

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

Sector	: Banking
HKSE Code	: 02388
Market Price	: HK\$25.95 (27/03/2012)
Shares Issued	: 10,572.8m
Mkt. Cap.	: HK\$226,786.6 m
52 weeks Hi/ Lo	: HK\$27.1 / HK\$19.95
HSI	: 22,646.82 (27/03/2012)
Main Business	: Banking and related financial services

Vice Chairman &amp; Chief Executive : Mr. He Guangbei

**SUMMARY OF THE FINAL RESULTS FOR THE YEAR ENDED 31<sup>ST</sup> DECEMBER 2012**
**Final Results Highlights**

	HK\$ million	Vs FY2011 (%)	Vs 30/06/2012 (%)
• Net interest income	24,708	+12.4%	
• Non-interest income	11,052	+24.6%	
• Total operating income	35,760	+15.9%	
• Operating expenses	(11,402)	+45.0%	
• Operating profit before impairment losses	24,358	+6.0%	
• Net reversal/(charge) of loan impairment allowance	(854)	+125.3%	
• Profit before taxation	25,521	+3.4%	
• Taxation	(3,974)	+2.8%	
• <b>Attributable profit to shareholders</b>	<b>20,930</b>	<b>+2.4%</b>	
• Total loans	778,264	+11.3%	+4.2%
• Total deposits	1,229,131	+7.2%	+3.7%
• Total assets	1,830,763	+5.3%	+8.7%
• Basic EPS (HK\$)	1.9796	+2.4%	
• Final DPS (HK\$)	0.6930	+24.2%	
• Total DPS (HK\$)	1.2380	+4.2%	
<b>Selected Ratios</b>	<b>FY2012</b>	<b>FY2011</b>	<b>1H2012</b>
• Net interest margin	1.60%	1.32%	1.64%
• Cost-income ratio	31.9%	25.5%	29.7%
• Return on average assets	1.24%	1.14%	1.35%
• Return on average equity	14.91%	16.68%	16.6%
• Impaired loan ratio	0.26%	0.10%	0.10%
• Impaired advances coverage	180.4%	398.6%	396.3%
• Loan-deposit ratio	63.3%	61.0%	63.0%
• Core CAR	12.3%	12.5%	13.0%
• Total CAR	16.80%	16.90%	17.4%
• Average liquidity ratio	41.2%	36.2%	39.9%

- **FY12 results slightly ahead of market expectations** Bank of China (Hong Kong) (BOCHK) reported FY12 net profit of HK\$20,930m, up 2.4% y-o-y, slightly above the market consensus of HK\$20,499m. The results were overshadowed by the non-recurring gain of HK\$2,797m in 2011, arising from the write-back of provision to Lehman Brothers Minibond. Stripping out the write-backs in 2011, adjusted net profit should have grown 14.9% y-o-y. In addition to the interim dividend of HK\$0.545 per share, BOCHK declared a final dividend of HK\$0.693 per share, representing a payout ratio of 62.5% (similar to FY11's 61.5%).

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- **Net interest income** increased by 12.4% y-o-y to HK\$24,708m, driven by widening net interest margin (NIM), which expanded notably by 28bps to 1.60% in 2012. The growth in NIM was attributable to higher asset yield as there are more investment channels, such as RMB loans & advances and RMB bonds, for BOCHK to deploy its RMB funds. At the same time, other participating banks placed less RMB fund with BOCHK, which helped ease the NIM dilution effect by its clearing bank business. On h-o-h basis, NIM was down 8bps in 2H12 due to lower average asset yields of debt securities and interbank placements. On the other hand, average interest-earning assets of BOCHK contracted 7.2% y-o-y, mainly due to the drop in participating banks' RMB deposits with BOCHK.
- **Non-interest income** registered a strong increase in FY12, up 24.6% y-o-y. Net fee income growth was muted, up only 0.9% y-o-y to HK\$7,906m. Although fee and commission income from loans (+40%), credit cards (+14.5%) and funds distribution (+60%) grew strongly, the increase was mostly offset by the decline of commission income from securities brokerage (-24%), insurance (-12%) and bills (-14%), reflecting the weak market sentiment and trade activities. On the other hand, net trading gain jumped 83.0% y-o-y to HK\$3,129m, with much higher gains being seen in foreign exchange products as well as interest rate instruments.
- **Operating expenses** surged 45% y-o-y to HK\$11,402m, as there was a sizeable recovery of HK\$2,797m from the underlying collateral of the Lehman Brothers Minibonds in 2011. Excluding the aforesaid recovery, core operating expenses should have risen by 7.9% y-o-y. Staff costs, the main component of operating expenses, rose by 6.1%, as a result of the increase in staff headcount in Mainland business and annual salary increment.
- **Asset quality** BOCHK recorded a spike of 125% in loan impairment charge to HK\$854m in 2012 as the net charge of individually assessed impairment allowances increased to HK\$512m, mainly caused by the downgrade of a few corporate loans. Nevertheless, asset quality remained at healthy level of 0.26% at end-2012, compared with an exceptionally low level of 0.10% a year earlier.
- **Capital position** BOCHK's core and total CAR stayed at relatively high level of 12.3% and 16.8% respectively at end-2012. Both ratios were the highest among listed HK banks, suggesting BOCHK has less chance to reduce its dividend payout in the future.

## Outlook & Prospects

- **Stable dividend trend** BOCHK followed a policy of 60%-65% payout ratio in the past several years. If BOCHK adopts advanced internal ratings-based approach (currently using foundation internal ratings-based), its core CAR will increase further to above 13%. Given the solid capital structure of BOCHK, the current dividend payout ratio should be largely secured and progressive dividend payout along with its earning growth can be expected in the medium term. Separately, HKMA recently raised the risk-weighted assets in mortgage business and the hike will affect growth prospects for banks with higher leverage. Nevertheless, BOCHK should be largely unaffected and its strong capital base should allow BOCHK to gain market share in mortgage business.
- **Asset deterioration as a near-term overhang** Asset quality is a major disappointment in BOCHK's FY12 results. In terms of impaired loan ratio and coverage ratio, BOCHK had very benign asset quality among local peers. However, its NPL almost tripled in 2H12, albeit from a very low base. According to Management, it was driven by two loans, one granted to a company in the shipping sector in HK and another in the photo-voltaic sector in China (which was the only exposure of BOCHK in the sector). It is still uncertain whether the spike in NPL is an isolated case or an early sign of asset deterioration but this will certainly become a share price overhang before BOCHK reveals its NPL trend again in August 2013.
- **Continued RMB market development offers additional upside** One of the bright spots in 2012 financial results was the improvement in NIM, helped by redeployment of BOCHK's RMB deposit. Apart from its role as sole RMB clearing bank in HK, BOCHK has over 25% market share in RMB customer deposits, which can now be increasingly deployed through RMB commercial loans, local interbank bond market, dim sum bonds, and swaps. We believe these developments will further enhance BOCHK's RMB business.
- **Valuations** Asset quality is a big miss for BOCHK's 2012 results and asset deterioration is likely to haunt its shares prices in the near term. Shares of BOCHK had a strong start to the year (+9% YTD), well ahead of HSI's flat return. On valuation front, BOCHK is currently trading at 1.86x FY13E P/B and 13.1x FY13E P/E, which is not cheap among HK banks. Nonetheless, we believe the positive catalyst for BOCHK's share price performance could be a potential increase in dividend. With an uncertain macro environment, investors will continue to chase stable yield-play like BOCHK. In addition, RMB business may offer additional surprise on NIM expansion in 1H13. As such, BOCHK remains our preferred pick among HK banks and we recommend a "Buy" rating on the counter.

**Recommendation: Buy**



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

As % of total customer advances	Individual allowance	Portfolio Non-performing allowance	Non-performing loans	Overdue and rescheduled advances
<b>As of 31/12/2012</b>	0.09%	0.38%	0.26%	0.22%
<b>As of 30/06/2012</b>	0.03%	0.36%	0.10%	0.08%
<b>As of 31/12/2011</b>	0.04%	0.37%	0.10%	0.07%

**II. Comparison of BOC Hong Kong's loan book: 31/12/2012 vs 31/12/2011**

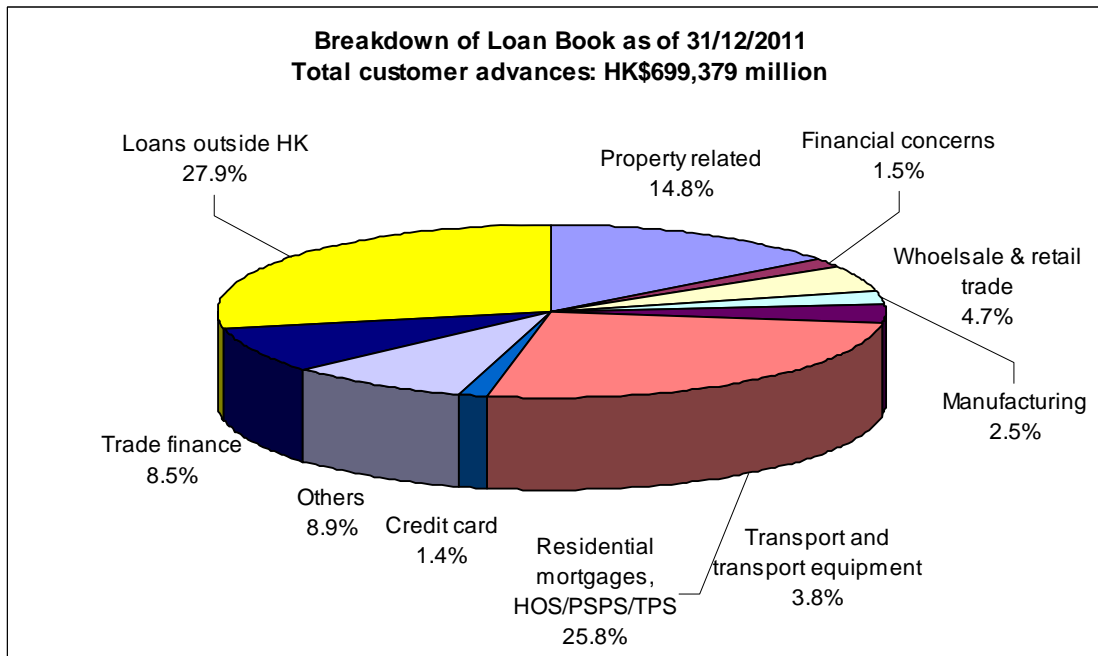
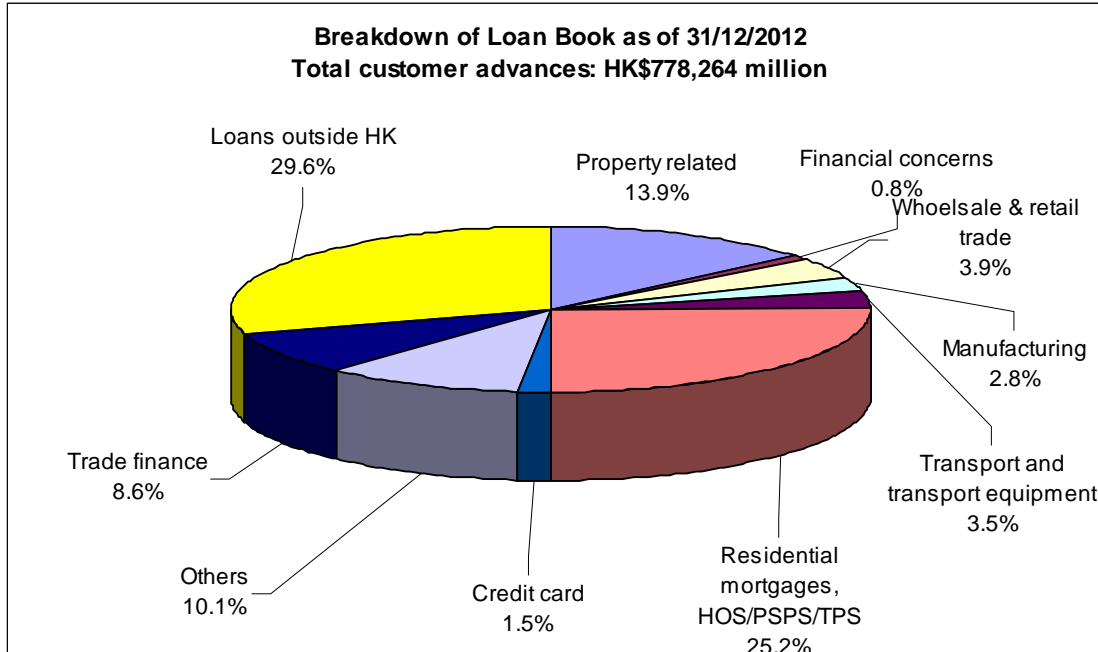
Loans-by industry	31 <sup>st</sup> Dec, 2012	Up/(down)	31 <sup>st</sup> Dec, 2011
	HK\$ million		HK\$ million
Property related	108,383	+4.5%	103,698
Financial concerns	5,984	-43.3%	10,562
Wholesale & retail trade	30,031	-8.3%	32,755
Manufacturing	21,758	+25.4%	17,352
Transport & transport equipment	27,241	+2.7%	26,525
Residential mortgages, HOS/PSPS	196,448	+8.7%	180,767
Credit card	11,534	+19.5%	9,655
Others	78,228	+25.6%	62,295
Trade finance	67,137	+12.8%	59,508
Stockbrokers	1,146	+23.1%	931
Loans outside HK	230,374	+17.9%	195,331
	<u>778,264</u>	<u>+11.3%</u>	<u>699,379</u>

**III. Comparison of BOC Hong Kong's loan book: 31/12/2011 vs 30/06/2011**

Loans-by industry	31 <sup>st</sup> Dec, 2012	Up/(down)	30 <sup>th</sup> June, 2012
	HK\$ million		HK\$ million
Property related	108,383	+5.7%	102,552
Financial concerns	5,984	-37.4%	9,554
Wholesale & retail trade	30,031	-6.1%	31,972
Manufacturing	21,758	+12.1%	19,403
Transport & transport equipment	27,241	-2.7%	27,999
Residential mortgages, HOS/PSPS	196,448	+4.5%	188,070
Credit card	11,534	+20.0%	9,609
Others	78,228	+10.6%	70,742
Trade finance	67,137	-1.0%	67,828
Stockbrokers	1,146	+65.6%	692
Loans outside HK	230,374	+5.5%	218,331
	<u>778,264</u>	<u>+4.2%</u>	<u>746,752</u>



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





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