

Analyst: Paul Sham
CHINA MERCHANTS BANK CO. LTD. (招商銀行)

Sector	: Banking	Chairman	: Mr. Qin Xiao
HKSE Code	: 3968	President & CEO	: Mr. Ma Weihua
Market Price	: HK\$23.70 (19/08/2008)		
Shares Issued	: 2,662m (H share)		
Mkt. Cap.	: HK\$63,089.4m (H shares)		
52 weeks Hi/ Lo	: HK\$40.40 / HK\$19.54		
HSI / HSCEI	: 20,484.37 / 10,714.44 (19/08/2008)		
Main Business	: Banking and related financial services		

SUMMARY OF THE INTERIM RESULTS FOR THE SIX MONTHS ENDED 30TH JUNE 2008
Interim Results Highlights

	RMB million	Vs 1H2007 (%)	Vs 31/12/2007 (%)
• Net interest income	24,125.0	+64.2%	
• Non-interest income	4,662.0	+63.1%	
• Total operating income	28,787.0	+64.0%	
• Operating expenses	(10,306.0)	+47.9%	
• Operating profit before impairment losses	18,481.0	+74.6%	
• Impairment losses on loans and advances	(1,392.0)	-8.5%	
• Profit before taxation	17,122.0	+90.1%	
• Taxation	(3,877.0)	+34.3%	
• Attributable profit to equity holders	13,245.0	+116.4%	
• Total loans	742,660.0	+18.0%	+10.3%
• Total deposits	1,046,626.0	+23.9%	+10.8%
• Total assets	1,395,791.0	+25.9%	+6.5%
• Basic EPS (RMB)	0.90	+114.3%	
• Interim DPS (RMB)	0.00	Unchanged	
Selected Ratios	1H2008	1H2007	FY2007
• Net interest margin	3.66%	2.96%	3.11%
• Cost-income ratio	35.8%	39.70%	40.8%
• Return on average assets	1.96%	1.20%	1.36%
• Return on average equity	36.4%	21.40%	24.8%
• NPL ratio	1.25%	1.66%	1.54%
• NPL coverage ratio	216.1%	170.00%	180.4%
• Loan-deposit ratio	71.0%	74.50%	71.3%
• Capital adequacy ratio	10.4%	10.62%	10.3%

- **1H08 results exceeded market expectations** China Merchants Bank (CMB)'s 1H08 earnings came in at RMB13,245m (EPS: RMB0.90), representing 116% y-o-y growth, higher than the consensus forecasts of RMB12,538m. Key highlights were the strong NIM expansion to 3.66% in 1H08, continued asset quality improvement and positive y-o-y growth in fee income despite the drop in stock market related fees.
- **Widened NIM** The bank recorded a 55bp expansion in NIM from 2007 levels. The widened NIM was primarily due to four factors: 1) the central bank raised the prime rate a number of times; 2) the interest rate of demand deposits remaining more or less the same; 3) the higher proportion of demand deposits relative to total deposits, and 4) wider net interest spread between deposit and loan.

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- **Healthy loan growth** CMB's loan book grew by 10.3% h-o-h during 1H08. Corporate loans totalled RMB497,614m, 11.61% more than at the end of 2007, and accounted for 67.0% of total loans. On the other hand, affected by the state's macroeconomic control measures and tight monetary policy, retail loan business slowed down. As of 30 June 2008, retail loans amounted to RMB190,034m, a 8.57% increase compared to the end of 2007. Residential mortgage loans grew only 5.4% h-o-h while accounts receivable at the credit card business increased 17.7% h-o-h. Retail loans accounted for 25.6% of total loans as of 30 June 2008, down 0.41% from the end of last year because of a credit crunch in the country's residential mortgage loan market.
- **Growth momentum in non-interest income maintained** Non-interest income posted a strong growth of 63.1% y-o-y. Such an increase was primarily attributable to increases in bank cards fees and trust services fees, up 64.6% and 1,069% (or 10.7x), respectively. However, wealth management agency fees were weak, down 32.9% y-o-y, due to the unfavourable A-share equity markets.
- **Enhanced cost efficiency** Operating expenses increased by 47.9% y-o-y in 1H08, due to a 58.7% jump in staff costs (53.9% of total operating costs) on increased headcounts (an addition of 1,782 employees, mainly for retail banking, including credit card business) and performance-based bonus. Business tax and surcharges increased by 53.9%, in line with the overall growth of business development. Depreciation and rental expenses increased 27.1% while G&A expenses increased by 31.5% amid rapid business expansion. Despite the surge in operating expenses, the stronger operating income growth (+64.0% y-o-y) led to an improvement in the bank's cost-to-income ratio to 35.8% in 1H08, compared with 39.7% in 1H07.
- **Continued loan quality improvement** CMB's asset quality remains benign. Both NPLs and overdue loans recorded 'double-decline'. NPL amount fell by 11% h-o-h and NPL ratio declined 0.29% to 1.25%; while overdue loans also dropped 5.8% h-o-h and overdue ratio fell 0.20% to 1.2%. Provision coverage ratio continued to rise further to a highly conservative 216%.
- **Profitability improved but inadequate CAR after WLB deal** CMB's saw its ROA and ROE jump to 1.96% and 36.4% respectively for 1H08. Meanwhile, the bank's CAR stood at 10.4% and core CAR was 8.83% as of 30 June 2008. CMB revealed that it planned to raise around RMB30bn of debts for the acquisition of Wing Lung Bank (WLB) in order to maintain the CAR.
- **Investments in debts issued by Fannie Mae and Freddie Mac** CMB disclosed that it had US\$255m Fannie and Freddie debt securities exposure, representing 0.1% of total assets. It consists of US\$110m Fannie senior debt, US\$70m Freddie senior debt and US\$75m MBS guaranteed by the two companies. Contrary to the market's loss estimation on the aforesaid debts, CMB even recorded a US\$0.83m MTM gain in 1H08.



Outlook & Prospects

- **Slowdown in retail business** CMB has the leading retail banking franchise in China. However, the profit contribution from CMB's retail banking business only grew 7.5% y-o-y, while that from corporate banking jumped 58.5% y-o-y. We believe CMB's retail banking development strategy will face a challenge amid weak demand for mortgage loans.
- **Debt financing proposed** CMB said on 12th June that it planned to raise as much as RMB30bn to bolster capital after the acquisition of WLB. The management said the fund-raising plan would enable the bank to maintain a capital adequacy ratio of about 10%. Since a higher interest rate is required on CMB's low credit rating, NIM will come under pressure accordingly.
- **Contraction of NIM in 2H08 and FY09** Even though the NIM rose from 2.96% in 1H07 to 3.66% in 1H08, CMB expressed its concern on its NIM decline in 2H08 amid a shift of capital from the stock market to fixed deposits and uncertain rate policies. Therefore, it is expected that the 2H08 margin will fall modestly, narrowing the full-year NIM in FY08. Moreover, fully-integrated WLB with a lower NIM (1.81% in FY07) and the fund-raising plan of RMB30bn subordinate debt, are likely to drive down the NIM further in FY09.
- **Wing Lung Bank deal** CMB is acquiring WLB at an expensive price of 3.1x WLB's 1Q08 Price-to-book. Management expected WLB to provide revenue synergies but we believe such benefits would not be material in short-term. Given WLB's sizeable scale and it is the first overseas bank that CMB has ever acquired, CMB would face a huge challenge in managing the merger over the long term. In addition, CMB's agreement of not cutting staff within the first 18 months after the merger would hinder the integration process. Therefore, potential revenue / cost synergies are not likely to happen in the near-term.
- **Reiterate Hold on rich valuations** A strong retail-banking franchise, good earnings momentum and high ROE have been the major appeals for CMB. Despite these positives, valuations of 3.6x FY08E PB and 13.3x FY08E PE look rich, particularly when compared with its closest rival China CITIC bank (1.6x FY08E PB, 11.7x FY08PE). The slowing growth of the retail banking business will also weaken CMB's high valuation base. We therefore maintain our "Hold" rating for the counter.

Recommendation: *Hold*

I. Comparison of China Merchants Bank's loan book: 30/06/2008 vs 31/12/2007

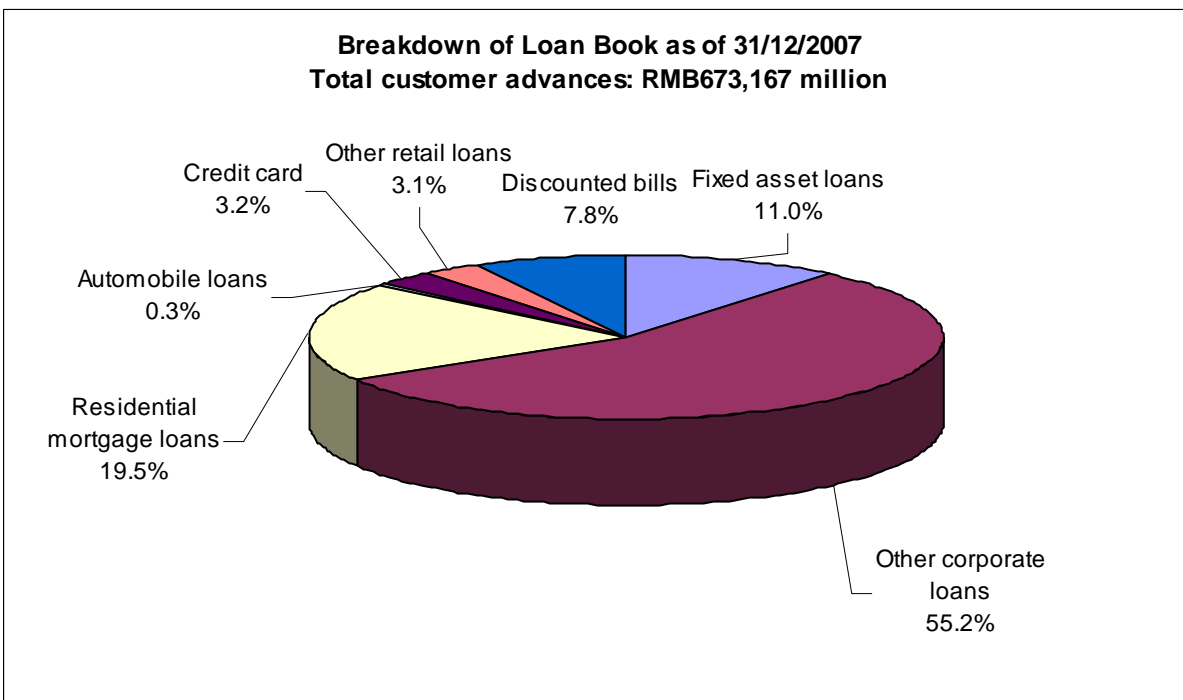
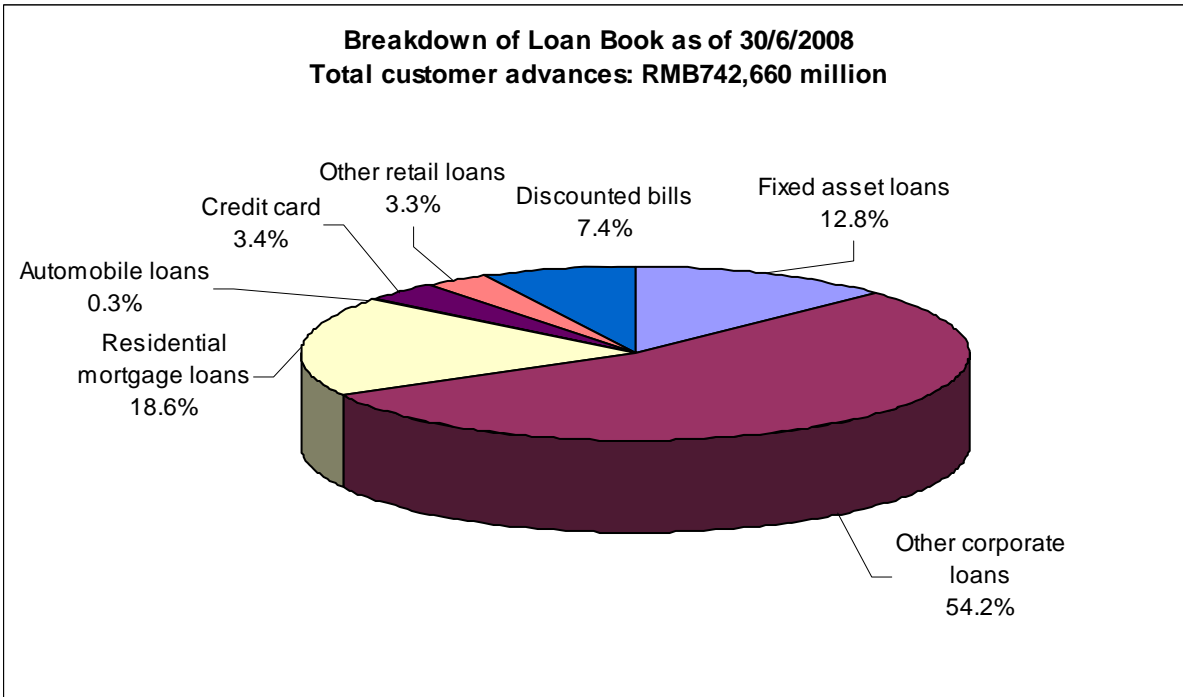
Loans-by industry	30 th Jun, 2008	Up/(down)	31 st Dec, 2007
	RMB million		RMB million
Fixed asset loans	95,231	+28.6%	74,045
Other corporate loans	402,383	+8.2%	371,820
Residential mortgage loans	138,214	+5.4%	131,138
Automobile loans	2,352	+21.2%	1,940
Credit card	25,087	+17.6%	21,324
Other retail loans	24,381	+18.2%	20,624
Discounted bills	55,012	+5.2%	52,276
	<u>742,660</u>	+10.3%	<u>673,167</u>

II. China Merchants Bank's pre-tax profit breakdown by businesses

Pre-tax profit by businesses (RMB million)				Breakdown	
	1H2008	1H2007	y-o-y (%)	1H2008	1H2007
Corporate banking	7,970	5,028	+58.5%	46.5%	55.8%
Retail banking	2,870	2,669	+7.5%	16.8%	29.6%
Treasury operations	6,096	1,218	+400.5%	35.6%	13.5%
Others	186	92	+102.2%	1.1%	1.0%
Total pre-tax profit	<u>17,122</u>	<u>9,007</u>	+90.1%	100.00%	100.00%



Breakdown of loan book of China Merchants Bank





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