

Analyst: Paul Sham
BANK OF COMMUNICATIONS CO., LTD. (交通銀行)

| | | | |
|-----------------|--|---------------|-------------------|
| Sector | : Banking | Chairman | : Mr. Hu Huaibang |
| HKSE Code | : 03328 | Vice Chairman | : Mr. Li Jun |
| Market Price | : HK\$5.17 (19/03/2009) | | |
| Shares Issued | : 23,064.5m (H share) | | |
| Mkt. Cap. | : HK\$119,243.5m (H share) | | |
| 52 weeks Hi/ Lo | : HK\$11.66 / HK\$3.42 | | |
| HSI | : 13,130.92 / 7,731.43 (19/03/2009) | | |
| Main Business | : Banking and related financial services | | |

SUMMARY OF THE FINAL RESULTS FOR THE YEAR ENDED 31ST DECEMBER 2008
Final Results Highlights

| | RMB million | Vs FY2007 (%) | Vs 30/06/2008 (%) |
|--|---------------|---------------|-------------------|
| • Net interest income | 65,862 | +22.1% | |
| • Non-interest income | 11,414 | +29.0% | |
| • Total operating income | 77,276 | +23.1% | |
| • Operating expenses | (30,867) | +22.0% | |
| • Operating profit before impairment losses | 46,409 | +23.8% | |
| • Impairment losses on loans and advances | (10,690) | +67.6% | |
| • Profit before taxation | 35,719 | +14.8% | |
| • Taxation | (7,229) | -32.5% | |
| • Attributable profit to equity holders | 28,393 | +40.0% | |
| • Total loans | 1,328,590 | +20.3% | +6.9% |
| • Total deposits | 1,865,815 | +19.9% | +3.0% |
| • Total assets | 2,682,947 | +27.1% | +10.4% |
| • Basic EPS (RMB) | 0.58 | +38.1% | |
| • Final DPS (RMB) | 0.10 | -33.3% | |
| • Total DPS (RMB) | 0.10 | -33.3% | |
| Selected Ratios | FY2008 | FY2007 | 1H2008 |
| • Net interest margin | 3.02% | 2.86% | 3.22% |
| • Cost-income ratio | 39.9% | 40.3% | 35.8% |
| • Return on average assets | 1.19% | 1.06% | 1.37% |
| • Return on average equity | 20.1% | 18.2% | 22.8% |
| • NPL ratio | 1.92% | 2.05% | 1.83% |
| • NPL coverage ratio | 116.8% | 95.6% | 107.6% |
| • Loan-deposit ratio | 71.2% | 71.0% | 68.6% |
| • Capital adequacy ratio | 13.5% | 14.4% | 14.1% |

- **FY08 results slightly ahead of expectations** Bank of Communications (BoCom)'s FY08 earnings grew by 40.0% y-o-y to RMB28,393m, slightly above the consensus estimates of RMB27,718m. However, the result indicated a faster-than-expected net interest margin (NIM) contraction and pick-up in the non-performing loan ratio since 1H08. Despite the worsening top line performance, the net earnings was distorted by the lower effective tax rate of 20.24%, below the statutory 25% rate, mainly due to the bank's interest income from government bonds being exempted from income tax.

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- **Net interest income growth capped by shrinking NIM in 2H08** Net interest income for FY08 rose to RMB65,862m (+22.1% y-o-y) as a result of loan growth (+20.3% y-o-y) and margin expansion (+16bps). Nevertheless, NIM was 3.02% for FY08, 20bps lower than the level for 1H08. The margin contraction in 2H08 was mainly attributed to the lower average loan yield and lower inter-bank rate as well as continuous time deposit migration.
- **Loan book growth backed by discount bills expansion** Overall loan growth was satisfactory, increasing 20.3% y-o-y. Corporate and personal loans went up by 17% and 19% respectively, while discounted bills were up 122% y-o-y, despite perceived lower yield for this type of loan. Customer deposit grew in-line with the advances, increasing 19.9% y-o-y. The loan-deposit ratio was 71.2%, representing an increase of 0.20 percentage point from the beginning of the year.
- **Non-interest income helped by fee growth and trading gains** Non-interest income grew 29.0% y-o-y. Of which, net fee income rose 24% y-o-y as bank card fees jumped 45.7% y-o-y and settlement & agent service fees were up 17.3% y-o-y. These two largest contributors of fee income remained strong in FY08 and helped offset the plunge in fund sales income (-61% y-o-y). The overall non-interest income was further boosted by a large trading gains of RMB1,557m (versus FY07's RMB250m) from its bond portfolio in 4Q08.
- **Lower cost-to-income ratio** In 2008, the operating expenses increased 22.0% to RMB30,867m but no breakdown was provided. Management attributed some of the increment to the substantial provision for impairment on bonds denominated in foreign currencies. Nevertheless, due to a faster growth in operating income, cost-to-income ratio fell to 39.9% from 40.3% a year earlier.
- **Loan quality began to deteriorate** Impaired loans ratio rose to 1.92% as compared with 1.83% in 2H08 mainly due to some problematic loans in segments such as textile, wholesale and real estate related loans. Geographically, increase in impaired loans came mostly from coastal areas (e.g. Yangtze River Delta), which also confirmed the concerns that mid-size banks with a higher geographic concentration in coastal cities will see a faster deterioration in asset quality.
- **Improving profitability and solid CAR** BoCom's CAR slightly decreased from 14.4% as of 31/12/2007 to 13.5% as of 31/12/2008 which is still regarded as a solid financial position. Meanwhile, the bank's profitability continued to improve, with ROA and ROE increasing to 1.19% and 20.1% respectively, from 1.06% and 18.2% in FY08.

Outlook & Prospects

- **NIM contraction likely continues** The NIM contraction in 2H08 was partly due to a remarkable shift in deposit mix from current deposit to time deposit, which made up of 51.3% of total deposit in end-2008 from 38.4% a year earlier. The sharp migration drove up the BoCom's funding cost in FY08. Given the possible benchmark interest rate cuts in 2009, we expect the trend of shrinking NIM for BoCom will likely continue in 1H09.
- **Asset quality at risk** BoCom's FY08 loan provisioning of 116.8% fell short of the 130% coverage as guided by Chinese regulators. Moreover, manufacturing sector accounted for 24% of the total loan book of BoCom, higher than peers at less than 20%. Management also guided that export-oriented manufacturing sectors such as textile and machinery were experiencing a challenging time in 4Q08. Despite the bank plans to focus on infrastructure projects and large corporate borrowers in 2009 and will continue to exit risky sectors, we are still concerned about BoCom's deteriorating asset quality as the global financial tsunami is spilling over into the Chinese economy.



- **Positive image of strategic cooperation with HSBC fading away** With HSBC as a major strategic shareholder, BoCom is one of the first mainland banks to adopt a more international and sophisticated operational model. Leveraging HSBC's brand, BoCom should have a competitive advantage in developing its wealth management products in the past few years. However, as the international financial enterprises like Citigroup, Lehman Brothers and AIG started to collapse since last year, the operational model of foreign banks is no longer well perceived by investors. Therefore, we believe the previous positive image of BoCom over its peers on its strategic cooperation with HSBC should begin to fade away.
- **Relatively high valuations** FY08 net profit looks fine but it was only due to non-recurring trading gains and deferred tax adjustments. The outlook for FY09 remains challenging for BoCom, evident from the start of NIM contraction and asset quality deterioration in 2H08. Furthermore, trading at 1.39x FY09E P/B and 9.54x FY09E P/E, we consider valuations of BoCom a bit pricey compared to its peer China CITIC Bank, which is trading at 1.00x FY09E P/B and 8.11x FY09E P/E. We see BoCom's valuations on the high side given similar earnings growth outlook. As such, we prefer China CITIC Bank to BoCom in the China banking sector.

Recommendation: *Prefer China CITIC Bank*

I. Comparison of Bank of Communications' loan book: 31/12/2008 vs 31/12/2007

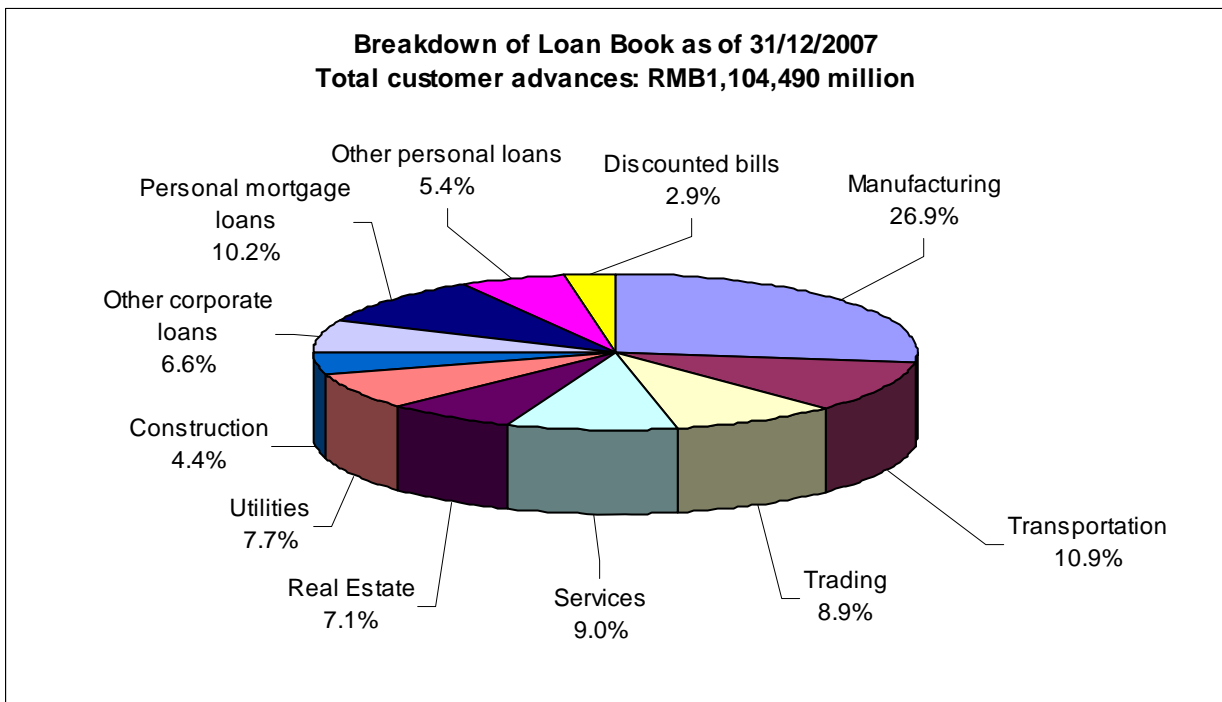
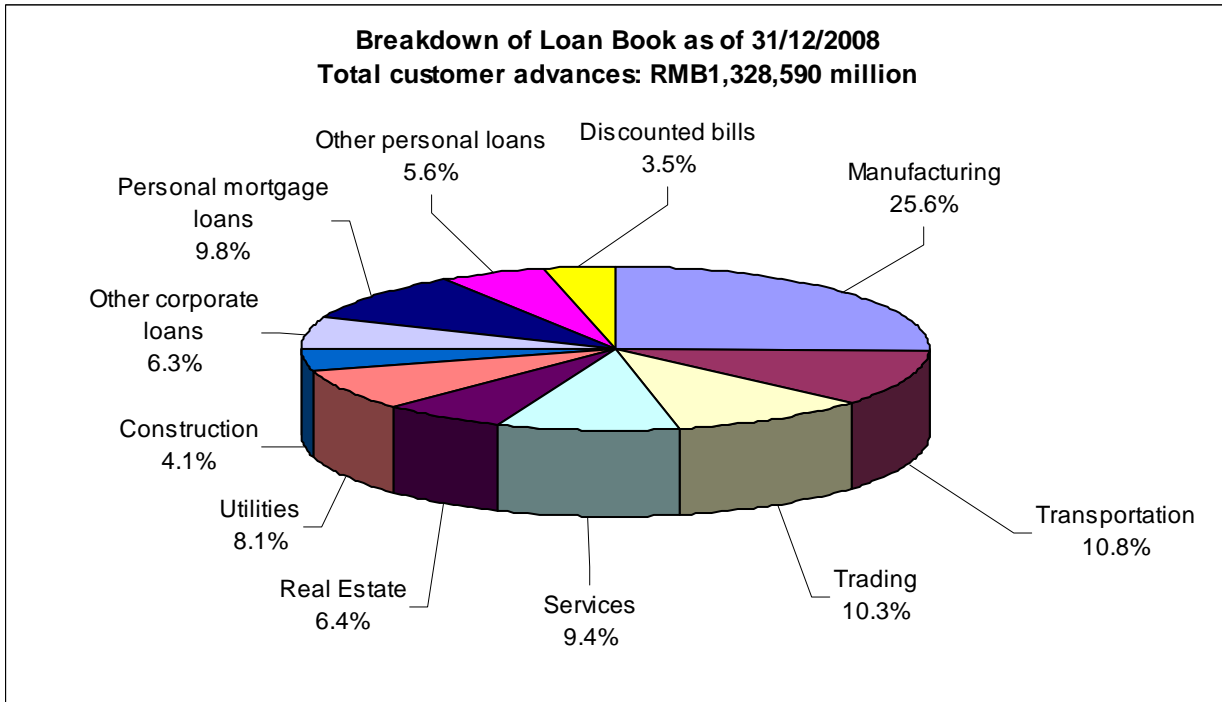
| Loans-by sectors | 31 st Dec, 2008 | Up/(down) | 31 st Dec, 2007 |
|------------------------------|----------------------------|---------------|----------------------------|
| | RMB million | | RMB million |
| Corporate loans | | | |
| <i>Manufacturing</i> | 321,501 | +15.4% | 278,706 |
| <i>Transportation</i> | 148,935 | +22.5% | 121,578 |
| <i>Electricity</i> | 105,541 | +37.5% | 76,751 |
| <i>Wholesale and retail</i> | 108,559 | +14.1% | 95,153 |
| <i>Services</i> | 49,990 | +34.1% | 37,267 |
| <i>Real estate</i> | 88,568 | +14.1% | 77,592 |
| <i>Utilities</i> | 92,207 | +16.1% | 79,411 |
| <i>Other corporate loans</i> | 138,498 | +3.3% | 134,078 |
| Personal mortgage loans | 133,415 | +18.1% | 112,941 |
| Other personal loans | 71,643 | +20.3% | 59,533 |
| Discounted bills | 69,733 | +121.5% | 31,480 |
| | 1,328,590 | +20.3% | 1,104,490 |

II. Comparison of Bank of Communications' loan book (by geographies): 31/12/2008 vs 31/12/2007

| Loans-by geographies | 31 st Dec, 2008 | Up/(down) | 31 st Dec, 2007 |
|----------------------------|----------------------------|---------------|----------------------------|
| | RMB million | | RMB million |
| Northern China | 257,720 | +22.8% | 209,844 |
| Northeastern China | 73,961 | +15.4% | 64,102 |
| Eastern China | 558,723 | +24.2% | 449,780 |
| Central and Southern China | 252,763 | +13.6% | 222,589 |
| Western China | 111,579 | +19.1% | 93,660 |
| Overseas | 73,844 | +14.5% | 64,515 |
| | 1,328,590 | +20.3% | 1,104,490 |



Breakdown of loan book of Bank of Communications by sectors



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