

**Analyst: Paul Sham**
**BOC HONG KONG (HOLDINGS) LIMITED (中銀香港)**

Sector	: Banking	Chairman	: Mr. Xiao Gang
HKSE Code	: 02388		
Market Price	: HK\$18.10 (28/08/2008)	Vice Chairman & Chief Executive	: Mr. He Guangbei
Shares Issued	: 10,572.78m		
Mkt. Cap.	: HK\$191,136.7m		
52 weeks Hi/ Lo	: HK\$24.10 / HK\$16.02		
HSI	: 20,972.29 (28/08/2008)		
Main Business	: Banking and related financial services		

**SUMMARY OF THE INTERIM RESULTS FOR THE SIX MONTHS ENDED 30<sup>TH</sup> JUNE 2008**
**Interim Results Highlights**

	HK\$ million	Vs 1H2007 (%)	Vs 31/12/2007 (%)
• Net interest income	10,029	+12.6%	
• Non-interest income	4,010	+27.0%	
• Total operating income	14,039	+16.4%	
• Operating expenses	(4,088)	+19.6%	
• Operating profit before impairment losses	9,951	+23.6%	
• <b>Net charge of impairment allowances</b>	<b>(2,227)</b>	<b>-1,441.6%</b>	
• Net charge of loan impairment allowances	(71)	-143%	
• Profit before taxation	8,434	-8.6%	
• Taxation	(1,253)	-21.6%	
• <b>Attributable profit to shareholders</b>	<b>7,088</b>	<b>-5.1%</b>	
• Total loans	475,587	+21.1%	+15.1%
• Total deposits	824,534	+0.8%	+2.9%
• Total assets	1,127,168	+7.6%	+5.6%
• Basic EPS (HK\$)	0.6704	-5.1%	
• interim DPS (HK\$)	0.438	+2.3%	
<b>Selected Ratios</b>	<b>1H2008</b>	<b>1H2007</b>	<b>FY2007</b>
• Net interest margin	2.03%	2.03%	2.07%
• Cost-income ratio	29.1%	28.3%	28.5%
• Return on average assets	1.32%	1.57%	1.53%
• Return on average equity	15.1%	17.3%	17.4%
• Impaired loan ratio	0.34%	0.41%	0.44%
• Impaired advances coverage	94.8%	70.2%	76.8%
• Loan-deposit ratio	57.7%	48.0%	51.5%
• Capital adequacy ratio	13.9%	14.3%	13.1%
• Average liquidity ratio	42.5%	50.1%	50.9%

- **1H08 net profit hit by asset write-down** Bank of China (Hong Kong) ("BOCHK") reported net earnings declined 5.1% y-o-y to HK\$7,088m in 1H08, due to the impact of a further HK\$2,149m write-down of US mortgage backed securities (MBS). Excluding the net write-down on MBS, its pre-tax earnings would have grown by 14.1% y-o-y.
- **NIM narrowed on low RMB yield** BOCHK's net interest margin (NIM) in 1H08 fell 7bps h-o-h to 2.03% on negative impact of lower HIBOR from rate cuts. BOCHK also attributed the shrink of NIM to its RMB clearing operations. Management said that the inability to deploy the huge inflow of RMB deposits received during 1H08 (+144% h-o-h, now 5% of total customer deposits) into higher yielding assets other than placing the funds with the PBOC, dragged down overall margins. Stripping out the

*This report has been prepared solely for information purposes and we are not soliciting any action based upon it. Neither this document nor its contents shall be construed as an offer, invitation, advertisement, inducement or representation of any kind or form whatsoever. The information is based upon information which we consider reliable, but accuracy or completeness is not guaranteed. Opinions expressed herein are subject to change without notice. At time of this report, East Asia Securities Company Limited has no position in securities of the company or companies mentioned herein.*

impact of the bank's RMB operations on margins, the h-o-h decline in margin in 1H08 would have been 2bps (from 2.12% to 2.10%).

- **Solid loan growth** BOCHK delivered strong loan growth (+15.1% h-o-h) in 1H08, with impressive gains across majority of its main lending segments such as trade finance (+30.5% h-o-h) and wholesale & retail trade (+19.9% y-o-y). The bright spot was on the loans used outside HK, growing 22.3% h-o-h, thanks to the expansion of Mainland operations. The Group's loan-to-deposit ratio was up 6.15 percentage points to 57.7% at end-June as total loan growth outpaced deposits growth of 2.9% h-o-h.
- **Non-interest income edged up 27%** Net-fee income increased by 10.1% y-o-y. The increase in loan and bill fees (+47.3% y-o-y), bond trading fees (+238.5% y-o-y) and insurance fees (+55.3% y-o-y) more than offset the decline in securities brokerage fees (-2.6% y-o-y) and asset management fees (-24.9% y-o-y). Besides, the foreign-exchange dealing profit increased by 464.5% y-o-y to HK\$875m, lifting the overall non-interest income by 27.0% h-o-h.
- **High cost growth** Operating expenses rose 19.6% y-o-y despite the slower increase of staff number (headcounts at end-Jun 08: 13,616, +5.8% y-o-y). Management attributed the high cost growth to the impact of the overall staff salary adjustments and the ongoing expansion into China and HK. Also, the heightened IT expenses incurred as the bank pushed through the peak period of its 5-year IT investment program. With the increase in operating expenses outpaced the increase in operating income, cost-to-income ratio increased slightly to 29.1% in 1H08, against 28.5% in FY07.
- **Subprime exposure** The net impairment charges on BOCHK's US mortgage related investment during 1H08 amounted to HK\$2,149m (HK\$420m write-back on sub-prime ABS securities, HK\$655m charge for Alt-A securities, and HK\$1,914m charge for prime residential MBS). Outstanding value of subprime MBS has tumbled from HK\$4,118m at end-Dec 2007 to HK\$1,243m at end-Jun 2008, with provision coverage ratio of 36.2%.
- **Asset quality remains benign** BOCHK reversed from a net provision write-back of HK\$166m to a net loan impairment charge of HK\$71m in 1H08. Despite this, impaired loan ratio has further declined to 0.34% and provision coverage ratio improved to 94.8% from 76.8% at end-Dec 2008.
- **Contributions from PRC branches** Pre-provision operating profit of the Mainland business registered a 7.6% y-o-y decline to HK\$218m in 1H08, dragged by the foreign exchange loss arising from the revaluation of Nanyang (China)'s Hong Kong Dollar capital funds against the appreciated RMB. Pre-tax profit dropped by 16.6% y-o-y to HK\$236m (2.8% of the bank's total). Excluding such losses, the pre-tax profit would have increased 21.7% y-o-y to HK\$314m. Deposits grew by 119.7% h-o-h to HK\$12,667m as of 30 June 2008 while loans rose by 17.2% to HK\$35,140m.
- **Weakened profitability due to MBS write-down but financial position remains healthy** ROE and ROA was 15.1% and 1.32% respectively in 1H08. Meanwhile, BOCHK's CAR stood at 13.9% as of 30 June 2008, strengthened by the support of the parent bank, Bank of China Limited (BOC), which granted a subordinated loan of EUR660m to BOCHK.

### Outlook & Prospects

- **Worrisome debt securities** BOCHK further reduced its subprime MBS exposure to HK\$1,243m after 1H08, down from HK\$4,118m at the end of FY07. Despite the substantial reduction of the subprime MBS in 2H07 and 1H08, BOCHK's total exposure on subprime, Alt-A and, Prime MBS still amounted to HK\$30,804m (about 32% of total equity), creating significant uncertainty on future earnings if the credit market further deteriorates.
- **The Asia-Pacific syndicated loan centre of its parent** Loan growth at BOCHK should remain strong in 2H08 even after a robust 15.1% expansion of the loan book in 1H08. BOCHK has been designated by its parent BOC as the principal arranger for the group's Asia-Pacific syndicated loan business, which will enable it to take the lead in syndicated loan arrangement in Asia outside Mainland. Not only will this help increase BOCHK's overseas syndicated loans, it will also expand its loan-arrangement fees and foreign exchange transaction fees.



- **Slow expansion in China banking business** The total number of BOCHK's outlets in China increased by 1 only, from 14 to 15, during 1H08. We doubt whether the group will be able to achieve its target of tripling the number of its outlets in China to 42 or more within 2010-2012. If the pace of BOCHK's expansion in China remains moderate, we believe it will still have to rely heavily on referral loans from its parent in China over the next one-to-two years.
- **Upside potential** BOCHK is trading at 1.94x FY08E P/B, 11.8x FY08E P/E and >5.34% dividend yield. BOCHK has proved to be a defensive stock in turbulent markets due to its stable and satisfactory dividend track record. Also, its unique position to collaborate with its parent BOC would allow BOCHK to deliver better organic growth among its peers, especially loan growth, showing encouraging growth of 15.1% in 1H08. As such, we recommend an "outperform" rating for the counter.

**Recommendation:    *Outperform***

**I. Impairment allowances, overdue and rescheduled advances of BOC Hong Kong**

As % of total customer advances	Individual allowance	Collective allowance	Impaired advances	Overdue and rescheduled advances
<b>As of 30/06/2008</b>	0.09%	0.23%	0.34%	0.23%
<b>As of 31/12/2007</b>	0.09%	0.24%	0.44%	0.30%
<b>As of 30/06/2007</b>	0.12%	0.17%	0.41%	0.31%

**II. Comparison of BOC Hong Kong's loan book: 30/06/2008 vs 31/12/2007**

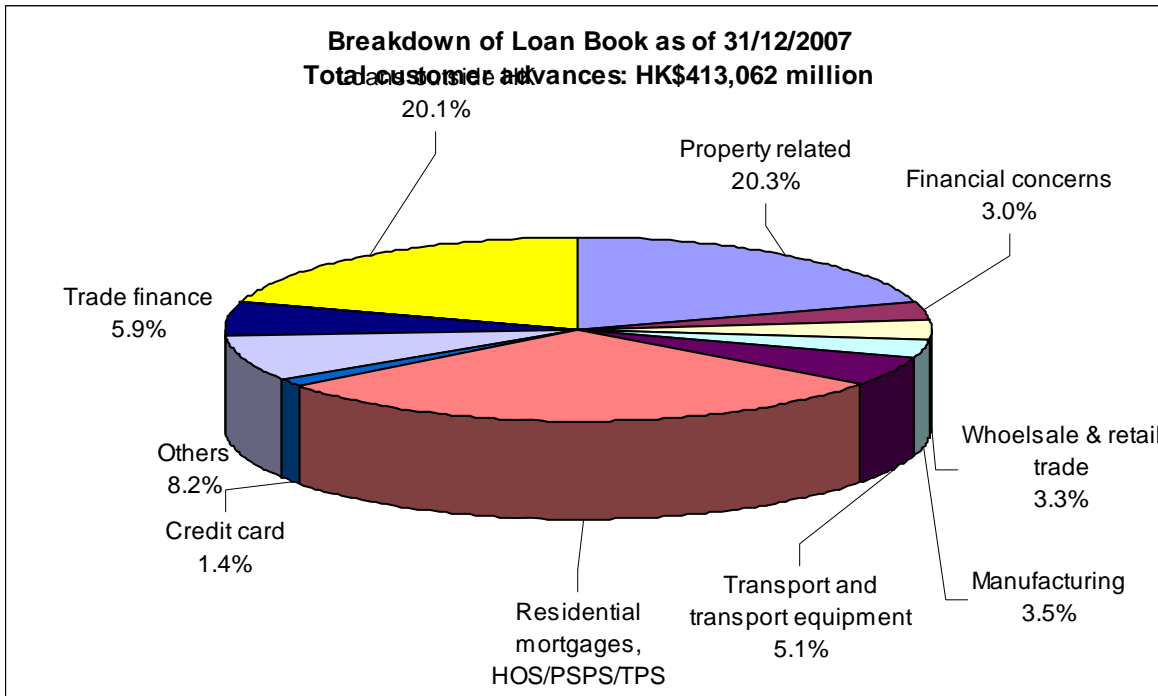
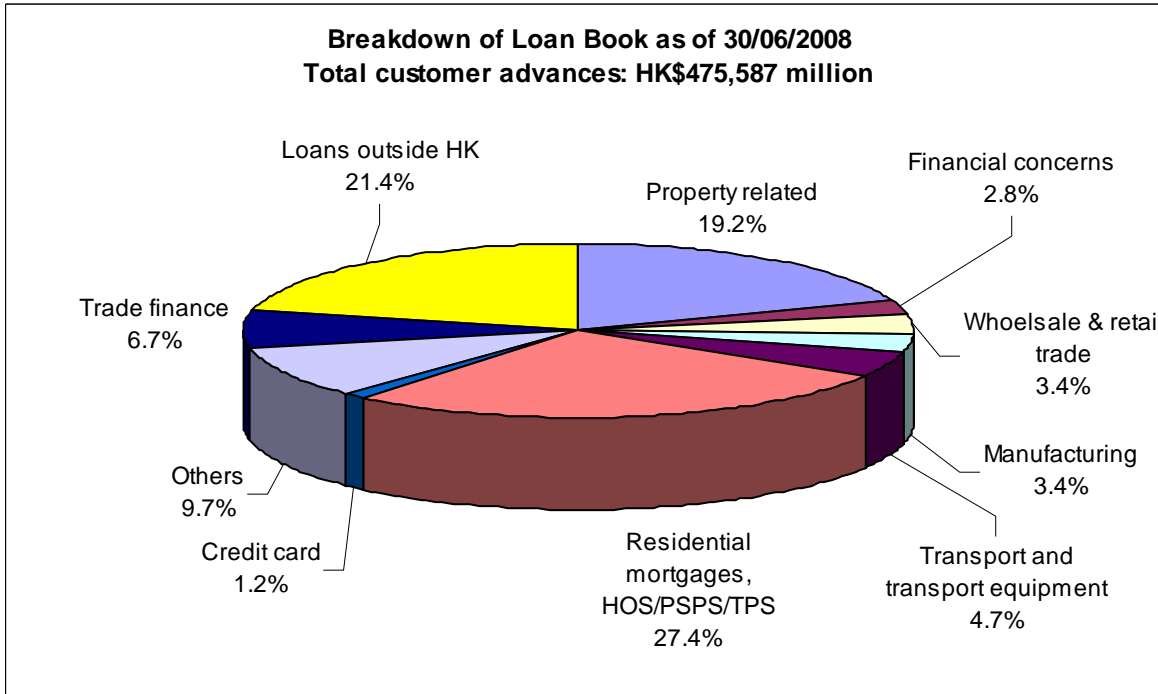
Loans-by industry	30 <sup>th</sup> June, 2008	Up/(down)	31 <sup>st</sup> Dec, 2007
	HK\$ million		HK\$ million
Property related	91,444	+8.9%	83,942
Financial concerns	13,500	+9.3%	12,346
Wholesale & retail trade	16,273	+19.9%	13,572
Manufacturing	16,313	+12.8%	14,468
Transport & transport equipment	22,289	+6.1%	21,001
Residential mortgages, HOS/PSPS	130,277	+8.1%	120,552
Credit card	5,666	-1.6%	5,761
Others	46,288	+37.0%	33,793
Trade finance	31,683	+30.5%	24,275
Stockbrokers	177	-26.9%	242
Loans outside HK	101,677	+22.3%	83,110
	<u>475,587</u>	+15.1%	<u>413,062</u>

**III. Comparison of BOC Hong Kong's loan book: 30/06/2008 vs 30/06/2007**

Loans-by industry	30 <sup>th</sup> June, 2008	Up/(down)	30 <sup>th</sup> June, 2007
	HK\$ million		HK\$ million
Property related	91,444	+13.0%	80,890.0
Financial concerns	13,500	+16.7%	11,565.0
Wholesale & retail trade	16,273	+26.2%	12,891.0
Manufacturing	16,313	+18.2%	13,801.0
Transport & transport equipment	22,289	+11.3%	20,030.0
Residential mortgages, HOS/PSPS	130,277	+14.0%	114,232.0
Credit card	5,666	+1.6%	5,578.0
Others	46,288	+22.0%	37,944.0
Trade finance	31,683	+46.7%	21,598.0
Stockbrokers	177	-97.8%	8,192.0
Loans outside HK	101,677	+53.8%	66,090.0
	<u>475,587</u>	+21.1%	<u>392,811</u>



**Breakdown of loan book of BOC Hong Kong**





**Important Disclosure / Analyst Certification / Disclaimer**

This document is published by East Asia Securities Company Limited, a wholly-owned subsidiary of The Bank of East Asia, Limited (BEA).

The research analyst primarily responsible for the content of this report, in part or in whole certifies that the views on the companies and their securities mentioned in this report accurately reflect his/her personal views. The analyst also certifies that no part of his/her compensation was, is, or will be, directly, or indirectly, related to specific recommendations or views expressed in this report.

This report has been prepared solely for information purposes and has no intention whatsoever to solicit any action based upon it. Neither this report nor its contents shall be construed as an offer, invitation, advertisement, inducement or representation of any kind or form whatsoever. The information is based upon information, which East Asia Securities Company Limited considers reliable, but accuracy or completeness is not guaranteed. Information and opinions expressed herein reflect a judgment as of the date of this document and are subject to change without notice. Any recommendation contained in this report does not have regard to the specific investment objectives, financial situation and the particular needs of any specific addressee. This report is not to be taken in substitution for the exercise of judgment by respective readers of this report, who should obtain separate legal or financial advice. East Asia Securities Company Limited and / or The BEA Group accepts no liability whatsoever for any direct or consequential loss arising from any use of this report or further communication given in relation to this report.

At time of this report, East Asia Securities Company Limited has no position in securities of the company or companies mentioned herein the report, while BEA along with its affiliates and/or persons associated with any of them may from time to time have interests in the securities mentioned in this report. BEA and its associates, its directors, and/or employees may have positions in, and may effect transactions in securities mentioned herein and may also perform or seek to perform broking, investment banking and other banking services for these companies.

BEA and/or any of its affiliates may beneficially own a total of 1% or more of any class of common equity securities of the subject company or companies mentioned in this report and may, within the past 12 months, have received compensation and/or within the next 3 months seek to obtain compensation for investment banking services from the subject company or companies mentioned in the report.

This document is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of, or located in, any locality, state, country or other jurisdiction, publication, availability or use would be contrary to law and regulation.