

Company results

Hong Kong

Bank of China (Hong Kong)^[g]

2H03 results review

Banks

22/3/04

HK\$14.65

Bank of China HK beat estimates for 2H03 results released last evening, but operations were still lacklustre. Management has made great strides in improving asset quality and governance, which is noted. Maintain HOLD.

Great comparisons: BOCHK's 2H03 earnings were 41% above the prior year and 64% higher than first half, despite negative loan growth and steeply falling margins. However, the increase came from effectively-zero provisioning in the half, real estate write-ups, and low taxes.

Good signals: Management has continued to build its reputation for focus on shareholder value by raising the dividend and payout ratio—an action we clearly value. In addition, we are optimistic that BOCHK will strengthen its management team with a reputable COO and Head of Risk.

Expensive on current forecasts: BOCHK is still some 8% above fair value based on our cost of capital methodology—expensive at 2.6x book value. We do take into account what we see as a higher risk of upside surprises in asset quality and property revaluation. Maintain HOLD rating and HK\$13.50 price target.

Forecasts and ratings

	2001	2002	2003	2004F	2005F
Net interest income (HK\$m)	14,987	13,942	12,874	13,554	14,306
Core earnings (HK\$m)	4,913	7,918	9,429	9,890	10,557
Net profit (HK\$m)	2,768	6,673	7,963	9,757	10,424
EPS (HK\$)	0.26	0.63	0.75	0.92	0.99
Ch to previous EPS (%)	-	-	-	2.5	-4.3
Core EPS (HK\$)	0.46	0.75	0.89	0.94	1.00
EPS growth (%)	-46.9	141.1	19.3	22.5	6.8
PER (x)	56.0	23.2	19.5	15.9	14.9
DPS (HK\$)	0.13	0.40	0.52	0.52	0.64
Yield (%)	0.9	2.7	3.5	3.5	4.4

Source: Company data, ING estimates

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HSI: 12,551

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Maintained

Hold

22 March 2004

Target price: 12 months

HK\$13.50 (-8%)

Bloomberg

2388 HK

Financial data

	2002	2003	2004F
ROE (%)	12.2	13.6	15.6
Core ROE (%)	14.5	16.1	15.8
ROA (%)	0.9	1.1	1.3
Core ROA (%)	1.1	1.3	1.3
NIM (%)	2.0	1.8	1.8
Cost/Income (%)	33.5	32.8	30.7
Overhead (%)	0.9	0.8	0.8
BVPS (HK\$)	5.4	5.7	6.1
Price/book (x)	2.7	2.6	2.4
PER (x)	23.2	19.5	15.9

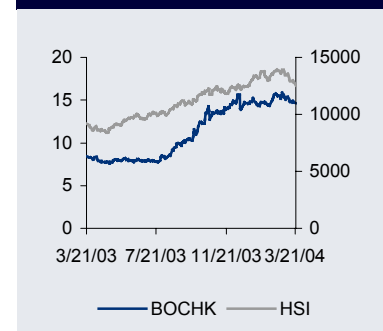
Share data

Market cap (US\$m)	19,909
Number of shares (m)	10,573
Daily turnover (US\$m)	53
Free float (%)	34.2
52-week hi/lo	7.60 - 15.90

Performance (%)

	1m	3m	12m
Absolute	-5.5	1.0	74.4
Relative to HSI	4.0	0.5	37.7

Share price performance



Source: Datastream

Results and returns

Bank of China (Hong Kong) reported its 2003 earnings this evening in Hong Kong, posting net income of HK\$8.0 million—well above consensus and ING estimates and a 19% jump from 2002. Although the percentage increase was not in and of itself egregious in this Hong Kong results season, the real surprise came in the second half, where earnings of HK\$5.0m were up 41% from the prior year and 64% on a consecutive half basis.

The result was characterised by several significant drivers outside the traditional net interest income and fee-based revenue books:

- 1) The almost total lack of provisioning in 2H03: HK\$2m versus HK\$1669m in 1H.
- 2) An HK\$120m upward revaluation in investment property, after a HK\$1.2bn charge against investment property and premises taken in 1H03.
- 3) A turnabout in securities gains from 1H03, as a HK\$177m profit in the earlier period became a HK\$255m loss.

Fig 1 Key Earnings Components: 1999-2005F

HK\$m	1999	2000	2001	2002	2003	2004F	2005F
Net interest income	14,820	16,046	14,987	13,942	12,874	13,554	14,306
Non-interest income	4,534	4,583	4,147	4,065	4,400	4,569	4,823
Non-interest expenses	6,334	5,568	5,847	6,025	5,658	5,556	5,782
Loan loss provisions	9,966	8,593	7,412	2,855	1,671	1,000	1,000
Core income	2,364	5,199	4,913	7,918	9,429	9,890	10,557
Net income	3,067	5,213	2,768	6,673	7,963	9,757	10,424
EPS	0.29	0.49	0.26	0.63	0.75	0.92	0.99

Source: Company data, ING estimates

Fig 2 Key Earnings Components: 1H01-2H03

HK\$m	1H01	2H01	1H02	2H02	1H03	2H03
Net interest income	7,734	7,253	6,891	7,051	6,584	6,290
Non-interest income	2,346	1,801	2,007	2,058	2,263	2,137
Non-interest expenses	2,868	2,979	2,997	2,860	2,697	2,961
Loan loss provisions	1,848	5,564	1,766	1,089	1,669	2
Core income	4,536	364	3,355	4,738	4,135	5,287
Net income	4,195	(1,427)	3,320	3,521	3,012	4,951
EPS	0.40	(0.13)	0.31	0.33	0.28	0.47

Source: Company data, ING estimates

Fig 3 Key Earnings Ratios (%): 2000-2005F

	2000	2001	2002	2003	2004F	2005F
ROA	0.65	0.34	0.89	1.06	1.30	1.41
Core ROA	0.64	0.61	1.05	1.26	1.32	1.43
ROE	16.20	6.47	12.23	13.59	15.63	15.70
Core ROE	16.16	11.49	14.51	16.09	15.85	15.90
NIM	2.30	2.12	2.02	1.77	1.83	1.96
Cost/income	26.99	30.56	33.46	32.75	30.66	30.22
Overhead	0.80	0.83	0.87	0.78	0.75	0.79
Effective tax rate	18.21	14.16	13.89	5.92	14.50	14.50

Source: Company data, ING estimates

In the bank's traditional businesses, revenue remained quite weak on slack loan growth and falling margins, as net interest income fell 4% in 2H03 from the already SARS-depressed level of 1H03 to finish the year down 8%.

Fee income

Fee income posted a mediocre 6% gain as 2002's largest category—fees and commissions on loans—fell by 34%, in line with the slack lending environment. Masked by this overall flat performance but cushioning the blow somewhat were strong performances by brokerage income (+58% YoY), insurance (+53% YoY) and asset management (+72%).

BOC is still somewhat deficient in fee income overall versus even its pure Hong Kong bank peers, posting fee income of only 0.39% of assets, versus 0.57% for the other local banks in our universe¹.

Fig 4 Fee income detail (HK\$m)

	2003	% Total	2002	% Chg
Securities brokerage	733	19.0	465	58
Credit cards	560	14.5	544	3
Bills commissions	556	14.4	586	-5
Loan commissions	473	12.3	714	-34
Payment services	315	8.2	296	6
Insurance	235	6.1	154	53
Asset management	211	5.5	123	72
Trust services	76	2.0	54	41
Guarantees	39	1.0	46	-15
Other	657	17.0	667	-1
TOTAL	3,855	100.0	3,649	6

Source: Company data, ING estimates

Costs well-controlled

BOC continued to reap the benefits of its 13-into-1 consolidation and tight expense control in 2003. Total expenses declined by 6% YoY, with staff costs, premises expense, and other outlays falling.

Much of the reduction comes from trimming the branch network and removing overlapping outlets, with the result that BOCHK is now down to 304 branches from 357 at IPO. Management reports that the first phase of rationalisation is complete—which seems to imply some further (albeit less severe) cuts.

It is worth noting that costs began to tick up in 2H on premises spending, recording a 4% YoY increase. We attribute this to a program of branch renovation which overhauled 26 offices during the year; expect further spending in 2004 with management disclosing plans to re-do 58 more in 2004. In addition, the bank's IT modernisation continues apace, with CRM implementation scheduled to begin by late 1H04.

Altogether, management does not expect (and we concur) any dramatic increase in costs, but warns that BOCHK may not maintain the cost-to-income ratio at its current 32.8%—this last seems rather pessimistic to us given the parlous state of revenue currently and potential upside in an improving market.

¹ HSB, BEA, DSF.

Asset Quality

Bank of China HK has made absolutely stellar strides in improving asset quality, although this was hardly a high bar considering the poor state of the portfolio to begin with. We are very impressed with management's ability to continue managing down troubled relationships even in difficult economic times.

BOCHK's criticised assets (loosely defined as NPLs) fell by 32% YoY with reductions in all categories of severity as well as foreclosed property. Non-performing assets now account for only 6.4% of total loans—still very high versus peer but a great improvement over the 8.8% level posted at YE02 or the 12.6% level at YE01.

Asset quality improvements are not coming at the expense of high provisions: total P&L charge for bad debts fell by 41% after a 61% drop in 2002. The bank is still charging-off more (on a net basis, including recoveries) than it provisions, but very high reserves (still 346bp on average loans) make this a reasonable thing to do. Note that we do not believe that the minimal provisioning of 2H03 is sustainable for even the medium term, but that we are not worried about the bank's reserves or provisioning at this time.

Fig 5 Loan loss provisions: 1999-2003

	1999	2000	2001	2002	2003
Provisions (HK\$m)	9,966	8,593	7,412	2,855	1,671
YoY % Chg	NA	-14	-14	-61	-41

Source: Company data, ING estimates

Fig 6 Asset quality breakout: 1999-2003

	1999	2000	2001	2002	2003
Criticised Loan Breakout:					
Pass (P)	285,478.0	302,967.0	285,726.0	295,130.0	291,203.0
Special Mention (SM)	9,649.0	7,914.0	12,000.0	1,436.0	798.0
Substandard (SS)	5,963.0	3,979.0	4,221.0	8,388.0	6,474.0
Doubtful (D)	12,924.0	7,044.0	5,432.0	3,486.0	2,521.0
Loss (L)	21,230.0	18,233.0	15,663.0	12,899.0	8,106.0
Classified (SS+D+L)	40,117.0	29,256.0	25,316.0	24,773.0	17,101.0
Criticised (Classified + SM)	49,766.0	37,170.0	37,316.0	26,209.0	17,899.0
NPAs, % of Total Loans	14.8	10.9	12.6	8.8	6.4
Weighted Classification Ratio (%)	8.8	6.7	6.1	5.1	3.5

Source: Company data, ING estimates

Fig 7 Charge-off Summary: 2000-2003

BP on average loans	2000	2001	2002	2003
Provisions	254.46	223.53	88.61	53.01
Net charge-offs	327.16	297.39	154.23	184.00
Provisions less charge-offs	(72.70)	(73.86)	(65.61)	(130.99)
Accumulated reserves	580.56	517.39	466.87	346.20

Source: Company data, ING estimates

Potential for further upside surprises

We view BOCHK as having high potential for additional surprises to the upside in terms of asset quality improvement, release of provisions as collateral values improve, and recoveries of previously charged-off loans.

Remember that BOCHK has charged off a net HK\$21bn over the past three years, more than 2.5x 2003 net income. Even small recoveries on this amount could be quite material for the bank.

Reserve Adequacy

BOCHK's reserves are still slightly underfunded by our calculations, but with the economy improving and the bank starting to see upgrades to performing status our methodology is probably on the severe side. In any case, the difference between actual reserves and our theoretical required amount is less than 5% of capital—nothing to worry about.

Fig 8 Reserve adequacy: YE2003

	Gross	Reserve	Required
HK\$m	Amount	Percentage (%)	Reserve
Pass	291,203	1	2,912
Special Mention	798	5	40
Substandard	6,474	20	1,295
Doubtful	2,521	50	1,261
Loss	8,106	100	8,106
ORE	1,757	20	351
Excess AIR	-	20	-
Total	310,859		13,965
Actual Reserves			10,913
Shortfall			3,052
Actual/Required			78%
Shortfall/Capital			5%

Source: Company data, ING estimates

To derive our required minimum level of reserves, we apply reserve weightings as follows: 1% on Pass; 5% on Special Mention; 20% on Substandard; 50% on Doubtful; and 100% on Loss loans. In addition, where not included in banks' internal classifications, we classify all excess (above 1.25%) accrued interest receivables and Other Real Estate (ORE, or foreclosed property) as Substandard. All assets are classified on a gross of collateral basis.

Loan Portfolio

BOC continues to shed loan balances, but curiously more so in the corporate realm than in the consumer book. While (non-HOS) mortgages were up 6% in 2H03 alone, manufacturing credits declined by 14%, property investment by 4%, and loans to property developers by 18%.

Management has announced a plan to curb the bank's exposure to property lending, a rather curious position in an upturn—especially while the bank is still expanding its retail mortgage book at thin spreads.

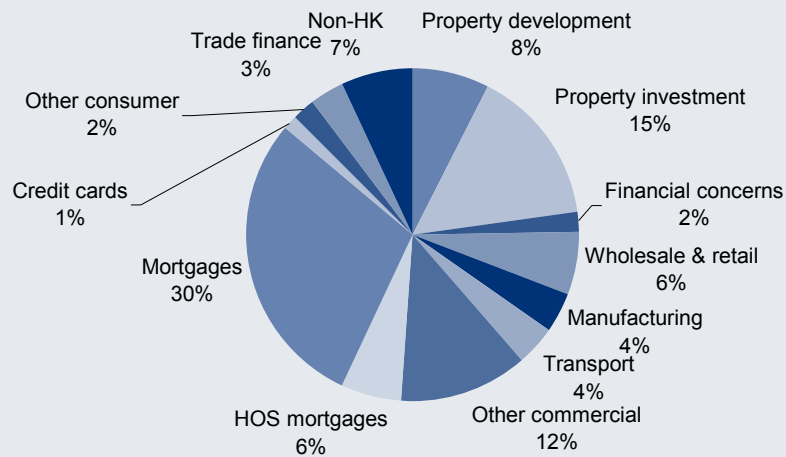
Trade finance was strong as well, as was the transport sector. As regards the latter, we believe that BOCHK has been quite aggressive in taxi and bus loans and is gaining substantial share.

Fig 9 BOCHK loan growth: 2H02-2H03

	2H02	1H03	2H03	% Chg	
				YoY	HoH
Total loans:	321,034	321,181	308,582	-3.9	-3.9
Loans for use in Hong Kong	301,508	302,109	286,901	-4.8	-5.0
industrial, commercial and financial	174,803	177,794	157,660	-9.8	-11.3
- property development	26,591	28,247	23,162	-12.9	-18.0
- property investment	50,992	48,728	46,754	-8.3	-4.1
- financial concerns	8,891	8,214	6,589	-25.9	-19.8
- stockbrokers	82	84	41	-50.0	-51.2
- wholesale and retail trade	23,781	23,709	18,858	-20.7	-20.5
- manufacturing	12,834	13,122	11,342	-11.6	-13.6
- transport	11,192	12,643	12,385	10.7	-2.0
- others	40,440	43,047	38,529	-4.7	-10.5
Individuals	117,832	115,120	119,390	1.3	3.7
- HOS Mortgages	19,956	18,890	18,244	-8.6	-3.4
- other mortgages	85,853	84,895	90,003	4.8	6.0
- credit card advances	3,554	3,385	3,756	5.7	11.0
- others	8,469	7,950	7,387	-12.8	-7.1
Trade finance	8,873	9,195	9,851	11.0	7.1
Loans for use outside Hong Kong	19,526	19,072	21,681	11.0	13.7

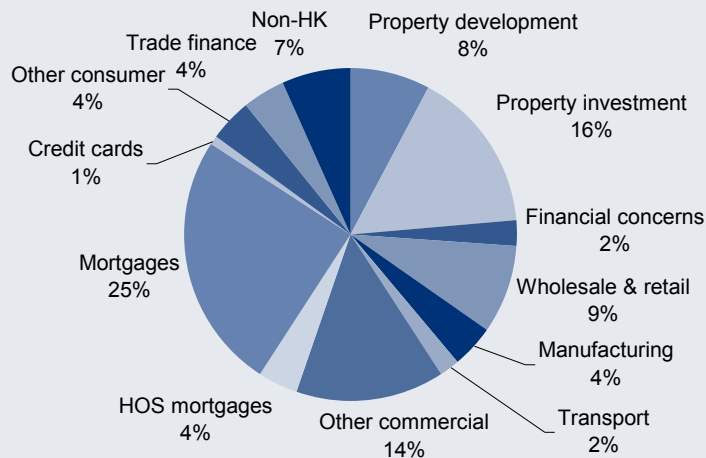
Source: Company data, ING estimates

Fig 10 Loan portfolio distribution: YE03



Source: Company data, ING estimates

Fig 11 Loan portfolio distribution: YE00



Source: Company data, ING estimates

Rates and Margins

Bank of China HK is caught in a liquidity trap along with its large bank counterparts in Hong Kong. With deposit rates within a few basis points of zero even at the long end, there is no room to absorb a fall in earning asset yield and thus shield margins—and fall is exactly what asset yields have done.

In 2H03 alone the bank's earning asset return fell by 33bp to 2.23, an historic low. On the funding side, the bank was only able to chop 22bp off its costs, helping to spur a 14bp drop in NIM.

Earning assets are repricing in part due to falling benchmark rates but also due to repricing of the mortgage book at higher and higher discounts to prime. The mortgage book yield in 2H03 was prime-191bp, leaving 60-80bp of further yield erosion to come if the portfolio reprices under current conditions.

Bear in mind also that the bank is very liquid and short-term oriented, so that its assets are more sensitive to short rates like HIBOR than they might otherwise be. The 1 month HIBOR has fallen from its 2H03 average of 64bp to under 8bp currently, and management agrees that absent an upward change in rates the bank's spread will be further constrained in 1H04.

Fig 12 Key Net Interest Margin Components (%): 1999-2003

	1999	2000	2001	2002	2003
Yield on earning assets	7.80	7.95	5.42	3.10	2.43
Cost of interest-bearing liabilities	5.26	5.40	3.26	1.16	0.77
Interest spread	2.55	2.55	2.16	1.94	1.67
Net interest margin	2.25	2.30	2.12	2.02	1.77

Source: Company data, ING estimates

Fig 13 Key Net Interest Margin Components (%): 2H01-2H03

	2H01	1H02	2H02	1H03	2H03
Yield on earning assets	4.44	2.99	2.98	2.56	2.23
Cost of interest-bearing liabilities	2.18	1.25	1.09	0.88	0.67
Interest spread	2.26	1.74	1.89	1.67	1.56
Net interest margin	2.05	1.95	1.96	1.83	1.69

Source: Company data, ING estimates

Fig 14 Change in Net Interest Margin Components:

	2000	2001	2002	2003
Yield on earning assets	+15bp	-253bp	-231bp	-67bp
Cost of interest-bearing liabilities	+14bp	-214bp	-210bp	-39bp
Interest spread	+1bp	-40bp	-21bp	-28bp
Net interest margin	+5bp	-18bp	-10bp	-25bp

Source: Company data, ING estimates

RMB Clearing

The bright spot for BOCHK has been its mainland-related initiatives such as the Great Wall card. To existing products was added in early 2004 the ability to take offshore Rmb deposits in Hong Kong, along with an awarded mandate as the sole Rmb clearing bank for Hong Kong.

Functionally, all Hong Kong banks taking Rmb deposits are required to net off their inflows and outflows with BOCHK, which then places any surplus funds with the PBOC at a negotiated rate of 0.99%. In addition to having a presumed advantage in getting RMB deposits of its own, BOCHK is entitled to an annualised 0.125% fee on the deposits of all other banks cleared through it.

What will be the earnings impact?

Unfortunately the direct earnings increase attributable to RMB clearing and deposit-taking will be minimal. We estimate that there is approximately RMB50bn in "escaped currency" circulating in Hong Kong. Although some of this is part of the underground economy and will probably continue to linger in the shadows, we believe that most (70%) of this leakage will eventually find its way into the banking system.

We also assume that BOCHK will have a 40% share of Rmb deposits, from which it will take a 49bp spread on average, along with clearing charges on the remaining 60%. At a 45% cost/income on the business, this will only yield HK\$50m per year—certainly welcome income but less than 1% of 2003 pre-tax net.

Fig 15 Profits from RMB deposit-taking in Hong Kong

	RMBm	HK\$m
RMB in circulation in HK	50,000	47,561
% deposited in banks at equilibrium	70%	
Offshore RMB deposits	35,000	33,293
BOCHK market share	40%	
BOCHK RMB deposits	14,000	13,317
Annual spread on deposits	0.50%	
Annual fee on non-BOCHK deposits	0.13%	
Annual revenue to BOCHK	96	92
Assumed cost/income	45%	
Projected pre-tax income	53	50
% of 2003 pre-tax income		0.5%

Source: Company data, ING estimates

Valuation and rating

Bank of China is currently trading at 2.6x trailing and 2.4x forward book value per share, and on earnings multiples of 19.5x 2003 and 15.9x 2004F EPS.

Based on our cost of capital valuation using a beta of 0.8, sustainable core ROE of 17%, and market risk premium of 6%, fair value for BOCHK is only 2.2x forward book value, or HK\$13.50.

We maintain our HOLD rating on BOCHK shares with a HK\$13.50 price target.

Fig 16 Valuation at Current Price

	2001	2002	2003	2004F
Share Price (HK\$)	14.65			
PER (x)	55.96	23.21	19.45	15.87
Core PER (x)	31.53	19.56	16.43	15.66
PUP (x)	11.66	12.93	13.33	12.33
P/BV (x)	2.97	2.72	2.57	2.40
P/ABV (x)	2.98	2.73	2.57	2.40

Source: Company data, ING estimates

Fig 17 Cost of capital valuation summary

5yr swap rate (%)	3.20
Market risk premium (%)	6.00
Estimated forward Beta	0.8
Cost of capital (%)	7.7
Sustainable LT core ROE (%)	17.0
Implied PBV (x)	2.21
2004F BVPS	6.11
Implied target price (HK\$)	13.48
Current price (HK\$)	14.65
Upside (%)	-8.0

Source: Company data, ING estimates

Fig 18 Valuation at Target Price

	2001	2002	2003	2004F
Share Price (HK\$)	13.50			
PER (x)	51.57	21.39	17.92	14.63
Core PER (x)	29.05	18.03	15.14	14.43
PUP (x)	10.74	11.91	12.29	11.36
P/BV (x)	2.74	2.51	2.37	2.21
P/ABV (x)	2.74	2.51	2.37	2.21

Source: Company data, ING estimates

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Recommendations

In Asia ex-Japan our recommendations are defined as follows:

Buy: At least 10% share price upside is expected over our 12-month view.

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Sell: At least 10% share price downside is expected over our 12-month view.

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