

Analyst: Paul Sham

BANK OF CHINA LIMITED (中國銀行)

Sector	: Banking	Chairman	: Mr. Xiao Gang
HKSE Code	: 03988		
Market Price	: HK\$4.27 (28/03/2011)	Vice Chairman & President	: Mr. Li Lihui
Shares Issued	: 83,622m (H share)		
Mkt. Cap.	: HK\$357,066m (H share)		
52 weeks Hi/ Lo	: HK\$4.88 / HK\$3.61		
HSI / HSCEI	: 23,068.19 / 12,8984.47 (28/03/2011)		
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	193,962	+22.1%	
• Non-interest income	82,556	+12.0%	
• Total operating income	276,518	+18.9%	
• Operating expenses	(122,409)	+14.1%	
• Operating profit before impairment losses	154,109	+23.0%	
• Impairment losses on loans and advances	(15,564)	+0.8%	
• Profit before taxation	142,145	+27.9%	
• Taxation	(32,454)	+26.0%	
• Attributable profit to equity holders	104,418	+29.2%	
• Total loans	5,660,621	+15.3%	+5.0%
• Total deposits	7,483,254	+13.0%	+3.7%
• Total assets	10,459,865	+19.5%	+8.0%
• Basic EPS (RMB)	0.39	+25.8%	
• Final DPS (RMB)	0.146	+4.3%	
• Total DPS (RMB)	0.146	+4.3%	
Selected Ratios	FY2010	FY2009	1H2010
• Net interest margin	2.07%	2.04%	2.04%
• Cost-income ratio	44.3%	46.1%	40.0%
• Return on average assets	1.14%	1.09%	1.18%
• Return on average equity	18.9%	16.5%	19.8%
• NPL ratio	1.13%	1.55%	1.20%
• NPL coverage ratio	196.7%	151.2%	188.4%
• Loan-deposit ratio	75.6%	74.2%	74.7%
• Capital adequacy ratio	12.6%	11.1%	11.7%
• Liquidity ratio (RMB portion)	43.2%	45.3%	42.7%
• Liquidity ratio (Foreign currency portion)	52.2%	55.6%	56.5%

- **FY10 results exceeded expectations** Net profit of Bank of China (BOC) grew by 29.2% y-o-y to RMB104,418m in FY10, the first time its earnings over RMB100bn. The results were above market forecast of RMB99,055m. Net interest margin (NIM) was the key positive surprise in FY10 results, while loan and deposit growth was weaker than expected. Dividend payout ratio was also disappointing, falling from 45% in the previous year to 39% in 2010 as BOC needs to preserve capital for the regulator's tightening on banks' capital adequacy.

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- **Rising NIM** BOC's NIM expanded to 2.07%, an increase of 3bps compared with the prior year. This was mainly driven by a higher NIM in domestic RMB business which increased by 6bps y-o-y to 2.27%, while that of foreign currency businesses was only 1.21%, a decrease of 23bps compared with the prior year. RMB businesses also expanded faster than foreign businesses. By the end of 2010, total assets of BOC's RMB businesses increased 19.51% y-o-y to RMB10,460bn, which represented 75.85% of total assets, an increase of 340bps y-o-y.
- **Below-average loan growth** Loan grew by 15.3% y-o-y, lower than sector level at around 20%. RMB-denominated loans increased at a faster pace than foreign currency-denominated loans. The former grew at 17.72% y-o-y and the latter expanded by 12.4% y-o-y, while deposit grew by 13.0% y-o-y. As a result, loan-to-deposit ratio rose to record high of 75.6% by end 2010.
- **Non-interest income increased 12.0%** In 2010, BOC earned a net fee income of RMB54,483m, an increase of 18.4% y-o-y. Strong growth was seen in settlement and clearing, credit commitment and bank card fees, with each increasing more than 20% during 2010. BOC also realised other non-interest income of RMB28,073m, up 1.43% compared with the prior year, of which RMB1.08bn related to a gain realised on the Bank's equity investment in Shanghai Airlines as a result of its acquisition by China Eastern Airlines.
- **Enhanced cost efficiency** The total operating expenses in FY10 rose 14.1% y-o-y. The higher expense was mostly driven by fast growth in staff costs (up 17.5% y-o-y). In addition, the charge of RMB2,889m for the Lehman Brothers Minibonds made by BOCHK during 2009 substantially reduced to only RMB78m. As a result, cost-to-income ratio improved to 44.3% in FY10 from 46.1% in FY09.
- **Toxic investment no longer a threat** At the end of 2010, the carrying value of US subprime mortgage related debt securities, US Alt-A mortgage-backed securities and Non-Agency US mortgage-backed securities held by the Group amounted to USD2.973 billion (RMB19.692 billion), representing only 0.18% of BOC's total asset. Amid improving credit condition, write-back on the above securities could be possible in FY11.
- **Credit quality further improved** BOC's impairment losses on loans amounted to RMB15,564m, an increase of RMB119m compared with the prior year. The credit cost was 0.29%, a decrease of 9bps compared with FY09. BOC's impaired loan ratio further improved to 1.13% from 1.55%. Allowance for loan impairment losses to non-performing loans rose from 151.2% as at end-2009 to 196.7% as at end-2010 (higher than the 150% requirement commencing from 2016).
- **Capital position strengthened by various means** During 2010, BOC replenished its capital through the issuance of subordinated bonds (RMB24.93bn), convertible bonds (RMB40.0) and rights issues in the A share and H share markets (RMB60bn). BOC's total CAR improved to 12.58% while core CAR also edged up higher to 10.09%.

Outlook & Prospects

- **Margin pressure in FY11** After a very rapid expansion in loans (+49.0% y-o-y) and deposits (+29.8%) in 2009, it seems BOC is losing growth momentum in further expanding its loan business. In particular, after only 13% deposit growth, the loan-to-deposit ratio of BOC has reached 75.6%, higher than the regulatory requirement of 75%. With increasing RRR requirement in 2011 (already 20% at present), the deposit cost is likely to be higher for BOC. In addition, its overseas loan book should continue to drag overall loan yield unless the Fed raises rate earlier than expected. Both factors will likely cause the margin expansion of BOC weaker than peers in 2011.
- **Limited risk on government lending** Outstanding balance of loans to local government financing vehicle (LGFV) was RMB380bn at end 2010, representing 6.7% of BOC's total loans. The corresponding NPL ratio was only 0.24%, much lower than firm-wise impaired loan ratio of 1.13%. BOC also made RMB7.3bn of collective provision on LGFV loans, representing 1.92% of total LGFV loans or 800% coverage ratio. Thus even if there is some further adverse impact from reclassification, additional provisioning is unlikely to weigh on operating profits. Management is also confident that NPL level will in general remain stable given that over 80% of its LGFV carried sufficient or largely sufficient underlying project cash flow.

- **Reduced payout ratio** BOC lowered its dividend payout ratio to 39% in FY10 in order to preserve more capital to maintain its organic growth and BOC said it currently has no plan to raise capital in the equity market before the end of 2012. Together with CCB's decision to reduce its dividend payout from 45% in 2009 to 38% in 2010, such reduction in dividend payout is likely to lower the attractiveness of China banks as a high yield defensive play.
- **Valuations** BOC is trading at 1.40 FY11E P/B, lagging behind CCB's 1.88x and ICBC's 1.94x amid its relatively large overseas operations and weak fundamentals. Nevertheless, BOC's trading discount to large peers will gradually narrow if it continues to report solid asset quality numbers and adjust business structure (focus more on RMB businesses). We believe its current valuations are undemanding and recommend an Outperform rating on the counter.

Recommendation: *Outperform*

I. Impaired loans and special-mention loans of Bank of China

As % of total customer advances	Impaired loans	Special mention loans
As of 31/12/2010	1.10%	2.62%
As of 30/06/2010	1.20%	2.71%
As of 31/12/2009	1.52%	2.83%

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

Pre-tax profit by businesses (RMB million)	FY2010	FY2009	y-o-y (%)	Breakdown	
				FY2010	FY2009
Corporate banking	89,170	69,437	+28.4%	62.7%	62.5%
Personal banking	32,980	26,377	+25.0%	23.2%	23.7%
Treasury operations	11,005	10,668	+3.2%	7.7%	9.6%
Commercial banking	133,155	106,482	+25.0%	93.7%	95.8%
Investment banking	1,815	2,134	-14.9%	1.3%	1.9%
Insurance	426	136	+213.2%	0.3%	0.1%
Others	6,749	2,345	+187.8%	4.7%	2.1%
Total pre-tax profit	142,145	111,097	+27.9%	100.0%	100.0%

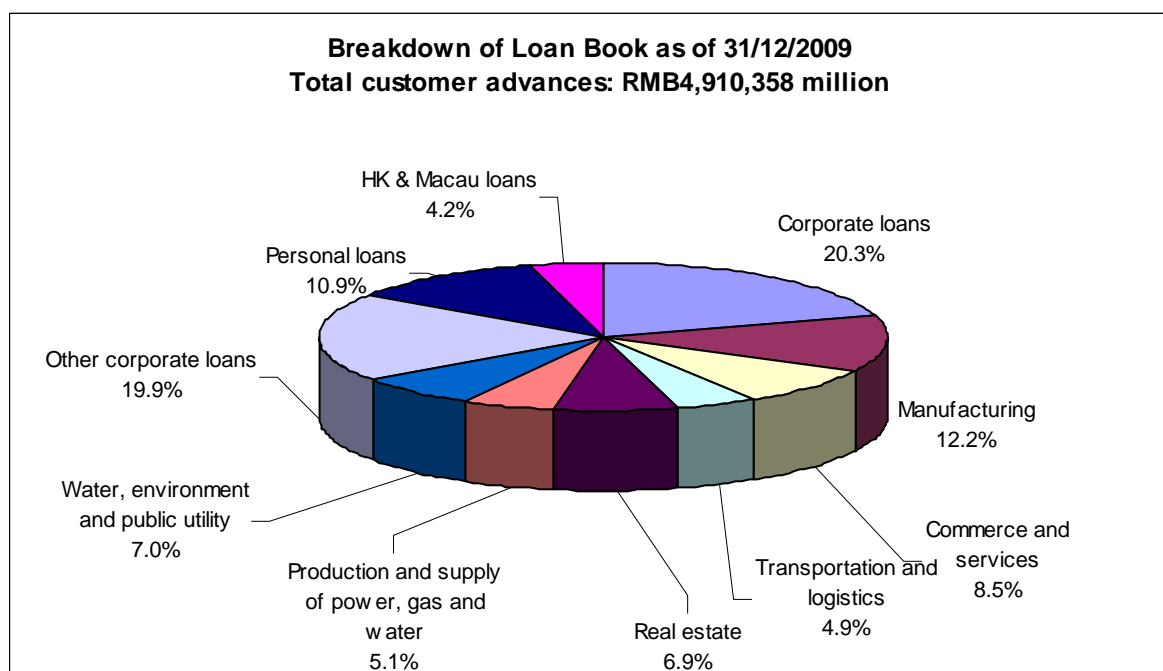
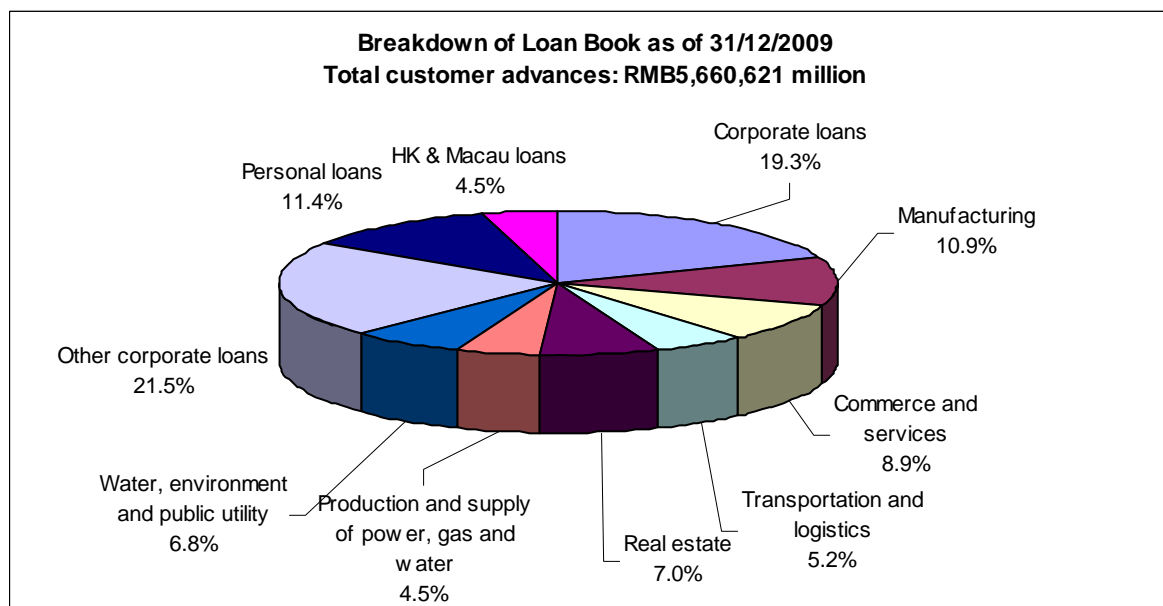
III. Bank of China's pre-tax profit breakdown by businesses

Loans-by industry	31st Dec, 2010 HK\$ million	Up/(down)	31st Dec, 2009 HK\$ million
Corporate loans			
Manufacturing	1,092,465	+9.6%	996,856
Commerce and services	614,713	+2.7%	598,411
Transportation and logistics	501,202	+47.4%	416,844
Real estate	296,747	+22.7%	241,824
Production and supply of power, gas and water	393,824	-5.5%	339,938
Water, environment and public utility	257,514	+2.9%	250,235
Other corporate loans	384,220	+12.3%	342,140
Personal loans	1,217,900	+24.3%	979,465
HK & Macau loans	646,432	+20.6%	536,097
Overseas operations loans	255,604	+22.6%	208,548
	5,660,621	+15.3%	4,910,358

IV. Bank of China's pre-tax profit breakdown by regions

Pre-tax profit (RMB million)	FY2010	FY2009	y-o-y (%)	Breakdown	
				FY2010	FY2009
Domestic	113,867	86,095	+32.3%	80.1%	77.5%
HK & Macau	24,719	20,936	+18.1%	17.4%	18.8%
Others	3,559	4,066	-12.5%	2.5%	3.7%
Total pre-tax profit	142,145	111,097	+27.9%	100.0%	100.0%

Breakdown of loan book of Bank of China



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