BUY. BOCHK's share price has underperformed the HSI YTD mainly because the Group reduced its dividend payout from over 60% in and before 2012 to 48% in 2013 so as to retain its capital position. As we believe the current share price has priced in a dividend level similar to that in 2013 and expect no further dividend cut in the near future, BOCHK's current valuation at 1.49x FY14E P/B is deemed attractive based on its solid fundamentals (10.7% net profit CAGR 2013-16E) and strong position in the Hong Kong bank sector. Our GGM TP of HK\$31.5 implies a 29.9% upside. Reiterate **BUY**.

Risk factors: 1) Sharp deterioration in asset quality in China; 2) Slowdown in RMB internationalization; 3) Policies affecting cross-border business development.

Financial summary

FY ended Dec 31	2012A	2013A	2014E	2015E	2016E
Revenue (HK\$ mn)	35,617	40,313	45,311	49,593	53,905
Chg (% YoY)	15.5	13.2	12.4	9.5	8.7
Net profit (HK\$ mn)	20,930	22,252	25,795	28,077	30,166
Chg (% YoY)	2.5	6.3	15.9	8.8	7.4
EPS (HK\$)	1.98	2.10	2.44	2.66	2.85
Chg (% YoY)	2.5	6.3	15.9	8.8	7.4
BVPS (HK\$)	14.28	15.02	16.29	17.67	19.15
Chg (% YoY)	16.3	5.2	8.4	8.5	8.4
P/E (x)	12.2	11.5	9.9	9.1	8.5
P/B (x)	1.70	1.61	1.49	1.37	1.27
ROAA (%)	1.17	1.15	1.20	1.18	1.14
ROAE (%)	14.91	14.37	15.58	15.64	15.50
DPS(HK\$)	1.24	1.01	1.17	1.27	1.37
Yield (%)	5.11	4.17	4.83	5.26	5.65

Source(s): Company, ABCI Securities estimates



Sector fundamentals remain solid

Interim reports for Hong Kong banks will be released starting from early Aug. As we expect a mid-single digit loan growth and a stable NIM supported by stable economic growth; sector fundamentals should remain solid with banks' average earnings to rise 6%-10% yoy for 1H14.

China business, which includes providing higher-yield RMB asset channels for Hong Kong banks' CNH deposit base, will remain as the key growth driver for Hong Kong banks. In our opinion, Hong Kong banks tend to be more disciplined and cautious compared to the Chinese banks in terms of expanding cross-border business through trade financing and offshore loans for mainland customers. Therefore we are not overly concerned about the increasing risks arising from the growing NPL and intensifying pricing competition induced by interest rate liberalization in China.

Exhibit 1: QoQ comparison of BOCHK's results (HK\$ mn)

	Operating income	YoY (%)	QoQ (%)	Operating profit	YoY (%)	QoQ (%)
1Q12	9,375	21.9	13.7	6,763	27.2	37.5
2Q12	8,790	18.2	(6.2)	6,012	21.9	(11.1)
3Q12	8,931	19.5	1.6	6,155	(21.3)	2.4
4Q12	8,664	5.1	(3.0)	5,429	10.4	(11.8)
1Q13	9,828	4.8	13.4	6,991	3.4	28.8
2Q13	9,963	13.3	1.4	7,108	18.2	1.7
3Q13	9,731	9.0	(2.3)	6,743	9.6	(5.1)
4Q13	10,791	24.5	10.9	7,388	36.1	9.6
1Q14	10,884	10.7	0.9	7,837	12.1	6.1

Source(s): Company, ABCI Securities

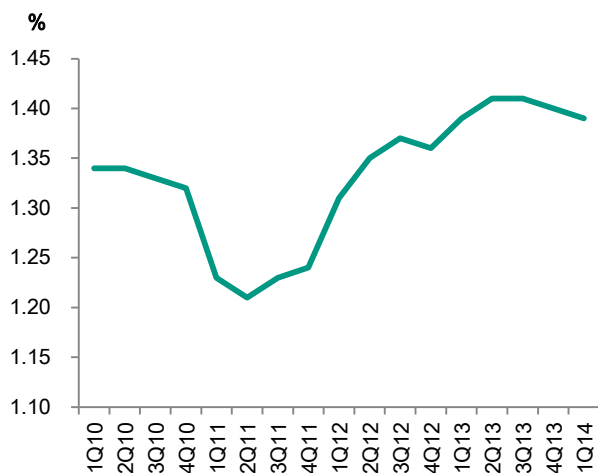
As one of the major players in Hong Kong, BOCHK's revenue and operating profit rose 10.7% and 12.1% yoy in 1Q14. Higher net interest income (NII) has been driven by healthy balance sheet growth and improving NIM trend; meanwhile, fee income grew steadily to offset the decline in net trading gain from forex and interest-rate instruments.

A Stable NIM outlook despite rising deposit costs

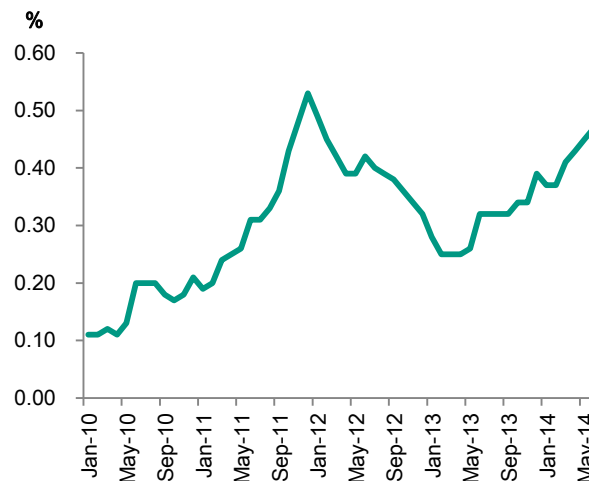
Up to June 2014, HKMA's banking statistics showed a steady trend. Overall, system NIM has been stable at 1.4% since 2Q13 despite the fact that composite interest rate picked up only slowly from 32bps in June 2013 to 47bps in June 2014. This shows that mild increase in deposit costs was largely offset by an improving trend of asset yield.

System LDR firmly stood at 73%-74%, while NPL ratio stayed minimal. With the NPL in China slowly trending up, overall asset quality of the Hong Kong banks should follow suit to decline mildly. Nonetheless, we believe that the overall NPL ratio would stay at a healthy level.

Following the system trend, NIM among the listed banks in Hong Kong have expanded by 2-15bps HoH or 9-28bps YoY in 2H13. While NIM expansion in smaller banks such as BEA (23 HK) and DSBG (2356 HK) in 2H13 were 22bps and 28bps YoY; NIM in BOCHK expanded by 13bps YoY during the same period.

Exhibit 2: System NIM trend


Source(s): HKMA, ABCI Securities

Exhibit 3: System composite interest rates


Source(s): HKMA, company, ABCI Securities

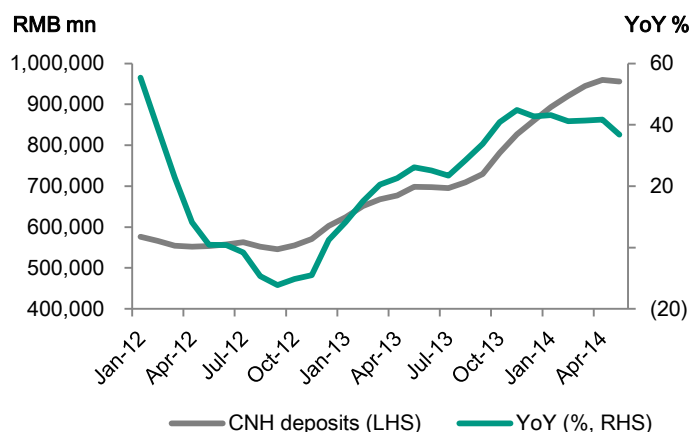
CNH funds to boost asset yield

We believe BOCHK's lower-than-peer NIM has been caused by its high market share in the CNH deposits that entail higher deposit costs compared to HKD deposits. With the continuous development of RMB-denominated asset channels which offer an increasing asset yield, we expect the improving yield will help to defend NIM in Hong Kong banks going forward; banks with a large CNH deposit base such as BOCHK would benefit more than peers by directing its CNH funds into asset classes with higher returns. Still, the bank's management is only targeting to maintain its NIM at the 2H13 level.

Exhibit 4: NIM trend of individual banks (%)

	2012	2013	YoY (bps)	1H12	2H12	1H13	2H13	HoH (bps)	YoY (bps)
BOCHK	1.60	1.68	8	1.64	1.56	1.67	1.69	2	13
HSB	1.85	1.89	4	1.85	1.84	1.84	1.93	9	9
BEA	1.67	1.90	23	1.63	1.70	1.83	1.98	15	28
DSBG	1.54	1.79	25	1.47	1.60	1.77	1.82	5	22
System	1.68	1.78	10	1.69	1.67	1.75	1.82	7	15

Source(s): Companies, ABCI Securities

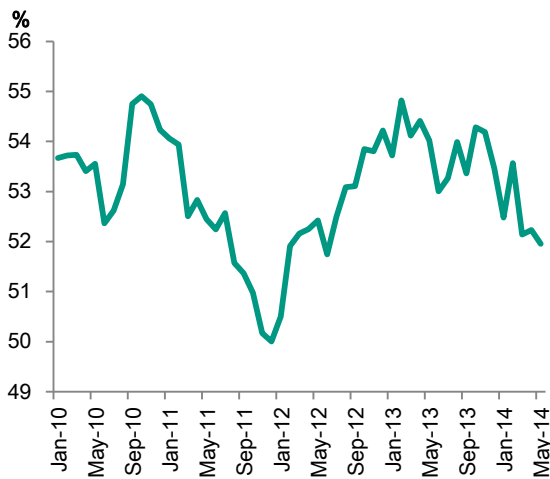
Exhibit 5: CNH deposits


Source(s): HKMA, ABCI Securities

Higher CASA mix reduces sensitivity to funding cost competition

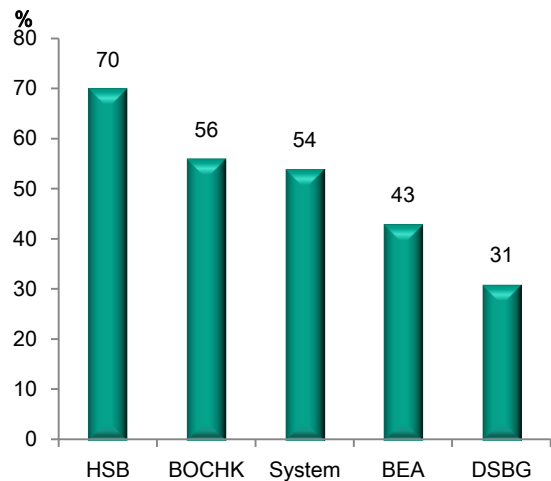
Higher deposit mix of current accounts and saving accounts (CASA) provides another defense for NIM in Hong Kong banks. System CASA-to-total deposits has been stable at 50%-55% since Jan 2010, which renders Hong Kong banks less sensitive to funding cost competition. Meanwhile large banks appear to have better CASA mix given their more extensive branch networks, with the ratios in HSB (11 HK) and BOCHK standing at 70% and 56% in 2013 compared to the system level of 54%.

Exhibit 6: System CASA-to-total deposits



Source(s): HKMA, ABCI Securities

Exhibit 7: CASA-to-total deposits in 2013



Source(s): HKMA, companies, ABCI Securities

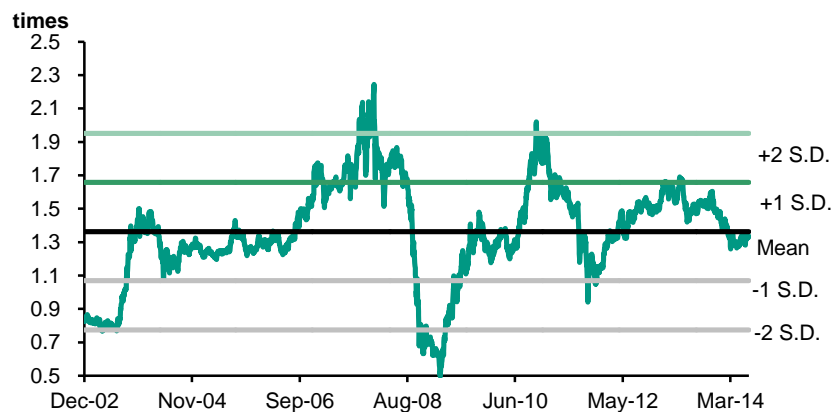


Reiterate BUY with TP at HK\$31.5

We have rolled forward our forecasts to 2016E while keeping the major assumptions in our model unchanged. We forecast BOCHK to achieve 10.7% CAGR earnings growth in 2013-16E, benefiting from its leading position by market share and its unique position as the sole RMB clearing bank in Hong Kong, as well as its solid fundamentals and steady growth in Hong Kong bank sector.

Our Gordon Growth Model (GGM) targets a P/B of 1.85x based on a sustainable ROE of 14.9% (simple average ROE in 2002-16E) and a cost of equity of 9.7% (8.6% previously). The cost of equity factors into a risk-free rate of 2% (10Y HK government bond yield), a beta at 0.85, an equity risk premium of 9% and a long-term growth of 3.5% (benchmark with HK GDP growth). By rolling our BVPS forecast to mid-2015 BVPS, our TP for BOCHK arrives at HK\$31.5 to imply a 29.9% upside.

Exhibit 8: BOCHK P/B band chart (x)



Source(s): Bloomberg, ABCI Securities estimates

BOCHK's share price has underperformed YTD (HSI: 2.8% vs BOCHK: (3.1%)). We believe this has been mainly caused by the reduced dividend payout ratio which fell from over 60% in and before 2012 to 48% in 2013 so as to retain the bank's CAR position. After the cut, however, BOCHK's 2014E dividend yield at 4.82% is still the highest among peers. As we believe the current share price has priced in a dividend level similar to that in 2013 and expect no further payout reduction in the near future, BOCHK's current valuation at 1.49x FY14E P/B is deemed attractive based on its solid fundamentals and strong position in the Hong Kong bank sector. Hence, we reiterate **BUY** after the recent share price correction.

Exhibit 9: Valuation comparison table (Closing price as of 28 July 2014)

	Ticker	Market cap (HK\$ mn)	Price (HK\$)	2014 ROE (%)	2014 PB (x)	2014 PE (x)	2014 div. yield (%)	
	BOCHK	2388 HK	256,390	24.25	16.0	1.49	9.94	4.82
	HSB	11 HK	248,540	130.00	20.7	2.19	14.42	4.26
	BEA	23 HK	76,599	32.90	8.3	1.12	11.76	3.43
	WHB	302 HK	38,239	124.00	9.8	1.66	18.93	1.91
	DSFH	440 HK	14,693	43.85	7.0	0.79	9.24	2.87
	CHB	1111 HK	6,473	14.88	5.2	0.80	9.92	na
	Average				11.2	1.34	12.37	8.59

Source(s): Bloomberg, ABCI Securities estimates



Financial forecasts

Consolidated income statement (2012A-2016E)

FY Ended Dec 31 (HK\$ mn)	2012A	2013A	2014E	2015E	2016E
Interest income	35,413	39,379	48,659	54,581	60,307
Interest expense	(10,705)	(11,463)	(16,254)	(18,411)	(20,476)
Net interest income	24,708	27,916	32,404	36,169	39,832
Non-interest income	10,909	12,397	12,907	13,424	14,073
Of which: Fees and commissions	7,763	8,965	9,473	10,124	10,840
Operating income (Top line)	35,617	40,313	45,311	49,593	53,905
Operating expenses	(11,259)	(12,083)	(13,641)	(15,067)	(16,647)
Pre-prov. oper. profit (PPOP)	24,358	28,230	31,670	34,526	37,258
Impairment loans losses	(859)	(737)	(562)	(553)	(625)
Operating profit	23,499	27,493	31,108	33,973	36,634
Non-operating income	2,022	300	539	542	547
Profit before tax	25,521	27,793	31,646	34,516	37,180
Tax	(3,974)	(4,718)	(4,905)	(5,350)	(5,763)
Minority interests	(617)	(823)	(946)	(1,088)	(1,252)
Net profit	20,930	22,252	25,795	28,077	30,166
Growth (%)					
Interest income	10.9	11.2	23.6	12.2	10.5
Interest expense	7.6	7.1	41.8	13.3	11.2
Net interest income	12.4	13.0	16.1	11.6	10.1
Non-interest income	23.0	13.6	4.1	4.0	4.8
Of which: Fees and commissions	(0.9)	15.5	5.7	6.9	7.1
Operating income (Top line)	15.5	13.2	12.4	9.5	8.7
Operating expenses	43.2	7.3	12.9	10.5	10.5
Pre-prov. oper. profit (PPOP)	6.0	15.9	12.2	9.0	7.9
Impairment loans losses	69.8	(14.2)	(23.7)	(1.6)	12.9
Operating profit	4.5	17.0	13.1	9.2	7.8
Non-operating income	(8.2)	(85.2)	79.5	0.7	0.8
Profit before tax	3.4	8.9	13.9	9.1	7.7
Tax	2.8	18.7	4.0	9.1	7.7
Minority interests	61.1	33.4	15.0	15.0	15.0
Net profit	2.5	6.3	15.9	8.8	7.4
Per share (HK\$)					
EPS	1.98	2.10	2.44	2.66	2.85
BVPS	14.28	15.02	16.29	17.67	19.15
DPS	1.24	1.01	1.17	1.27	1.37
Key ratio (%)					
Net interest margin	1.60	1.68	1.67	1.70	1.70
Net interest spread	1.55	1.63	1.55	1.57	1.57
Cost to income ratio	31.6	30.0	30.1	30.4	30.9
Return on average assets	1.17	1.15	1.20	1.18	1.14
Return on average equity	14.9	14.4	15.6	15.6	15.5
Effective tax rate	15.6	17.0	15.5	15.5	15.5
Dividend payout	62.5	48.0	48.0	48.0	48.0

Source(s): Company, ABCI Securities estimates



Consolidated balance sheet (2012A-2016E)

As of Dec 31 (RMB mn)	2012A	2013A	2014E	2015E	2016E
Assets					
Cash & balances with central banks	198,748	353,741	424,489	488,163	536,979
Dues from banks & non-bank FI	66,025	46,694	76,991	46,956	34,046
Investment securities	608,215	580,407	652,731	722,648	799,754
Net loans and advances	774,559	854,097	954,654	1,064,716	1,188,995
Total interest earning assets	1,647,547	1,834,939	2,108,865	2,322,482	2,559,773
Property and equipment	63,107	66,955	70,303	73,818	77,509
Other non-int. earn assets	120,109	145,042	89,896	109,574	139,378
Total assets	1,830,763	2,046,936	2,269,063	2,505,874	2,776,660
Liabilities					
Customer deposits	1,229,131	1,327,980	1,467,050	1,615,161	1,779,353
Demand deposits	700,860	740,921	836,892	931,577	1,037,601
Time deposits	528,271	587,059	630,157	683,583	741,752
Due to other banks & FIs	179,206	278,273	320,456	359,532	403,500
Subordinated term debt	28,755	19,849	19,948	20,048	20,148
Total interest bearing liabilities	1,437,092	1,626,102	1,807,454	1,994,740	2,203,001
Other liabilities	238,597	257,826	285,326	318,986	366,140
Total liabilities	1,675,689	1,883,928	2,092,781	2,313,726	2,569,140
Share capital	52,864	52,864	52,864	52,864	52,864
Reserves	98,105	105,949	119,362	133,962	149,649
Investment revaluation reserve	31,259	34,682	37,457	39,329	41,296
General reserve	14,035	10,533	7,758	5,886	3,919
Retained earnings	52,811	60,734	74,147	88,747	104,434
Minorities	4,105	4,195	4,056	5,321	5,007
Shareholders equity excludes MI	150,969	158,813	172,226	186,826	202,513
Growth (%)					
Assets					
Cash & balances with central banks	(28.7)	78.0	20.0	15.0	10.0
Dues from banks & non-bank FI	(38.8)	(29.3)	64.9	(39.0)	(27.5)
Investment securities	19.0	(4.6)	12.5	10.7	10.7
Net loans and advances	11.2	10.3	11.8	11.5	11.7
Total interest earning assets	3.3	11.4	14.9	10.1	10.2
Property and equipment	21.1	6.1	5.0	5.0	5.0
Other non-int. earn assets	30.5	20.8	(38.1)	21.9	27.3
Total assets	5.3	11.8	10.9	10.4	10.8
Liabilities					
Customer deposits	7.2	8.0	10.5	10.1	10.2
Demand deposits	20.4	5.7	13.0	11.3	11.4
Time deposits	(6.4)	11.1	7.3	8.5	8.5
Due to other banks & FIs	(24.3)	41.0	15.2	12.2	12.2
Subordinated term debt	0.3	(31.0)	0.5	0.5	0.5
Total interest bearing liabilities	1.8	13.2	11.2	10.4	10.4
Other liabilities	23.4	8.1	10.7	11.8	14.8
Total liabilities	4.4	12.4	11.1	10.6	11.0
Share capital	0.0	0.0	0.0	0.0	0.0
Reserves	27.6	8.0	12.7	12.2	11.7
Investment revaluation reserve	35.0	11.0	8.0	5.0	5.0
General reserve	48.9	(25.0)	(26.3)	(24.1)	(33.4)
Retained earnings	19.2	15.0	22.1	19.7	17.7
Minorities	20.1	10.0	10.0	10.0	10.0
Shareholders equity excludes MI	16.3	5.2	8.4	8.5	8.4
Key ratio (%)					
Loan to deposits	63.3	64.6	65.4	66.3	67.2
Core CAR	12.3	10.7	10.8	10.8	10.8
Total CAR	16.8	15.8	9.7	9.8	9.8
NPL ratio	0.23	0.18	0.21	0.21	0.21
NPL growth	153.0	(14.5)	32.6	12.0	12.1
Net bad debt charge ratio	0.1	0.1	0.1	0.0	0.0
Provision to total loans	0.5	0.5	0.5	0.5	0.5
Provision coverage	206.3	275.8	235.6	234.7	233.8

Source(s): Company, ABCI Securities estimates



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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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