

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

Sector	: Banking	Chairman	: Mr. Xiao Gang
HKSE Code	: 02388	Vice Chairman & Chief Executive	: Mr. He Guangbei
Market Price	: HK\$16.00 (28/08/2009)		
Shares Issued	: 10,572.78m		
Mkt. Cap.	: HK\$169,164.5m		
52 weeks Hi/ Lo	: HK\$18.52 / HK\$6.30		
HSI	: 20,098.62 (28/08/2009)		
Main Business	: Banking and related financial services		

SUMMARY OF THE INTERIM RESULTS FOR THE SIX MONTHS ENDED 30TH JUNE 2009
Interim Results Highlights

	HK\$ million	Vs 1H2008 (%)	Vs 31/12/2008 (%)
• Net interest income	8,929	-11.0%	
• Non-interest income	4,099	+2.2%	
• Total operating income	13,028	-7.2%	
• Operating expenses	(4,194)	+2.6%	
• Operating profit before impairment losses	8,834	-11.2%	
• Net reversal of loan impairment allowances	60	-184.5%	
• Net charge of impairment allowances on investment	(1,168)	-45.6%	
• Profit before taxation	8,244	-2.3%	
• Taxation	(1,369)	+9.3%	
• Attributable profit to shareholders	6,691	-5.6%	
• Total loans	475,564	-0.0%	+3.3%
• Total deposits	825,584	+0.1%	+1.6%
• Total assets	1,146,150	+1.7%	-0.1%
• Basic EPS (HK\$)	0.6329	-5.6%	
• Interim DPS (HK\$)	0.2850	-34.9%	
Selected Ratios	1H2009	1H2008	FY2008
• Net interest margin	1.76%	2.03%	2.00%
• Cost-income ratio	32.2%	29.1%	34.4%
• Return on average assets	1.23%	1.32%	0.27%
• Return on average equity	15.1%	15.1%	3.8%
• Impaired loan ratio	0.37%	0.34%	0.46%
• Impaired advances coverage	113.9%	94.8%	107.6%
• Loan-deposit ratio	57.6%	57.7%	56.7%
• Capital adequacy ratio	16.1%	13.9%	16.2%
• Average liquidity ratio	39.7%	42.5%	41.7%

- **1H09 net profit helped by the absence of one-offs** Bank of China (Hong Kong) ("BOCHK") announced an encouraging set of results for the first half of 2009, with bottom line earnings coming in at HK\$6,691m, down 5.6%, but significantly ahead of the market estimate of HK\$4,681m. The strong results were helped by the absence of the significant provision for Lehman Mini-bonds. Key positives included in the results were very strong fees (brokerage and loan commissions) and sharp improvement in asset quality.
- **NIM narrowed partly offset by loan growth** Net interest income fell by 11.8% y-o-y to HK\$8,929m. Net interest margin (NIM) in 1H09 narrowed 27bps y-o-y to 1.76% on decline in net interest spread and contribution from net free funds. Loan growth was strong on h-o-h basis, especially for the loan growth

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in HK, up 7.0% (loan outside HK fell 10.1% h-o-h). The bank reported significant growth in corporate loans, as it benefited from closer cooperation with the parent, Bank of China (03988.HK).

- **Non-interest income edged up slightly by 2.2%** The bank reported 29.3% h-o-h or 1.6% y-o-y growth in net fees income. The key positive was the fee income driven by extremely strong brokerage income, which up 48.9% h-o-h or 26.1% y-o-y. This compares with flat market turnover, showing that BOCHK gained significant market share in stock brokerage and Management attributed the results to the improving stock trading platform. Loan commissions also registered strong growth of 51.3% y-o-y as BOCHK was appointed by the parent as "Asia-Pacific Syndicated Loan Centre".
- **Higher expenses on Lehman provisions** Operating expenses rose 2.6% y-o-y largely attributable to expenses relating to the Lehman Brothers Mini-bonds issue totalling HK\$222m in 1H09. Excluding the impact of Lehman related compensation, costs dropped about 2.8% y-o-y, as staff costs reduced by HK\$226m or 9.1% y-o-y due to the reduction in performance-related remuneration and headcount. With the increase in operating expenses against the decrease in operating income, cost-to-income ratio increased to 32.2% in 1H09, compared with 29.1% in 1H08.
- **Credit quality was sound** Thanks to the stabilizing economic environment since 2Q09, BOCHK reported improvement in asset quality with decline in both impaired loan amount and ratio (0.37% in 1H09 versus 0.46% in FY08). BOCHK even recorded a release of allowances from collective assessment totalling HK\$174m. This enabled the bank to have a net write-back of credit cost in 1H09.
- **Low provisions for US mortgage-backed securities (MBS)** Helped by the stabilisation of the capital markets in 2Q09, the net impairment charges on BOCHK's US mortgage related investment during 1H09 amounted to only HK\$1,168m, compared with HK\$2,149m in 1H08 and HK\$9,751m in 2H08. BOCHK already made HK\$1.1bn during 1Q09, implying very little additional write-down in 2Q09.
- **Profitability and capital position at comfortable levels** ROE and ROA was 15.1% and 1.23% respectively in 1H09. BOCHK's CAR stood at 16.1%, strengthened by the support of its parent, BOC, which granted a subordinated loan of EUR660m to BOCHK in 2H08.

Outlook & Prospects

- **Recovery in the banking sector** The recent encouraging news on the economic recovery provides a supportive macro backdrop for the local banking sector, especially for BOCHK. This is expected to be supported by improving trends in the US housing market (positive for BOCHK's MBS investment) and building expectations for interest rate hikes (which would help restore margins). In addition, BOCHK is well positioned for buoyant property market activity as it has a relatively high exposure to mortgages (27.5% of total loans) and commercial property lending (20.1% of total loans). BOCHK is also the most leveraged in the sector to stock brokerage should market turnover remain at elevated levels given that its brokerage income accounted for 41.8% of total fee income.
- **Clearer picture on Mini-bond impact** One swinging factor for BOCHK is the Mini-bond provisions in 2H09. The Lehman Mini-bond repurchase scheme announced on 22 July is likely to cost BOCHK HK\$3.6bn at maximum but BOCHK only booked provisions of HK\$222m in 1H09 and HK\$769m in 2H08. Therefore, most of the charges will be booked in 2H09 and BOCHK may face a maximum potential provision of HK\$2.7bn in the second half of 2009. But on a positive note, the bank can finally put the issue behind it by concentrating on its core business and move out of the downturn.
- **RMB trade settlement scheme** The scheme would be positive for the banking sector as a whole, and for BOCHK in particular given its strength in the existing retail RMB business in HK, Chinese parentage and likely maintenance in our view of a clearing bank role going forward. Earnings impact is difficult to estimate at the mean time but this could be a multi-year catalyst for the stock.
- **Upside potential** BOCHK is trading at 1.81x FY09E P/B, 15.4x FY09E P/E and >3.7% dividend yield. We believe the valuations are attractive as the above multiples fail to reflect BOCHK's improving franchise and growth prospects ahead. Lehman Mini-bond compensation should be fully provided for by the end of the year. The US securities impairments appear to be over, and credit quality appears sound. As such, we recommend a "Buy" rating for the counter.

Recommendation: Buy

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

As % of total customer advances	Individual allowance	Portfolio allowance	Non-performing loans	Overdue and rescheduled advances
As of 30/06/2009	0.13%	0.29%	0.37%	0.31%
As of 31/12/2008	0.17%	0.33%	0.46%	0.24%
As of 30/06/2008	0.09%	0.23%	0.34%	0.23%

II. Comparison of BOC Hong Kong's loan book: 30/06/2009 vs 31/12/2008

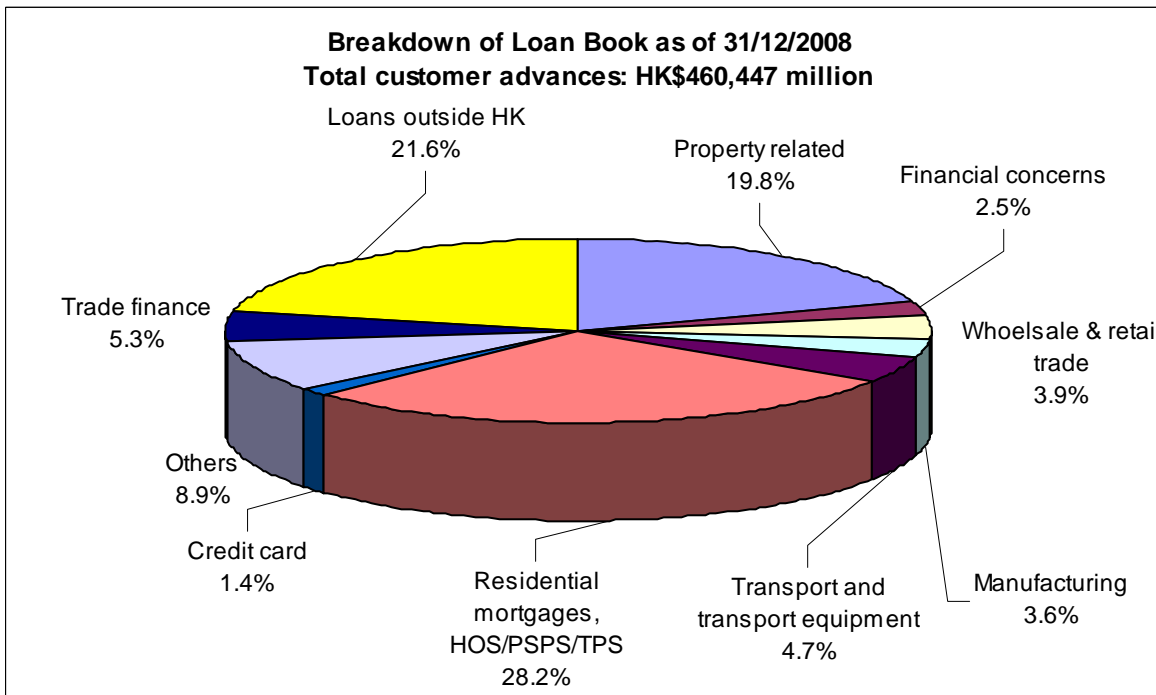
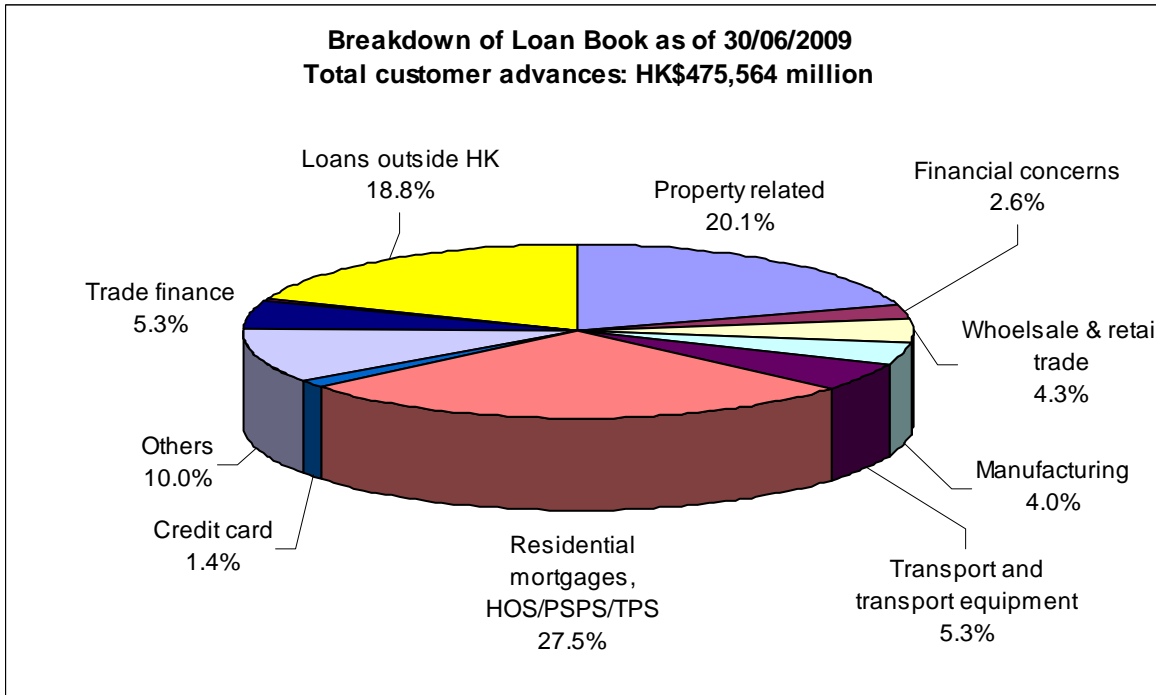
Loans-by industry	30 th June, 2009	Up/(down)	31 st Dec, 2008
	HK\$ million		HK\$ million
Property related	95,743	+4.9%	91,230
Financial concerns	12,443	+7.8%	11,547
Wholesale & retail trade	20,471	+12.8%	18,156
Manufacturing	19,044	+16.1%	16,410
Transport & transport equipment	25,152	+16.5%	21,590
Residential mortgages, HOS/PSPS	130,955	+0.9%	129,780
Credit card	6,492	-0.9%	6,553
Others	47,523	+15.3%	41,207
Trade finance	25,052	+2.0%	24,555
Stockbrokers	3,449	+2681.5%	124
Loans outside HK	89,240	-10.1%	99,295
	<u>475,564</u>	+3.3%	<u>460,447</u>

III. Comparison of BOC Hong Kong's loan book: 30/06/2009 vs 30/06/2008

Loans-by industry	30 th June, 2009	Up/(down)	30 th June, 2008
	HK\$ million		HK\$ million
Property related	95,743	+4.7%	91,444
Financial concerns	12,443	-7.8%	13,500
Wholesale & retail trade	20,471	+25.8%	16,273
Manufacturing	19,044	+16.7%	16,313
Transport & transport equipment	25,152	+12.8%	22,289
Residential mortgages, HOS/PSPS	130,955	+0.5%	130,277
Credit card	6,492	+14.6%	5,666
Others	47,523	+2.7%	46,288
Trade finance	25,052	-20.9%	31,683
Stockbrokers	3,449	+1848.6%	177
Loans outside HK	89,240	-12.2%	101,677
	<u>475,564</u>	-0.0%	<u>475,587</u>



Breakdown of loan book of BOC Hong Kong



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