

### SECTOR UPDATE

## Banking – China

1H23 Result Wrap-up: Getting Back On Track Slowly

Chinese banks recorded a modest 2.7% earnings growth, primarily attributed to rising trading gains and reduced provisions, which counterbalanced the adverse effects of NIM compression and sluggish fee income. The sector's valuation has suffered in recent years due to market concerns on NIM compression and asset quality. At this point, the sector is trading at a fairly balanced valuation, with the attractive 7% yield offsetting the impact of NIM compression. Maintain MARKET WEIGHT.

#### WHAT'S NEW

- 1H23 earnings registered a marginal growth.** For the six SOE banks and 10 joint-stock banks that we assessed, these major Chinese banks delivered a combined net profit of Rmb977.5b, up 2.7% yoy, primarily due to a spike in trading gains and lower provisions charged. However, net interest margin (NIM) compression and depressed fee income continue to weigh on banks' revenue and earnings.
- Corporate loan and retail loan growth diverged significantly.** Total bank loans grew 11.6% yoy to Rmb158.8t in 1H23. Corporate loans saw a substantial yoy growth of 13.6% driven by strong demand from policy-driven industries such as infrastructure, green finance, manufacturing and inclusive finance. Conversely, the retail sector experienced a sluggish growth, with a modest 2.2% yoy expansion in 1H23, primarily due to declining mortgage and credit card loans.
- Fee and commission income under pressure.** Banks' fee income dropped 3.3% yoy in 1H23, attributed to the sluggish fee income from their agency distribution of mutual funds and wealth management business amid the volatile market. Among banks, joint-stock banks experienced a more significant 9.8% yoy drop in fee income, whereas SOE banks recorded a modest fee growth of 0.4% yoy. The positive news was the robust fee income growth from insurance agency distribution, as residents' preferences have shifted towards allocating their funds to insurance products at this juncture, which partly compensated for the weak fee income performance. In terms of revenue structure, fee income to total revenue ratio declined 1.3ppt yoy to 24.7%.
- Rising CIR.** Cost-to-income ratio (CIR) of banks rose 1.7ppt yoy to 30.7% on average as revenue declined 0.1% yoy but opex recorded a positive 5.8% yoy growth. CIR for China Construction Bank (CCB) and China Merchants Bank (CMB) increased 0.5ppt and 1.5ppt respectively to 24.7% and 31.9%, mainly due to subdued revenue growth. Many banks have reiterated that they will adopt a more cautious approach towards managing their opex.
- Easing NIM compression.** According to China Banking and Insurance Regulation Commission (CBIRC), Chinese banks' NIM remained at 1.74% in 2Q23. Among these, NIMs of SOE banks and joint-stock banks declined by a smaller extent of 2bp qoq to 1.67% and 1.81% respectively. Based on our sample size, the asset yield of banks decreased by 5bp qoq to 4.07% due to lower market interest rates and insufficient effective credit demand. In contrast, liability cost edged up by 2bp to 2.15% due to a higher time deposit ratio.

#### PEER COMPARISON

Company	Ticker	Rec	Price @ 27 Sep 23 (HK\$)	Target Price (HK\$)	Market Cap (HK\$ b)	Upside/(Downside) to TP (%)	PE 2023F (x)	2024F (x)	P/B 2023F (x)	2024F (x)	Yield 2023F (x)	2024F (x)	ROE 2023F (%)	2024F (%)	NIM 2023F (%)	2024F (%)
CCB	0939 HK	BUY	4.41	6.30	1,123.8	42.9	3.0	2.7	0.34	0.31	10.1	11.0	11.6	11.6	1.84	1.88
CMB	3968 HK	BUY	32.45	50.00	873.5	54.1	5.2	4.5	0.72	0.65	6.4	7.4	16.6	17.0	2.20	2.25

Source: Bloomberg, UOB Kay Hian

### MARKET WEIGHT

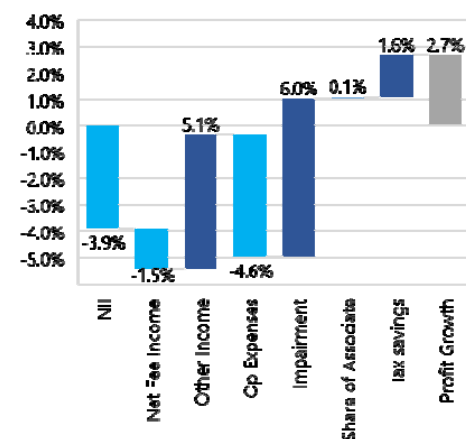
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#### SECTOR TOP PICK

Company	Ticker	Rec	Share Price (HK\$)	Target Price (HK\$)
CMB	3968 HK	BUY	32.45	50.00

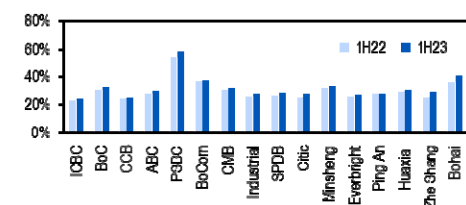
Source: UOB Kay Hian

#### CONTRIBUTING FACTORS TO PROFIT GROWTH



Source: Respective companies, UOB Kay Hian

#### COST-TO-INCOME RATIO



Source: Respective companies, UOB Kay Hian

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### ESSENTIALS

- High RWA growth slightly drains banks' capital.** The capital adequacy ratio (CAR) and common equity Tier-1 (CET-1) capital of Chinese banks faced dilution of 0.21ppt and 0.3ppt to 11.78% and 14.66% respectively in 1H23, mainly due to slowing profit growth and rapid risk-weighted asset (RWA) growth. SOE banks experienced a larger capital consumption as they distributed loans at a faster pace to support the real economy. Nonetheless, they still have stronger capital positions compared with joint-stock banks. We believe the Big 4 SOE banks and joint-stock banks with higher CAR (such as CMB) will be able to maintain their dividend payout ratios against the backdrop of NIM compression.
- NIM outlook.** Based on our observations, NIM of all SOE banks except Postal Savings Banks of China (PSBC) and three joint-stocks banks fell below the 1.8% red line. However, the PBOC has changed its tune from "supporting the real economy" to "maintaining reasonable profits and NIM for banks" in the 2Q23 monetary policy report. This might increase the visibility of banks' NIM performance in future. In addition, the authority introduced a set of policies in 3Q23 to support banks' NIM, including deposit rate cuts and reduction in the reserve requirement ratio, aimed at lowering banks' funding costs and mitigating the adverse effects of the existing mortgage rate repricing and LPR cuts. At this juncture, we maintain our stance that the sector-wide NIM compression will gradually alleviate in the upcoming quarters.
- Asset quality remains largely benign.** In 2Q23, the aggregate sector NPL ratio stayed flat at 1.62% while the leading indicator, special mention loan ratio, improved by 0.02ppt qoq to 2.14%. The NPL balance grew at a slower rate of 2.7% qoq in 2Q23 (1Q23: 4.5% qoq), indicating that the net NPL formation may have peaked. As more property policies are introduced progressively, we expect concerns on banks' asset quality to ease further.
- Sufficient provisions to buffer lower net credit cost.** Meanwhile, the sector's provision coverage ratio and provision-to-loan ratio increased 0.88ppt and 0.03ppt qoq to 206.13% and 3.35% respectively. Specifically, the provision coverage ratios for SOE banks, joint-stock banks and city commercial banks in 2Q23 were 249.8%, 220% and 185.8%, representing changes of -0.88 ppt, -0.25 ppt, and +4.93 ppt respectively from the previous quarter. We expect banks to continue to reduce their net credit costs in 2H23, leveraging their ample loan-loss provisions to release more earnings.

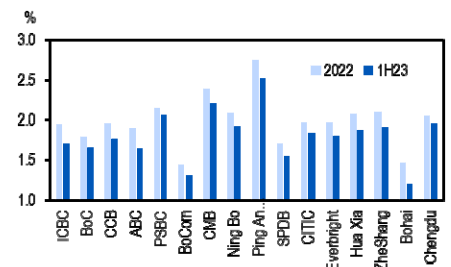
### ACTION

- Maintain MARKET WEIGHT.** Sector valuation has suffered in recent years due to market concerns on NIM compression and asset quality. We note that the current sector valuation, standing at -1.3SD from the historical mean, is reasonably fair, especially when taking into account the expected persistence of NIM compression in the coming quarters, which may result in a declining ROE. In contrast, Chinese banks provide an appealing dividend yield of 7% that can balance out the NIM dilution impact, further justifying our MARKET WEIGHT call.
- Top pick.** CMB remains as our top pick as: a) its real estate risk has peaked in 1H23, and b) it is a proxy to economic recovery given its market-leading position in the retail banking and wealth management businesses.

### RISKS

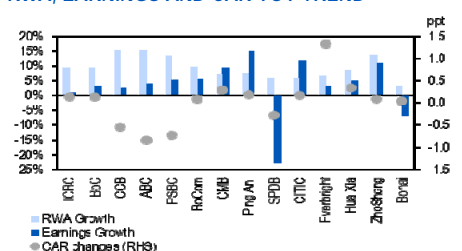
- Deterioration of asset quality from the contagion effect of the property sector.
- Weaker-than-expected economic recovery in 2H23 from a lack of significant stimulus.
- Reacceleration of NIM compression due to asset yield trending down.

### NIM PERFORMANCE



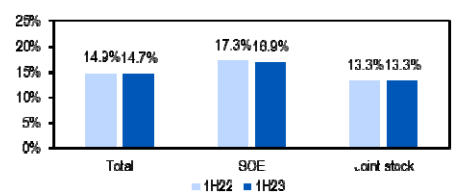
Source: Respective banks, UOB Kay Hian

### RWA, EARNINGS AND CAR YOY TREND



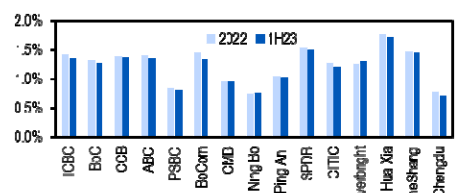
Source: Respective banks, UOB Kay Hian

### CAR COMPARISON



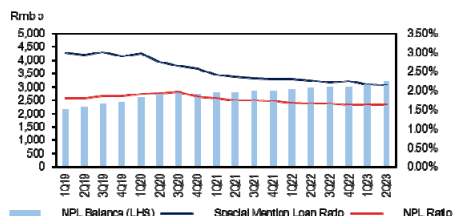
Source: CBIRC, UOB Kay Hian

### NPL RATIO TREND BY BANKS



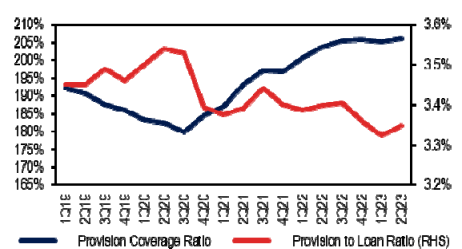
Source: Respective banks, UOB Kay Hian

### SECTOR NPL TREND



Source: CBIRC, UOB Kay Hian

### SECTOR PROVISION TREND



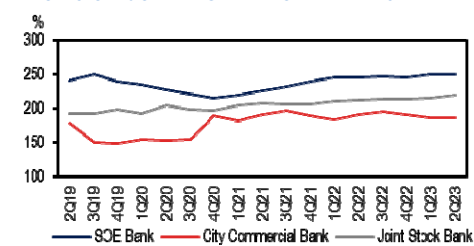
Source: CBIRC, UOB Kay Hian

### CHINESE BANKS COMPARISON OF PROFIT & LOSS

1H23	NII	Net Fee Income	Other Income	Revenue	Operating Expenses	PPOP	Impairment	Net Profit
ICBC	-3.9%	-3.4%	5.4%	-3.4%	2.8%	-5.3%	-8.7%	1.1%
BoC	4.8%	4.3%	53.1%	8.9%	16.2%	5.7%	14.9%	3.3%
CCB	-1.6%	0.5%	27.9%	-0.9%	1.0%	-1.5%	-7.7%	2.6%
ABC	-3.3%	2.5%	82.1%	0.7%	5.8%	-1.3%	-3.0%	3.9%
PSBC	2.3%	1.8%	0.1%	2.0%	9.9%	-7.2%	-28.7%	5.2%
BoCom	-3.1%	-0.8%	42.7%	4.7%	5.8%	4.2%	-1.5%	5.5%
CMB	1.2%	-11.8%	26.0%	-0.4%	4.4%	-2.5%	-24.8%	9.2%
Industrial	-0.8%	-30.3%	12.7%	-4.1%	2.6%	-6.5%	-7.4%	-4.9%
SPDB	-12.0%	-8.6%	14.7%	-7.5%	0.6%	-10.4%	1.1%	-22.8%
CITIC	-0.9%	1.2%	-11.5%	-2.0%	7.6%	-5.3%	-17.8%	11.8%
Minsheng	-6.4%	9.8%	-1.5%	-3.6%	1.8%	-6.0%	-5.5%	-3.7%
Everbright	-3.4%	-9.4%	19.0%	-2.5%	1.4%	-3.9%	-8.4%	3.3%
Ping An	-2.2%	1.9%	-19.3%	-3.7%	-3.6%	-3.8%	-16.7%	14.9%
Huaxia	-9.0%	-36.5%	90.2%	-1.7%	2.0%	-3.2%	-10.4%	5.1%
ZheShang	3.2%	12.2%	7.1%	4.6%	20.9%	-0.8%	-7.1%	11.0%
Bohai	-17.8%	23.7%	179.3%	-3.0%	11.4%	-11.0%	-16.0%	-6.9%
<b>Total</b>	<b>-1.9%</b>	<b>-3.3%</b>	<b>23.2%</b>	<b>-0.1%</b>	<b>5.8%</b>	<b>-2.5%</b>	<b>-7.6%</b>	<b>2.7%</b>

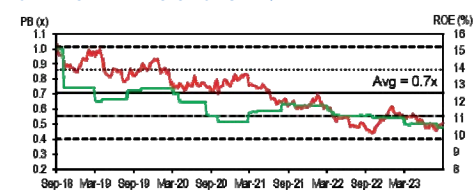
Source: UOB Kay Hian

### PROVISION COVERAGE RATIO BY BANKS



Source: UOB Kay Hian

### CHINESE BANKS SECTOR P/B



Source: Bloomberg, UOB Kay Hian

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