

Analyst: Paul Sham

CHINA MERCHANTS BANK CO. LTD. (招商銀行)

Sector	: Banking	Chairman	: Mr. Qin Xiao
HKSE Code	: 03968	CEO	: Mr. Ma Weihua
Market Price	: HK\$20.70 (06/04/2011)		
Shares Issued	: 3,910.4m (H share)		
Mkt. Cap.	: HK\$80,945m (H share)		
52 weeks Hi/ Lo	: HK\$23.90 / HK\$16.90		
HSI / HSCEI	: 24,285.05 / 13,657.63 (06/04/2011)		
Main Business	: Banking and related financial services		

SUMMARY OF THE FINAL RESULTS FOR THE YEAR ENDED 31ST DECEMBER 2010

Final Results Highlights

	RMB million	Vs FY2009 (%)	Vs 30/06/2010 (%)
• Net interest income	57,076	+41.4%	
• Non-interest income	14,616	+31.3%	
• Total operating income	71,692	+39.2%	
• Operating expenses	(32,634)	+24.5%	
• Operating profit before impairment losses	39,058	+54.5%	
• Impairment losses on loans and advances	(5,570)	+81.3%	
• Profit before taxation	33,343	+49.0%	
• Taxation	(7,574)	+82.6%	
• Attributable profit to equity holders	25,769	+41.3%	
• Total loans	1,431,451	+20.7%	+7.6%
• Total deposits	1,902,231	+18.0%	+8.3%
• Total assets	2,402,507	+16.2%	+5.3%
• Basic EPS (RMB)	1.23	+29.5%	
• Final DPS (RMB)	0.29	+38.1%	
• Total DPS (RMB)	0.29	+38.1%	

Selected Ratios	FY2010	FY2009	1H2010
• Net interest margin	2.65%	2.23%	2.56%
• Cost-income ratio	45.5%	50.9%	41.0%
• Return on average assets	1.15%	1.00%	1.21%
• Return on average equity	22.7%	21.2%	24.3%
• NPL ratio	0.68%	0.82%	0.67%
• NPL coverage ratio	302.4%	246.7%	297.6%
• Loan-deposit ratio	75.3%	73.5%	75.8%
• Capital adequacy ratio	11.5%	10.5%	11.6%

- **FY10 results slightly missed market expectations** China Merchants Bank ("CMB") reported net profit of RMB25,769m, up 41.3% y-o-y, slightly below market expectations of RMB25,887m. The lower than expected earnings growth was mainly due to an 81.3% y-o-y hike in provision charge, while operating income actually grew by 39.2% y-o-y, representing strong core earnings growth. CMB declared a FY10 cash dividend of RMB0.29 per share, representing a payout ratio of 24%, versus 22% in FY09 as to preserve the capital for meeting the CAR requirement.

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- **Interest income boosted by widened NIM** Net interest income grew strongly by 41.4% y-o-y, the biggest jump among HK-listed PRC banks. The increase was led by 20.7% y-o-y increase in loans and 42bps y-o-y widening in net interest margin (NIM). The fast NIM expansion was attributable to 45bps increase in asset yield and 15bps decrease in liability yield.
- **Loan portfolio expanded 20.7% y-o-y** Following strong growth of 64.2% in FY09, retail loans slowed to 31.2% in FY10 and represented 33.8% of CMB's total loans and advances (FY09: 32.2%). Corporate loans grew at even slower pace of 24.1% y-o-y to RMB870,515m, which accounted for 60.8% of total loan portfolio during 2010. As its loans and advances still outpaced the growth of deposit, CMB's loan-to-deposit ratio was lifted to 75.3% as of 31/12/2010 from 73.5% a year earlier.
- **Fee income growth regained momentum** Non-interest income was up 31.3% to RMB14,616m due to broad-based growth in fee income, which regained its momentum in FY10 after the disappointing performance in FY09. CMB's main fee income contributors, namely bank card fees, settlement & clearing fees and agency service fees, grew strongly by 42.7%, 28.6% and 23.6% y-o-y respectively. "Other fee income" also surged by 82.61% y-o-y, which was mainly due to the rapid growth of financial consultancy fee.
- **Improved cost efficiency** The 24.5% increase in expenses were attributable to the increases in staff cost (+26.1% y-o-y) as the bank recruited additional headcounts along with business expansion. Due to a significant increase in net operating income against a steady rise in expenses, Cost-to-income ratio accordingly fell to 45.5% from 50.9% a year earlier.
- **4.3% contribution from WLB** Wing Lung Bank (WLB) continues to integrate well with CMB to record 52.5% y-o-y increase in consolidated after-tax profit which amounted to HK\$1,349m, driven by 14.8% y-o-y increase in net interest income and 11.6% increase in net fee income. Operating expenses of WLB recorded a decrease of 10.70% y-o-y, primarily due to the additional provision made for the Lehman Brothers Minibond incident in 2009. As at 31st December 2010, the capital adequacy ratio and core capital adequacy ratio of WLB stood at 14.87% and 9.65% respectively.
- **Unexpected jump in impairment losses** Impairment losses on loans was RMB5,570m, representing an increase of 81.3% y-o-y. While other peers mostly recorded lower provisions for 2010, the surprising jump in CMB's loan provisions was attributable to higher provision rates for loans to local government financing vehicle (LGFV) in 2010. CMB's NPL balance was almost flat y-o-y at RMB9,686m (but up 9.4% h-o-h) and the NPL ratio declined further to 0.68% at end-2010, thanks to the enlarged loan portfolio. Coverage ratio remained the highest in the sector at 302.4%.
- **Capital position – the weakest link** After the completion of RMB21.5bn rights Issue in April 2010, CMB's core CAR improved to 8.04% at end-2010 (end-2009: 6.63%), but is still far below the industry average of 10.1%. In terms of CAR, CMB's 11.5% level is approaching the industry average of 12.2%. With a lower capital level among peers, market is expecting the bank to further raise capital within this year.

Outlook & Prospects

- **Fee income business back on fast track** After a disappointing 3.2% y-o-y growth in net fee income during FY09, CMB's fee income regained momentum in FY10, driven by a rebound in agency fees and bank card fees. This set of results should ease market worries that CMB was losing market share in the bank card market and other fee income.
- **Management guidance for 2011** Management revealed that CMB's NPL balance rose by RMB862m (or 9.8% q-o-q) in 4Q10. The sudden jump in NPL was attributable to tighter classification standards for LGFV (RMB240m), other corporate loans (RMB526m), mortgage loans (RMB86m) and credit cards (RMB70m). Regarding the outlook in 2011, the tone was mostly positive, expecting higher NIM, sustainable fee income growth, falling cost-to-income ratio and stable credit costs. In addition, CMB reported a falling NPL balance in Jan and Feb 2011, after CMB adopted tighter classification standards for the above-mentioned LGFV and retail loans as of end 2010.

- **Possible further fund raising** Management used to suggest that CMB would not need to raise capital for three years after the rights issue in April 2010. Nevertheless, CMB reported tier 1 of 8.04% at end-2010 and its tier 1 is likely to fall below 8% once the dividend is paid. With a low capital level among peers, the bank is likely to break its promise and request for capital raise again in the near future.
- **Rich valuations** CMB's FY10 results showed all-rounded recovery in fundamentals and the earnings momentum is likely to continue in FY11. Nevertheless, trading at 2.35x FY11E P/B and 11.3x FY11E P/E, valuations of CMB are the highest among the H-share banks. In addition, CMB is believed to tap the market again to bolster its capital position, which could be a near-term overhang on its share prices. As such, we prefer CNCB (which has lower valuations) to CMB in the China banking sector.

Recommendation: *Prefer China CITIC Bank (00998.HK)*

I. Comparison of China Merchants Bank's loan book: 31/12/2010 vs 31/12/2009

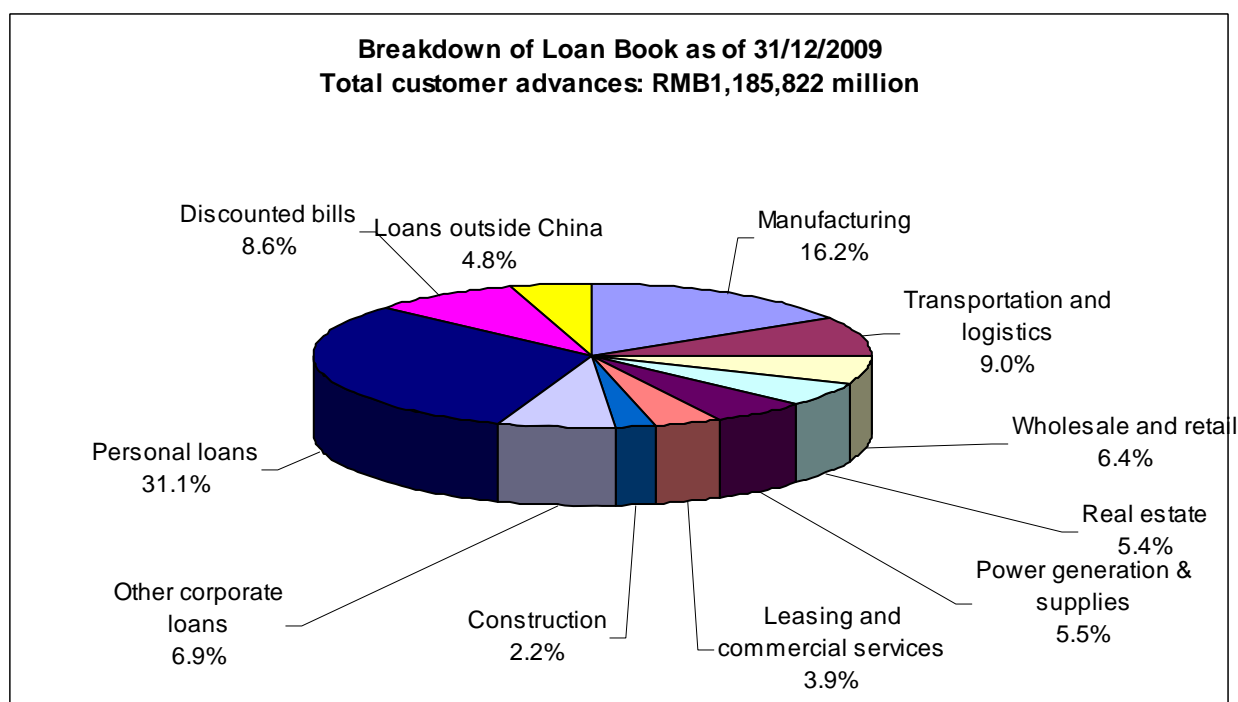
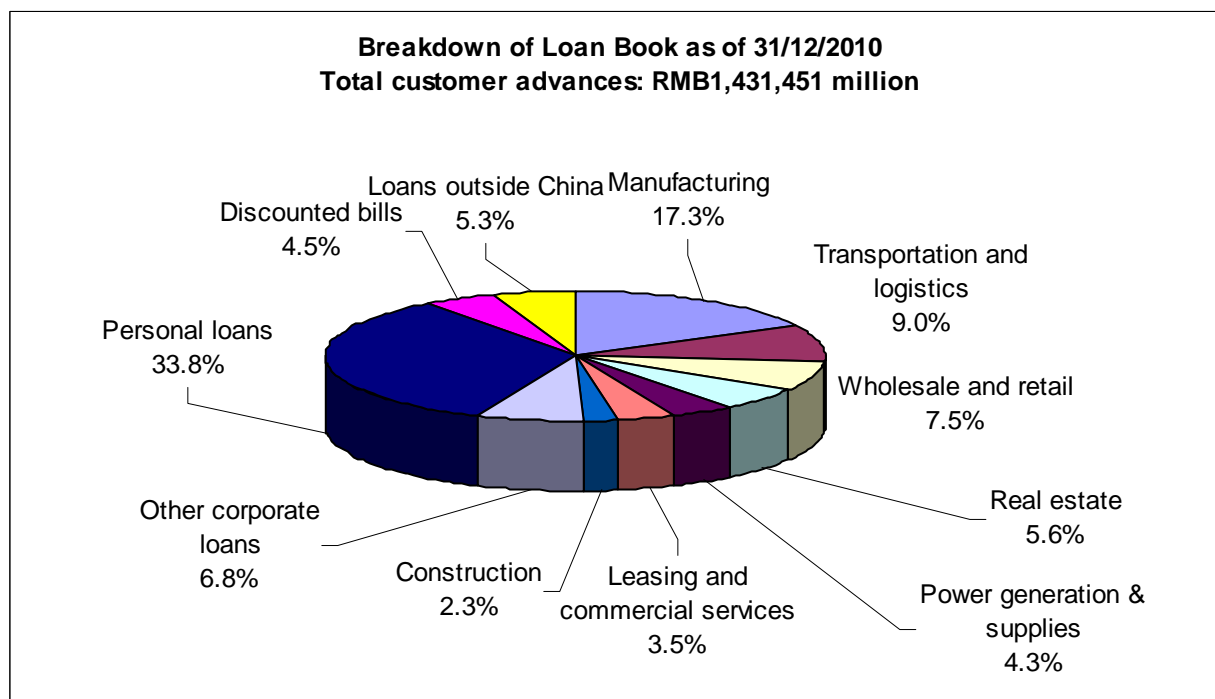
Loans-by industry	31 st Dec, 2010	Up/(down)	31 st Dec, 2009
	RMB million		RMB million
Corporate loans			
<i>Manufacturing</i>	248,069	+29.3%	191,890
<i>Transportation and logistics</i>	128,401	+20.6%	106,456
<i>Wholesale and retail</i>	106,654	+41.6%	75,310
<i>Real estate</i>	80,856	+27.1%	63,611
<i>Power generation & supplies</i>	61,466	-6.6%	65,797
<i>Leasing and commercial services</i>	49,899	+8.5%	45,978
<i>Construction</i>	33,348	+28.1%	26,027
<i>Other corporate loans</i>	97,519	+18.5%	82,293
Personal loans	484,032	+31.2%	369,015
Discounted bills	64,948	-36.7%	102,549
Loans outside China	76,259	+34.0%	56,896
	<u>1,431,451</u>	<u>+20.7%</u>	<u>1,185,822</u>

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

Pre-tax profit by businesses (RMB million)				Breakdown	
	FY2010	FY2009	y-o-y (%)	FY2010	FY2009
Corporate banking	25,391	12,708	+99.8%	76.2%	57.5%
Retail banking	6,400	2,196	+191.4%	19.2%	9.9%
Treasury operations	2,350	7,007	-66.5%	7.0%	31.7%
Others	(798)	201	-497.0%	(2.4%)	0.9%
Total pre-tax profit	<u>33,343</u>	<u>22,112</u>	<u>+50.8%</u>	<u>100.00%</u>	<u>100.00%</u>



III. Breakdown of loan book of China Merchants Bank



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