16 September 2014 | 69 pages

Diversified Banks
Asia | Singapore

OCBC (OCBC.SI)

OCBC-Wing Hang Bank Business Model & Synergies Deep Dive

- **Upgrade to Buy, TP S$11.50 —** *Why read this report?* OCBC needs c.S$170m synergies (+35% vs. WHB+OCBC HK 2013 profit S$480m) to turn WHB earnings accretive. We view S$280m potential upside (+58%) by 2017 using a "dual-entity" approach: **[1]** WHB: fee upside, lower funding cost; OCBC HK: China cross-border flow gains. **[2]** DBS HK: 2009-13 profits grew +21% four-year CAGR, on China internationalization. **[3]** HK 2015E banks forecast +9-12% PPOP growth; WHB has just 2% market share. **[4]** China internationalization: review of medium-term opportunities and challenges. **[5]** How WHB fits into OCBC's regional business growth strategy. OCBC becomes our new top pick among the Singapore banks.

- **WHB synergies estimate S$280m —** We expect OCBC to adopt a dual-entity HK model: OCBC HK branch leverages the parent balance sheet to capture corporate cross-border China flows, WHB's retail-SME franchise is preserved and enhanced. **(1) Fees/non-II:** Historically weak vs. peers, WHB has upside for wealth mgmt, trade, cross-border credit fees/corporate advisory, foreign exchange and treasury. **(2) Leveraging LDR:** At 76%, WHB has room to raise LDR; OCBC HK can utilize parent's balance sheet funding & capital base to target big-ticket corporate deals. **(3) Lower funding costs:** WHB recently secured a 2-notch LT credit rating upgrade to A+, vs. OCBC's AA-. **(4) Capital:** Moving WHB from standardized to IRB could improve tier-1 ratios by 100-120bps. **(5) Costs:** Assumed minimal synergies: WHB operates a lean cost base in our view and any efficiency gains may be offset by integration costs & future HK platform investments.

- **Investment Risks — [1]** A highly competitive HK banking sector poses challenges for NIMs, mkt. share; **[2]** Delivering synergies entails execution risk, takes time and there are up-front integration costs; **[3]** We are less optimistic about WHB's onshore China business (10% of WHB profit) vs. mgmt; **[4]** Mgmt's claim of an earnings-accretive deal by 2017 looks realistic in our view, but it is three years away before we can judge its success; **[5]** Pro forma CET1 ratio of 10.2% immediately post WHB + rights issue looks light versus peer Singapore banks at >12% fully loaded.

Statistical Abstract

Year to 31 Dec	Net Profit (S$M)	Diluted EPS (S$)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2012A	2,825	0.81	21.4	12.0	1.4	12.8	3.4
2013A	2,768	0.80	-1.3	12.2	1.5	12.1	3.5
2014E	3,372	0.90	13.5	10.7	1.4	13.3	3.7
2015E	3,587	0.90	-0.5	10.8	1.3	12.2	4.0
2016E	3,930	0.98	9.6	9.8	1.2	12.5	4.1

Source: Powered by dataCentral

- Estimate Change
- Target Price Change
- Rating Change

Buy	**1**
from Neutral	
Price (15 Sep 14)	S$9.67
Target price	S$11.50
from S$10.68	
Expected share price return	18.9%
Expected dividend yield	4.0%
Expected total return	**22.9%**
Market Cap	S$38,079M
	US$30,146M

Price Performance
(RIC: OCBC.SI, BB: OCBC SP)

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Fiscal year end 31-Dec	2012	2013	2014E	2015E	2016E
Valuation Ratios					
P/E adjusted (x)	12.0	12.2	10.7	10.8	9.8
P/E reported (x)	12.3	12.4	10.9	11.0	10.0
P/BV (x)	1.4	1.5	1.4	1.3	1.2
P/Adjusted BV diluted (x)	1.5	1.5	1.3	1.3	1.2
Dividend yield (%)	3.4	3.5	3.7	4.0	4.1
Per Share Data (S$)					
EPS adjusted	0.81	0.80	0.90	0.90	0.98
EPS reported	0.79	0.78	0.89	0.88	0.97
BVPS	6.68	6.47	7.13	7.63	8.20
Tangible BVPS	5.56	5.38	5.47	5.98	6.57
Adjusted BVPS diluted	6.61	6.46	7.61	7.61	8.18
DPS	0.33	0.34	0.36	0.39	0.40
Profit & Loss (S$m)					
Net interest income	3,748	3,883	4,653	5,262	5,702
Fees and commissions	1,198	1,355	1,508	1,719	1,888
Other operating Income	1,699	1,383	1,711	1,690	1,765
Total operating income	**6,645**	**6,621**	**7,873**	**8,671**	**9,355**
Total operating expenses	-2,695	-2,784	-3,202	-3,721	-3,990
Oper. profit bef. provisions	**3,950**	**3,837**	**4,671**	**4,950**	**5,365**
Bad debt provisions	-271	-266	-344	-393	-414
Non-operating/exceptionals	-33	-4	20	32	33
Pre-tax profit	**3,646**	**3,567**	**4,346**	**4,590**	**4,984**
Tax	-593	-597	-756	-797	-847
Extraord./Min. Int./Pref. Div.	-318	-292	-309	-296	-298
Attributable profit	**2,735**	**2,678**	**3,282**	**3,497**	**3,839**
Adjusted earnings	2,795	2,736	3,342	3,557	3,899
Growth Rates (%)					
EPS adjusted	21.4	-1.3	13.5	-0.5	9.6
Oper. profit bef. prov.	23.7	-2.9	21.7	6.0	8.4
Balance Sheet (S$m)					
Total assets	**295,943**	**338,448**	**392,774**	**423,302**	**448,316**
Avg interest earning assets	211,743	237,432	278,488	312,175	335,769
Customer loans	144,030	169,620	204,742	225,998	248,497
Gross NPLs	1,145	1,239	1,369	1,496	1,560
Liab. & shar. funds	**295,943**	**338,448**	**392,774**	**423,302**	**448,316**
Total customer deposits	165,139	195,974	235,856	255,325	279,991
Reserve for loan losses	1,654	1,741	1,905	2,020	2,148
Shareholders' equity	**25,804**	**25,115**	**31,067**	**33,042**	**35,301**
Profitability/Solvency Ratios (%)					
ROE adjusted	12.8	12.1	13.3	12.2	12.5
Net interest margin	1.77	1.64	1.67	1.69	1.70
Cost/income ratio	40.6	42.0	40.7	42.9	42.6
Cash cost/average assets	0.9	0.9	0.9	0.9	0.9
NPLs/customer loans	0.8	0.7	0.7	0.7	0.6
Reserve for loan losses/NPLs	144.5	140.5	139.2	135.1	137.7
Bad debt prov./avg. cust. loans	0.2	0.2	0.2	0.2	0.2
Loans/deposit ratio	87.2	86.6	86.8	88.5	88.8
Tier 1 capital ratio	16.7	14.6	13.3	13.2	13.2
Total capital ratio	18.6	16.3	15.6	15.3	15.2

Powered by: dataCentral

Contents

Wing Hang Bank — Estd. S$280m Synergies

Upgrade to Buy: price target S$11.50

We have upgraded OCBC to a Buy with a target price of S$11.50. Our new report performs a deep dive analysis of the Wing Hang-OCBC HK business model, to see how earnings synergies can be extracted, to derive our three-year synergies estimate of S$280m.

We have taken a positive stance on OCBC's decision to acquire Wing Hang Bank (WHB) as it provides another platform for OCBC to develop its Greater China strategy with manageable near-term earnings dilution. Our deep dive report:—

- Analyzes WHB business model strengths/weaknesses and where OCBC can add value to derive our S$280m estimated net synergies.
- Reviews the DBS Hong Kong 2010-2013 experience: successes, shortcomings and read-though for OCBC-WHB.
- Puts WHB's franchise into context of its Hong Kong banks peer group, using an ROA analysis to identify its key profitability gaps.
- Takes a closer look at the China/RMB internationalization progress and the banking opportunities and challenges in the coming years.
- Shows how WHB fits into OCBC's overall group business model and regional platform. Our target price of S$11.50 values OCBC at 2015E multiples of 1.5x P/B (vs. 12.3% ROE) and 12.8x PER.

Dual-entity approach to Wing Hang Bank synergies

On synergies, we expect a dual-entity business model to be used; OCBC's HK branch will capture the corporate cross-border China business, while WHB's existing SME-retail model will be enhanced on fees, improved funding costs and NIMs, as well as capital efficiency. Post rights, we estimate that OCBC needs to derive over S$170m in synergies to deliver an accretive deal. Our bottom-up estimate of S$280m by 2017 suggests that OCBC can comfortably reach this goal.

Figure 1. Summary of Bottom-Up Synergies + Citi Estimates of Synergies (Total S$280m)

Area	Synergy Estimates (3 yrs)	Comments
Fees and other Non-II	HK$760m/S$120m	WHB's 2013 fees-to-total income ratio of 16% is one of the lowest of peer banks and an obvious priority for OCBC to derive near-term revenue synergies. Key focus areas likely wealth management, treasury and increase broader cross-sell initiatives into the WHB customer base.
Net interest income	HK$1bn/S$160m	NII growth would be driven a combination of three interlinked synergies, namely: accelerating loan volumes (larger ticket credits booked into OCBC HK branch), leveraging up WHB's balance sheet/LDR and lowering WHB's underlying funding costs utilizing OCBC's superior credit rating.
Capital mgmt.	1%pt of CET1	Migrating WHB from standardized Basel 3 to A-IRB is a minimum 18-month process, but any capital savings would be an effective reduction on OCBC's purchase price. WHB mgmt. indicated that a 1%pt ratio improvement (on roughly 8% capital savings) was a realistic outcome.
Costs synergies	Minimal	We view that WHB already operates a relatively lean cost base versus HK bank peers, plus there appears to be minimal overlap with OCBC HK. Any cost efficiencies would in our view be offset by near-term integration costs incurred in the initial phases of the integration process, as well as new investment in technology and training.
TOTAL	**HK$1.76bn / S$280m**	OCBC mgmt. guide that the WHB deal will be earnings accretive by 2017. Based on the recently announced rights issue, we estimate that OCBC need to generate an estimated S$170m of earnings synergies to make the deal earnings neutral by 2017E. Based on our synergy estimates this therefore seems achievable over three years.

Source: Citi Research

Note that our S$11.50 target price uses a 2015E forecast earnings base, which as the table shows only factors in relatively small net synergies of S$44m (<2% of our 2015E OCBC profit forecast of S$3.59bn).

[1] We estimate bottoms-up potential earnings synergies of S$280m

"Merger of scope"— OCBC has talked about a "merger of scope" where OCBC gains access to WHB's customer segments and product expertize (especially in SMEs), while OCBC will add product capabilities, notably in treasury and wealth mgmt./bancassurance. We see OCBC's primary goal in acquiring WHB as being in a better position through which to capture China flows going offshore. This includes investment flows, trade flows, trade settlement.

Figure 2. OCBC-WHB — Our Assumed Profile of Net Synergies 2015E-2017E

S$ Millions	2015E	2016E	2017E
Total Net Synergies	**44**	**140**	**280**
NII	48	80	160
Fee	12	20	40
Other non-II	24	40	80
Less: Integration Costs [1]	-40	0	0

Source: Citi Research [1] Per Mgmt. guidance

Dual-entity approach — At the WHB level, a primarily SME and retail banking model, the most immediate wins appear to be in WHB's fee income, which is one of the weakest of its peers. In particular, WHB's wealth mgmt. offering is poor, yet this is one of OCBC's key strengths. In capturing China cross-border flows, we also expect a lift to loan, trade and corporate advisory fees, as well as foreign exchange and treasury non-interest income. In terms of driving loan growth and net interest income, a lot of the cross-border loan activity will by nature more corporate and SOE-related, and will likely be captured at the OCBC HK branch, utilizing OCBC's greater access to (US$) funding and utilizing the larger parent capital base. That said, there is room to leverage up WHB's own balance sheet LDR, while the bank has recently secured a two-notch improvement of its credit rating to A-, which should improve funding costs. WHB is also well positioned to benefit from an eventual rise in interest rates.

Capital efficiency — Although not an immediate win, a move of WHB to the IRB Basel 3 standard (from standardized) should improve capital ratio through RWA efficiency and help defray part of OCBC's capital burden, although this is likely an 18 month process to achieve.

We are less positive on cost synergies, onshore China — We see minimal synergies coming from the cost side, since in our view WHB already operates a lean cost structure. Rather, there is likely to be additional investment cost to upgrade the technology platform and re-tool staff to generate additional revenues. To this end, OCBC has committed to a business-as-usual approach to the early months of the WHB takeover with no layoffs for the first 18 months. For WHB's onshore China presence, notably the 15-branch network in Guangdong province, we are less optimistic than OCBC in being able to cultivate near-term synergies. WHB's China operation has proved to be a drag on group profitability, but that is not out of line with the mainland China operations of other Hong Kong banks, including larger operations such as those run by Bank of East Asia. The likely reasons in the WHB case are lack of scale and a low-cost deposit base, as well as credit costs that are higher than in the rest of the group.

DBS Hong Kong experience of 2010-2013 — DBS has also adopted a dual-entity approach to capturing the China opportunity since 2010. In ROA profitability terms the HK geography (DBS HK subsidiary + HK branch of DBS Singapore) has become the most profitable part of DBS group, delivering a 2013 ROA of 1.39% (versus Singapore 0.92%, SSEA 1.19%). DBS' strategy was one of China-led

growth, moving into higher margin SME lending, focusing on fee income core competencies (wealth mgmt., markets, and transactions banking), and capturing the offshore RMB opportunity. DBS also gradually exited the HK mass market retail business, rationalized domestic distribution, and repositioned that network to target affluent wealth space, as well as improve customer segmentation for more targeted product offerings.

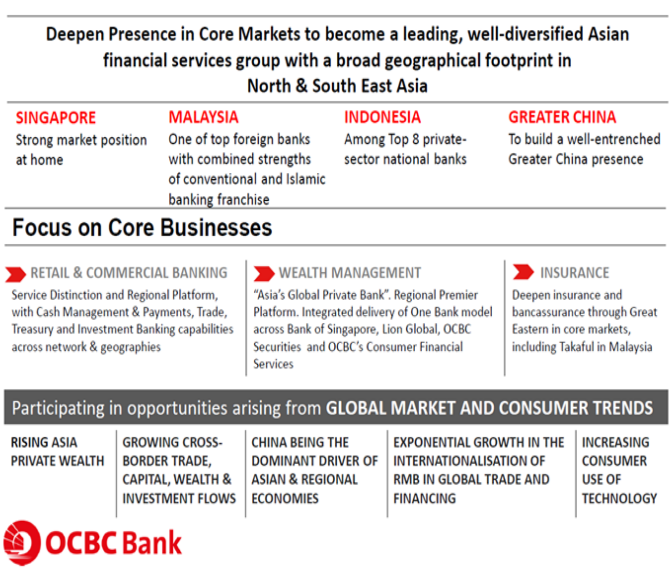
Read though for OCBC-WHB — From 2010 to 2013, DBS appeared to have made considerable progress, with the total HK geography posting an impressive +20% 4-yr profit CAGR in HKD terms on c.+12% 4-yr CAGR assets growth, contributing 24% of group earnings (2010: 22%). Our OCBC synergies estimate of S$280m represents a three-year profit CAGR of c.17%, of which probably up to 10% may come from asset growth.

A further tilt in OCBC's growth toward Greater China

While continuing to be a predominantly Asean banking franchise, Greater China has been OCBC's highest growth profit contributor in the past few years, and the WHB acquisition should further accelerate that growth. OCBC CEO Samuel Tsien has spent a considerable portion of his 30-year banking career in Hong Kong, notably as CEO of Bank of America (Asia). Thus in our view he is well qualified to make the WHB acquisition a successful one.

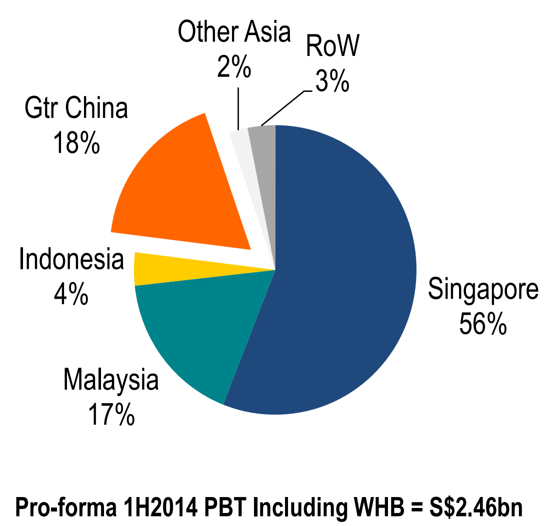
Along with Asean (Malaysia and Indonesia), Greater China is key to OCBC's regional growth plans. Like its peers, OCBC derived about 60% of its 1H2014 earnings (PBT) from Singapore, while its regional earnings was still dominated by Asean (23%). However, Greater China (comprising mainland China, Hong Kong and to a lesser extent Taiwan) has been OCBC's faster-growing profit contributor in the past few years, rising in 2010 from just S$34m PBT (or 1% of group PBT) to 1H2014 PBT of S$260m, or 11% of group PBT. On a pro forma basis including WHB, this rises to 18% of group PBT.

Figure 3. OCBC Corporate Strategy — Summary



Source: OCBC

Figure 4. OCBC 1H 2014 PBT Pro Forma Including WHB



Source: Company (Gtr China = China, Hong Kong, Macau, Taiwan), Citi Research

Improved China distribution — In addition to 42 branches in Kong Kong, WHB has a further 15 branches in China (complimenting OCBC's 16 China branches) as well as 13 branches in Macau under Banco Wing Hang. While OCBC's China network is largely spread across China's eastern coastal cities (plus Chongqing, Chengdu in central China), WHB's network focuses on the major cities in the Pearl River Delta region of Guangdong province in the south. OCBC's China strategy has been largely corporate focused while WHB's capabilities are in SME banking. Guangdong is one of the largest provinces in China by GDP. While Macau would present an entirely new business to OCBC, the goal would be to tap wealth mgmt. and private banking opportunities.

OCBC CEO Samuel Tsien — Mr Samuel N Tsien has over 30 years of working experience in the banking industry. Born in Shanghai and raised in Hong Kong, Mr Tsien majored in Economics at the University of California, Los Angeles. Shortly after his graduation in 1977, he joined Bank of America (Hong Kong) as a management trainee. He had held various key positions in corporate banking and credit risk management in Hong Kong and the US.

In 1995, he was appointed Chief Executive Officer of Bank of America (Asia). Prior to this, he was named Senior Vice President of Bank of America Corporation in 1993, and subsequently Executive Vice President in 1996. When China Construction Bank fully acquired Bank of America (Asia) in December 2006, Mr Tsien assumed the position of President and Chief Executive Officer of China Construction Bank (Asia) Corporation following the equity transfer.

He joined the Oversea- Chinese Banking Corporation (OCBC Bank) in Singapore in July 2007 as Global Head of Business Banking, and was promoted to Group Chief Executive Officer of the bank in April 2012.

Rights issue dilution looks manageable

Figure 5. Summary Math — OCBC – WHB Deal + Equity Raising Plans

OCBC — WHB Deal Math	
Offer Price Per WHB Share	**HK$ 125**
# WHB Shares (m)	309.8
Total Consideration (HK$ m)	38,723
Total Consideration (S$ m)	**6,219**
SGD-HKD Rate 18 Aug 2014	6.23
WHB 2013 NAV HK$	21,700
WHB 2013 Profit HK$	2,187
Acquistion P/B	**1.78x**
Acquistion PER	**17.7x**
Estimated Goodwill (S$ m)	**2,684**
SGD-HKD Rate 31 Dec 2013	6.14
SGD-HKD Rate 2013 Average	6.20
OCBC Market Capitalization Pre-Deal (S$ m)	**35,908**

Citi Assumptions for Deal Financing				
Assumed Portion Financed via Equity		54%		
- Equity to be Raised (S$ m)		3,366		
- Financed by Cash/Debt (S$m, Balance)		2,852		
Assumed Equity Issue price (S$)		**7.65**	**TERP (S$)**	**9.92**
New Shares at Assumed Issue Price (millions)		440.048		
OCBC Forecast Impact	**2014E**	**2015E**	**2016E**	**2017E**
EPS	-3.0%	-5.1%	-4.5%	-4.0%
BV/S	0.9%	0.1%	-0.7%	-1.5%
PER	0.68x	0.26x	0.18x	0.11x
P/B	-0.05x	-0.04x	-0.03x	-0.02x
CET1	-1.08% pts	-1.14% pts	-1.23% pts	-1.31% pts
Net Profit	3.1%	6.7%	7.4%	7.9%
ROE	-1.36% pts	-0.72% pts	-0.54% pts	-0.37% pts
OCBC Mkt. Cap. Chg	9%			

Notes:

[1] OCBC will end up owning 100% of WHB post compulsory acquisition of remaining shares at a cost of S$6.2bn
[2] OCBC has announced a 1 new for 8 old rights issue at S$7.65 per rights share to raise S$3.37bn new equity. The remainder we have assumed will be debt financed at a cost of 4.125% (approx. S$118m annual interest cost).
[3] This table shows pro forma adjustments assuming NO synergies or integration costs have been built in — purpose being to illustrate the immediate implications of adding 100% of WHB earnings less the funding costs of assumed new equity + debt.
Source: Citi Research estimates

The S$6.2bn WHB deal has been approximately 54% rights funded, the rest in debt and cash. Before considering any net synergies, the pro forma earnings dilution looks manageable at 4-5%. Although some investors may be concerned with a CET1 of 10.2% vs over 12% for peers, OCBC has re-affirmed that there will be no sales of major investments and maintains a 40-50% dividend payout cum scrip scheme.

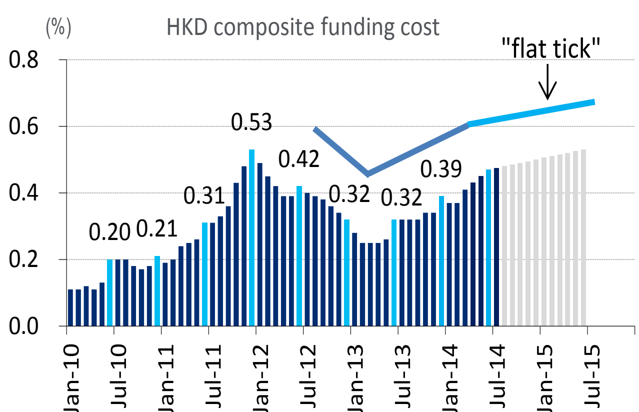
The S$6.2bn WHB acquisition price will be funded S$3.37bn by new equity, the rest cash/debt funded (OCBC raised S$2.5bn in Tier-2 sub debt in 2Q14). We compute 4-5% EPS dilution, before assessing the impact of integration costs & expected WHB earnings synergies. Some investors may consider the Jun-2014 pro forma CET1 of 10.2% (post capital raising) a little light versus peers (>12% CET1 fully loaded), but OCBC mgmt. has re-affirmed that there is no need for material non-core divestments and maintains its usual 40-50% dividend payout guidance, although we expect the group to continue with scrip dividend schemes as a means to build CET1. There are some capital efficiencies to be gained from moving WHB to Basel 3 IRB, but that is probably an 18-month process.

Five investment risks

Investment risks largely focus on execution. Despite the attraction of cross-border China flows, Hong Kong remains a highly competitive banking market, where funding costs and NIM pressure are a challenge for smaller banks. Delivering synergies will take time, and based on mgmt. guidance, it is likely to be three years before we can judge its success. We are less upbeat than mgmt. about onshore China opportunities, and OCBC's present CET1 of 10.2% looks light versus domestic peers (at over 12%).

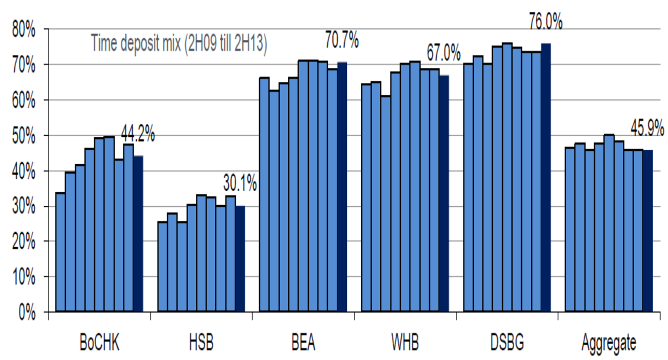
[a] Highly competitive HK banking market — In what is a relatively mature domestic HK banking market, there generally has been earnings pressure on smaller HK banks for a number of years. Several peer banks are raising capital or seeking parent support to gain share, making margin expansion difficult in lieu of a structural increase in rates. More limited distribution versus large banks and being a second-tier brand may be reasons why smaller banks are at a funding disadvantage for lower-cost CASA, as well as more limited fee income generation. Funding squeeze and rising deposit costs have been typical concerns for smaller HK banks.

Figure 6. HKD Composite Funding Costs Ticking Up



Source: Datastream, Citi Research

Figure 7. Smaller Banks More Vulnerable to Higher Deposit Costs



Source: Companies, Citi Research

[b] Synergy execution risks — Although we have estimated a possible net synergies upside of S$280m, it will take time for OCBC to realize that potential. OCBC has indicated for the need to make progressive investments in systems and channel, and deepen product capabilities in WHB. Also, OCBC has committed that there will be no redundancies near term and indeed the aim is to invest in people through training and development programs. Thus, in the near term the impact on earnings may be to the downside on likely integration costs (although OCBC estimates that this will be small at S$40-50m) rather than upside to earnings from synergy benefits.

[c] Onshore China — We remain of the view that the most important upside for OCBC in acquiring WHB is to better leverage the cross-border China flows into Hong Kong and beyond (into SE Asia), with Hong Kong still expected to be the dominant offshore RMB center for the foreseeable future. Despite its long-term strategic value, WHB's onshore China operation, not dissimilar to those of some other HK banks, has been a relative drag on earnings, we think due to a lack of scale, low-cost funding, and also higher credit costs versus the wider group.

[d] Likely earnings accretive only by 2017 — Even if all goes well, mgmt does not expect the WHB deal to be earning accretive for another three years. In the near term, stock performance may be affected by the perceived deal EPS dilution.

[e] Capital – We note that the pro forma CET1 ratio of 10.2% post WHB and rights issue appears a little light versus peer Singapore banks at >12% fully loaded. Our sense is that while fully loaded CET1 ratios are most prominent in the minds of management, OCBC is making use of the transitional B3 period to build capital parity with its peers, including finding RWA efficiencies (especially in moving WHB from standardized to IRB), use of scrip dividends, and divestment of minor non-core assets over time. However, we sense that the door may remain open to another equity raising if other avenues fail to raise CET1 to the desired levels over time.

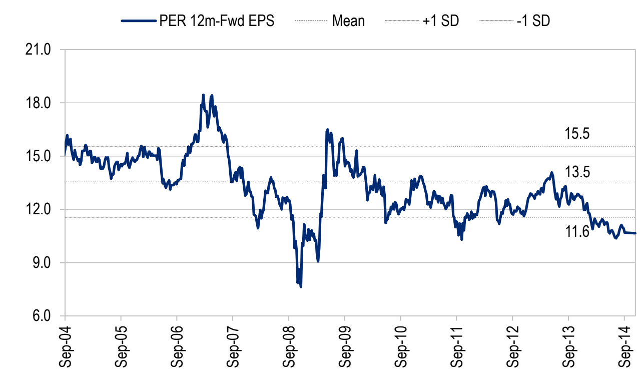
Figure 8. Earnings Revisions*

	Net Profit (S$ m)			EPS (S$)			DPS (S$)		
Year End Dec	**New**	**Old**	**%Chg**	**New**	**Old**	**%Chg**	**New**	**Old**	**%Chg**
2014E	3,372	3,372	0.0	0.90	0.90	0.0	0.36	0.36	0.0
2015E	3,587	3,563	0.7	0.90	0.89	0.7	0.39	0.37	4.5
2016E	3,930	3,910	0.5	0.98	0.98	0.5	0.40	0.39	2.6

* Upgrade to Buy post price weakness, minor adjustments to estimates, new TP S$11.50.

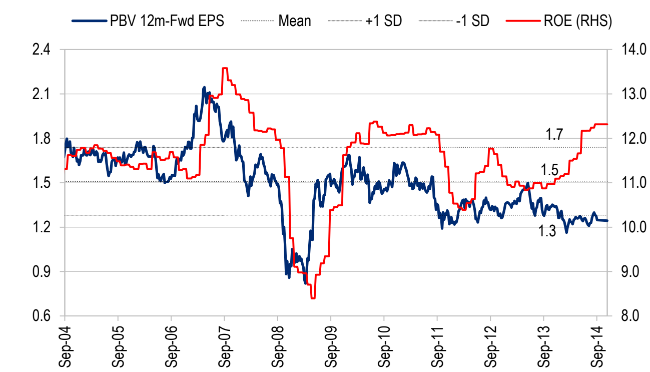
Source: Citi Research estimates

Figure 9. 12M-Forward Consensus PER



Source: Datastream, Citi Research

Figure 10. 12M-Forward Consensus P/B vs ROE



Source: Datastream, Citi Research

Figure 11. OCBC – Bank Earnings Forecasts and Key Assumptions (Local Currency Millions Unless Stated)

	FY10A	FY11A	FY12A	FY13A	FY14E	FY15E	FY16E
Loan Growth (%)	**29.3**	**26.9**	**6.6**	**17.8**	**20.7**	**10.4**	**10.0**
Net Interest Margin (bps)	198	186	177	164	167	169	170
Net Interest Income (SGD m)	**2,947**	**3,410**	**3,748**	**3,883**	**4,653**	**5,262**	**5,702**
NII Growth (%)	4.3	15.7	9.9	3.6	19.8	13.1	8.4
Non Interest Income (SGD m)	**2,378**	**2,212**	**2,897**	**2,738**	**3,220**	**3,409**	**3,653**
Non-II Growth (%)	17.2	-7.0	31.0	-5.5	17.6	5.9	7.2
-Fee Income (SGD m)	994	1,137	1,198	1,355	1,508	1,719	1,888
-Fee Growth (%)	36.2	14.4	5.4	13.1	11.3	14.0	9.8
-Insurance Income (SGD m)	586	508	838	756	925	800	815
-Insurance Income Growth (%)	-13.1	-13.3	65.0	-9.8	22.4	-13.5	1.9
-Other Income (SGD m)	798	567	861	627	786	890	950
-Other Income Growth (%)	27.8	-28.9	51.9	-27.2	25.4	13.2	6.7
Total Income (SGD m)	**5,325**	**5,622**	**6,645**	**6,621**	**7,873**	**8,671**	**9,355**
Total Income Growth (%)	9.7	5.6	18.2	-0.4	18.9	10.1	7.9
Non-II % of Total Income	44.7	39.3	43.6	41.4	40.9	39.3	39.0
Operating Costs (SGD m)	**2,254**	**2,430**	**2,695**	**2,784**	**3,202**	**3,721**	**3,990**
Costs Growth (%)	25.5	7.8	10.9	3.3	15.0	16.2	7.2
Costs % of Total Income	42.3	43.2	40.6	42.0	40.7	42.9	42.6
Pre-Provision Profit (SGD m)	**3,071**	**3,192**	**3,950**	**3,837**	**4,671**	**4,950**	**5,365**
PPP Growth (%)	0.4	3.9	23.7	-2.9	21.7	6.0	8.4
PPOP/Avg Loans (Bps)	327	269	290	247	252	232	228
Provision Charges (SGD m)	**134**	**221**	**271**	**266**	**344**	**393**	**414**
- NPL Ratio (%)	0.9	0.9	0.8	0.7	0.7	0.7	0.6
- Provision Coverage (%)	147	134	144	141	139	135	138
- Provisions bps of Loans	14	19	20	17	19	18	18
Others (SGD m)	-57	-54	-33	-4	20	32	33
Pre-tax Profit (SGD m)	**2,880**	**2,917**	**3,646**	**3,567**	**4,346**	**4,590**	**4,984**
Tax (SGD m)	432	470	593	597	756	797	847
Minorities (SGD m)	194	167	228	202	218	206	207
Net Profit (SGD m)	**2,253**	**2,280**	**2,825**	**2,768**	**3,372**	**3,587**	**3,930**
FD EPS (SGD)	0.68	0.66	0.81	0.80	0.90	0.90	0.98
FD EPS Growth (%)	13.3	-1.8	21.4	-1.3	13.5	-0.5	9.6
BVPS (SGD)	5.66	6.02	6.68	6.47	7.13	7.63	8.20
BVPS Growth (%)	7.1	6.3	11.0	-3.1	10.1	7.0	7.5
RoRWA (%)	2.20	1.95	2.19	1.98	2.00	1.84	1.87
Tier 1 ratio (%)	**16.3**	**14.5**	**16.7**	**14.6**	**13.3**	**13.2**	**13.2**
Core Tier 1 ratio (%)	12.5	11.4	12.8	10.6	10.3	10.5	10.7
CAR (%)	17.6	15.7	18.6	16.3	15.6	15.3	15.2
Loan to Deposit ratio (%)	**86.3**	**87.4**	**87.2**	**86.6**	**86.8**	**88.5**	**88.8**
EPS SENSITIVITY STUDY	**FY10A**	**FY11A**	**FY12A**	**FY13A**	**FY14E**	**FY15E**	**FY16E**
EPS Base Case (SGD)					**0.90**	**0.90**	**0.98**
% Impact from							
Loan Growth: +1% Chg					0.3	0.4	0.4
NIM: +10bps Chg					6.8	7.2	7.1
Cost Income %: +1% Chg					1.9	2.0	2.0
Provisions / Loans: +10bps Chg					4.5	4.9	5.0
ROA/ROE DECOMP (%)	**FY10A**	**FY11A**	**FY12A**	**FY13A**	**FY14E**	**FY15E**	**FY16E**
Net interest income	1.39%	1.35%	1.31%	1.22%	1.27%	1.29%	1.31%
Total operating income	2.51%	2.22%	2.32%	2.09%	2.15%	2.13%	2.15%
Operating expenses	1.06%	0.96%	0.94%	0.88%	0.88%	0.91%	0.92%
Op profit before provisions	1.45%	1.26%	1.38%	1.21%	1.28%	1.21%	1.23%
Provisions	0.06%	0.09%	0.09%	0.08%	0.09%	0.10%	0.10%
Tax	0.30%	0.25%	0.29%	0.25%	0.27%	0.25%	0.24%
Net profit (ROA)	**1.06%**	**0.90%**	**0.98%**	**0.87%**	**0.92%**	**0.88%**	**0.90%**
Leverage (x)	11.8	12.8	13.2	14.1	14.5	14.0	13.9
ROE	**12.5%**	**11.5%**	**13.0%**	**12.3%**	**13.4%**	**12.3%**	**12.6%**

Source: Company and Citi Research estimates

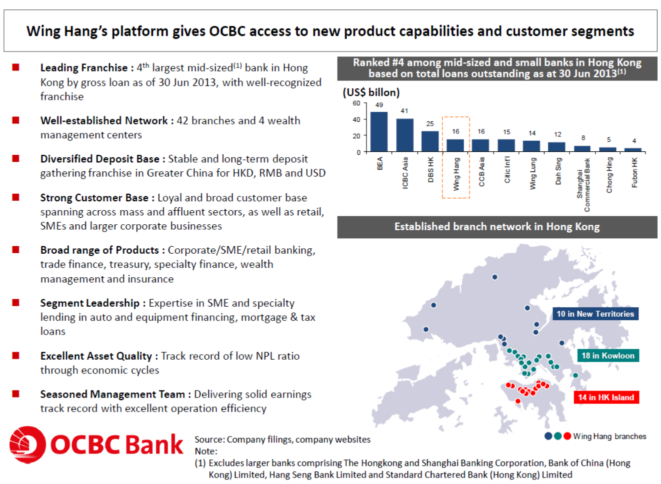
Analyzing OCBC-WHB Earnings Synergies

OCBC management qualitatively outlined during its S$3.3bn rights issue briefing some of the strategies they may adopt to make the Wing Hang Bank (WHB) acquisition earnings accretive by 2017, but did not provide quantitative targets. In this report we provide a bottom-up analysis of how much and from which areas OCBC-WHB might extract earnings synergies. Versus our estimate that >S$170m of earnings synergies is needed to make the WHB deal EPS accretive, our detailed analysis suggests that net synergies up to S$280m might be achieved.

OCBC: Enhancing WHB's franchise via "merger of scope"

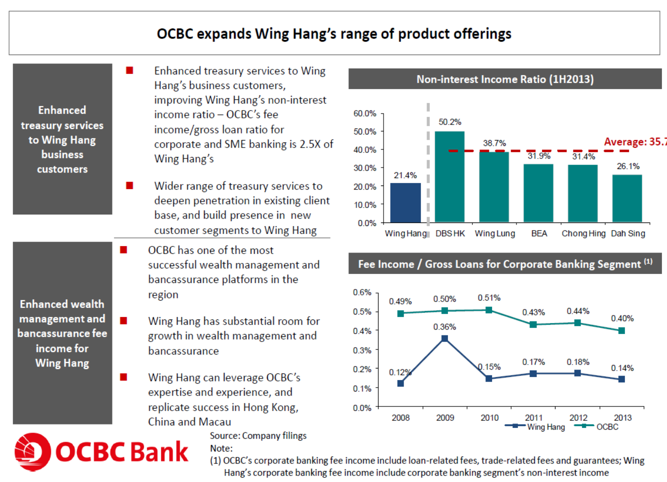
OCBC talked of a "merger of scope" where OCBC gets access to WHB's customers and expertize (especially SMEs), while OCBC will add product capabilities, notably in treasury and wealth mgmt./bancassurance. OCBC will also progressively invest in systems, channels and deepen WHB's product capabilities. OCBC views that there will be no redundancies near term and indeed the aim is to invest in WHB staff through training and development programs.

Figure 12. "Merger of scope" #1 — WHB's platform



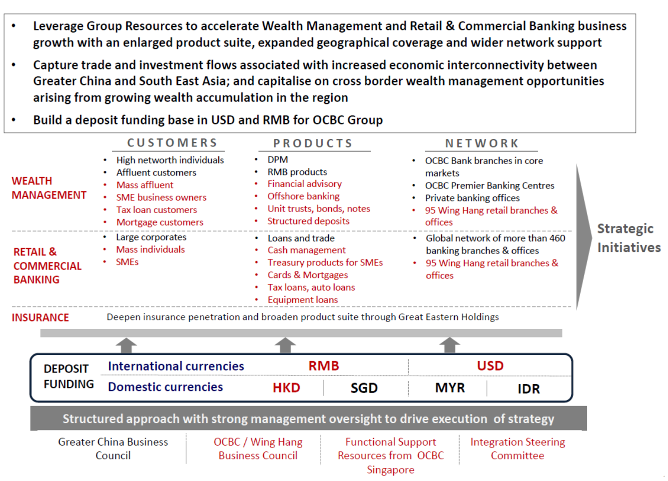
Source: OCBC

Figure 13. "Merger of scope" #2 — OCBC's product capabilities



Source: OCBC

Figure 14. OCBC-WHB Greater China Strategy



Source: OCBC (Items in red = post-WHB additional products/capabilities)

Figure 15. Implementing Greater China Strategic Initiatives

Deepen relationships with Large Corporates	• Continue focus on growing large corporate relationships through OCBC Hong Kong branch, including **Hong Kong blue chip companies and Chinese Top Tier SOEs** • Leverage on Wing Hang's presence in the **Pearl River Delta** region to increase penetration of Chinese corporates and SOEs and promote **onshore-offshore business strategy**
Grow SME Segment	• Extend Wing Hang's successful **SME lending model** and specialty products to OCBC China • Deepen presence across SME segment with a **more comprehensive range of products**, including RMB products
Expand Product & Service Suite	• Introduce **wealth products and treasury advisory** services to the enlarged customer base • Extend **offshore banking** and network services to individuals and businesses – products and market access • Roll out **treasury & investment banking** services to Wing Hang's business customers
Strengthen Sales Management & Promote Group Customer Concept	• Support **sales efforts** with training, product development, incentive programmes and sales promotion • Promote **group customer** concept addressing customers' needs with the collective resources of the Bank and its subsidiaries in private banking (Bank of Singapore), commercial banking (OCBC Malaysia, OCBC China, OCBC NISP), insurance (Great Eastern) and asset management (Lion Global Investors)
Increase Cross-Sell – Deepen Penetration	• Increase product penetration in customer franchise through a more robust **cross-sell culture** infrastructure, e.g. **Private Banking** for SME business owners, Wealth and OCBC **Premier Banking** for mass affluent mortgage & tax loan customers, **Offshore Banking** for Greater China customers in South East Asia, **Treasury** products for SME businesses
Leverage network synergies – Flow Business and Deposits	• Provide network support to OCBC's customers expanding into Greater China with WHB's broad based branch coverage in the Pearl River Delta region and vice versa • Capture the increasing **trade and investment flows** between the core markets of Singapore, Malaysia, Indonesia and Greater China • Access **USD and RMB** customer deposits for OCBC group

Source: OCBC

For the overall Greater China strategy, OCBC plans to leverage WHB to further its existing "onshore-offshore" strategy to target large corporates and SOEs, capturing trade and investment flows especially from China into SE Asia. For WHB's SME and retail base, OCBC sees scope to expand WHB's successful SME model into other regions of China, while adding to the product suite (such as treasury and investment banking). The retail side will be enhanced by wealth mgmt. and structured products, plus deepen cross sell by making WHB customers a customer of the entire OCBC group. The emphasis is mostly on revenue synergies, although over time business efficiencies will also be sought. The near-term wins look likely to come on the fee/non-II front, including wealth mgmt., treasury, and cross sell. Near term integration costs are not viewed as being significant (mgmt. indicated S$40-50m).

Our view: dual-entity approach to driving synergies

We recently had an opportunity to discuss possible business strategies with WHB mgmt. From this we expect a two-pronged business approach to be adopted.

OCBC HK branch: capturing corporate China cross border flows — In 2013 OCBC derived S$208m of pretax profit (6% of group total) from Greater China, with roughly three quarters of that coming from OCBC's HK branch (2013 net profit HK$802m vs. WHB HK$2.2bn). We see OCBC's primary goal in acquiring WHB as being in a better position to capture China flows going offshore. This includes investment flows, trade flows, trade settlement. This will by nature by more corporate and SOE-related, and is likely to be captured at the OCBC HK branch level, given larger balance sheet and capital needs. As we explain later in this report (in the sections "RMB internationalization — progress as of mid-2014" on page 33 and "Capturing cross border loans/fee flows: key growth driver" on page 37) we expect Hong Kong to remain the most important global financial center for China/RMB internationalization. Even if just a small portion of China's total RMB and credit volume continues to flow offshore, it is significant in terms of incremental business for Hong Kong-based banks to capture.

WHB level: leveraging the balance sheet — The overall onshore-offshore strategy does not change but there will be incremental growth opportunities. Aside from streamlining the credit process, WHB can now approach larger customer relationships that previously could not be fulfilled due to concentration risk. Large-ticket loans can be handled by the OCBC HK branch with the backing of the parent's capital base and access to lower cost USD funding. The WHB balance sheet LDR itself can be possibly further leveraged up to 80% (2013: 76%) despite HKMA prudential rules introduced in Jan 2014 on stable funding requirements for high credit growth.

Net interest income and NIM — WHB has always had a very conservative business approach, including higher levels of balance sheet liquidity and lower counterparty concentration risk. WHB has just secured a ratings upgrade (from Fitch) 2 notches higher (to A+) which puts WHB on the lower credit rating than larger HK peer Hang Seng Bank but still a notch lower than OCBC (AA-). Given a more secure and lower-cost funding (given OCBC's backing), henceforth the mgmt. appetite can be higher in terms of counterparty risk and leveraging OCBC's larger capital base. Note also that WHB's NIM is also positively leveraged to rising interest rates. Mgmt. suggested that a 1%pt interest rate hike could lift NIMs 25bps.

Fee strategies — Wealth mgmt. and insurance are potential upsides, currently just 18% of fee income. Similarly brokerage income is well below the peak of a few years ago. Presently WHB's wealth strategy is a simple one, such as selling alternative time deposit substitutes to customers based on relationship. OCBC's approach could be more KPI driven, with more training on cross sell and introducing a wider suite of products. Customer targets will include WHB's existing customer base including SME owners, but there is an opportunity to expand the SME base through the supply chain of corporate relationships. This may include recapturing relationships with companies that simply outgrew WHB. HK Life is owned and

managed by several banks but in the view of mgmt. never reached its full potential. Mgmt. suggested that AIA last year sold half of its new HK policies to mainland Chinese. Many of these are wealthier than HK counterparts. WHB also has a lot of HNW individuals in the older generation customer base.

Trade finance — The volume opportunity remains but mgmt. note that margins have come down significantly over the past year, so more has to be done to derive the same income. Additional upside will be gained in operational accounts, cash mgmt., and foreign exchange in Hong Kong. WHB already have had some success on the Treasury side and OCBC can provide incremental help.

Cost base — For now there appears to very little in the way of cost synergies. WHB we think is one of the more cost-efficient of the HK bank peers. OCBC has committed that WHB would operate business as usual with no layoffs for the first 18 months, with OCBC looking to build upon their capabilities. Integration is set to be done at a measured pace that does not destroy the WHB franchise. A large part of the integration relates to automation. At the back end, OCBC is more sophisticated in infrastructure and mgmt. style (including CRM, MIS, work stream, and setting KPIs). Some low-hanging fruit/immediate wins can come from revenue alignment of regional relationships (for example rates with Visa and Mastercard).

Asset quality — Credit costs for WHB are currently very low at 5-6bps. Historically (going back a decade), the normalized level would have been 50bps but the likely normal level in the future would be about 20bps.

Macau — WHB has done well over 15 years growing as a local bank with the economy growing operating income.

China onshore — Just under 10% of WHB group profit, the onshore China operation encountered some bad debts two years ago and interest rate volatility can affect profits. Corporate business spreads have been under pressure and it is harder to grow CASA. WHB did start to grow a small enterprise lending model, but management suggested that Southern China is not showing the strength of growth and exports as it had done in the past.

Capital — It may take up to two years to implement IRB. Mgmt. estimated the saving may be about 8% of capital or 100-120bps improvement on capital ratios.

Our WHB synergies estimate — HK$1.76bn or S$280m

In this section we elaborate on the broad OCBC-WHB strategies discussed in the previous section and explain how we derive an estimate of S$280m of potential net synergies which — if OCBC can deliver — will then make the WHB acquisition earnings accretive by 2017.

Figure 16. Summary of Bottom-Up Synergies + Citi Estimates of Synergies (Total S$280m)

Area	Synergy Estimates (3 yrs)	Comments
Fees and other Non-II	HK$760m/S$120m	WHB's 2013 fees-to-total income ratio of 16% is one of the lowest of peer banks and an obvious priority for OCBC to derive near term revenue synergies. Key focus areas likely wealth management, treasury and increase broader cross-sell initiatives into the WHB customer base.
Net interest income	HK$1bn/S$160m	NII growth would be driven a combination of three interlinked synergies, namely: accelerating loan volumes (larger ticket credits booked into OCBC HK branch), leveraging up WHB's balance sheet/LDR and lowering WHB's underlying funding costs utilizing OCBC's superior credit rating.
Capital mgmt.	1%pt of CET1	Migrating WHB from standardized Basel 3 to A-IRB is a minimum 18-month process, but any capital savings would be an effective reduction on OCBC's purchase price. WHB mgmt. indicated that a 1%pt ratio improvement (on roughly 8% capital savings) was a realistic outcome.
Costs synergies	Minimal	We view that WHB already operates a relatively lean cost base versus HK bank peers, plus there appears to be minimal overlap with OCBC HK. Any cost efficiencies would in our view be offset by near term integration costs incurred in the initial phases of the integration process, as well as new investment in technology and training.
TOTAL	**HK$1.76bn / S$280m**	OCBC mgmt. guide that the WHB deal will be earnings accretive by 2017. Based on the recently announced rights issue, we estimate that OCBC need to generate an estimated S$170m of earnings synergies to make the deal earnings neutral by 2017E. Based on our synergy estimates this therefore seems achievable over three years.

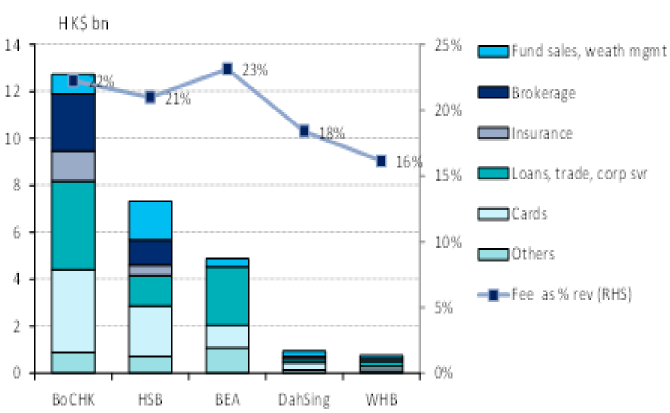
Source: Citi Research

Synergy #1 – Fee and other non-interest income growth

Overall we estimate HK$760m/S$120m of synergies in non-interest income over the next three years

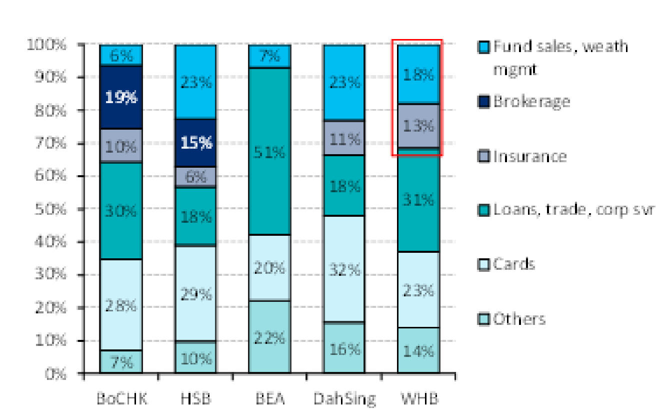
WHB's net fee income as % total revenue was 15% in 2013 (non-II ratio 22%), one of the lowest among the five major domestic Hong Kong banks. Net fees and commissions absolute dollar contribution of HK$661m (total non-II HK$962m) was substantially lower than leading domestic HK banks like BoCHK, HSB and BEA (Figure 17), and even lower than DSB (who in assets terms is >20% smaller than WHB). In terms of fee income mix contribution, WHB has a relatively even balance between loans/trade fees, stock brokerage (wealth mgmt. is very small) and retail credit cards (Figure 18). For the period 2010 to 2013, WHB's net fees actually fell slightly (c.3%) in absolute dollar terms, but a turnaround in investments fair value (from loss to gain) drover the overall non-II profit jump of 47% to HK$962m.

Figure 17. HK Banks – fee income, and fees as % total revenue (2013)



Source: Citi Research

Figure 18. HK Banks – fee income mix (2013)



Source: Citi Research

Reviving fees a top priority — With seemingly little attention paid to increasing WHB's core fee franchise, this would probably be the first priority for OCBC to develop revenue synergies in a relatively short span of time. The three main areas we see where OCBC can add value to the fee franchise are: wealth mgmt., loan, trade and other corporate advisory fees, and foreign exchange/treasury income. We would not view credit cards as a high priority due to the saturated nature of the domestic market and because it is not one of OCBC's major fee strengths:

1. Wealth management: Compared to peers, WHB had one of the weakest wealth offerings; 2013 fees of HK$143m was comprised of HK$121m in broking income with only HK$22m of actual wealth fees. OCBC in contrast arguably has one of the most successful wealth mgmt. and bancassurance platforms in Asean; thus we assume over three years that HK$300m of revenue synergies may be a reasonable target for wealth, initially cross-selling into WHB's existing SME & retail customer base, but also adding to the higher-end affluent platform that can be captured under Bank of Singapore, as well as broadening and deepening offshore RMB product offerings.

OCBC's strategic goals — "Increase product penetration in customer franchise through a more robust cross-sell culture infrastructure, e.g. Private Banking for SME business owners, Wealth and OCBC Premier Banking for mass affluent mortgage & tax loan customers, Offshore Banking for Greater China customers in South East Asia, Treasury products for SME businesses".

As a comparison, DBS HK from 2010 to 2013 saw wealth mgmt.-related fee income more than double to over HK$593m for the three-year period.

2. Credit, trade fees, and corporate advisory: This segment accounted for 25% of WHB's total non-II in 2013 but in absolute terms at HK$240m is only 10% of what the larger balance sheet HK peers (BOC HK and BEA) have earned from exploiting cross-border corporate flows. OCBC has thus far been highly successful in exploiting its "onshore-offshore" strategy to developing its China business, both through trade loans and project-based financing, and (whether the loans are booked at OCBC HK or WHB) we estimate HK$200m (>80%) fees upside to this area.

OCBC's strategic goals — "Continue focus on growing large corporate relationships through OCBC Hong Kong branch, including Hong Kong blue chip companies and Chinese Top Tier SOEs; Leverage on Wing Hang's presence in the Pearl River Delta region to increase penetration of Chinese corporates and SOEs and promote onshore-offshore business strategy."

As a comparison, DBS HK from 2010 to 2013 saw this category of fees grow HK$100m, and although not publicly disclosed we estimate perhaps another HK$200m of such fees were probably booked at the DBS Singapore HK branch.

3. Foreign exchange/treasury: WHB's overall dealing income of HK$136m in 2013 was not even 5% of the flow that the leading banks (HSB, BOCHK) could derive. This business should be enhanced on the back of capturing higher corporate flows, sale of wealth products, and tapping into the RMB payments and flows space. We assign HK$360m of additional revenue synergies to this line.

OCBC's strategic goals — "Introduce (wealth products and) treasury advisory services to the enlarged customer base; Extend offshore banking and network services to individuals and businesses – products and market access; Roll out treasury & investment banking services to Wing Hang's business customers"

As a comparison, DBS HK from 2010 to 2013 saw treasury and foreign exchange income grow almost HK$600m, although we concede that it is more difficult to judge whether such strong growth can be replicated as it depends on favorable markets conditions (volatility).

4. How about Insurance? WHB currently has a small insurance exposure through an associate stake in Hong Kong Life Insurance Limited, but for the purpose of this analysis, we are currently assigning zero synergies benefits, even though in practice this should be a potential OCBC strength. At the moment how OCBC plans to develop an insurance strategy is unknown. OCBC mgmt. is still reviewing its insurance options, recognizing that the domestic HK market is already highly competitive. Mgmt. indicated that it would be desirable to have a greater insurance presence in mainland China, but the mode of entry has yet to be decided.

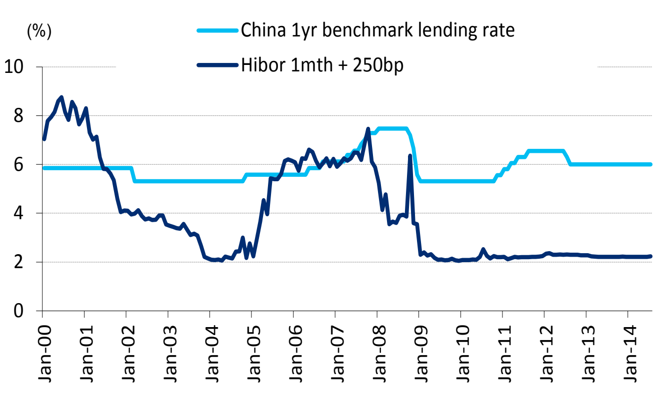
Synergy #2 — Accelerating loan growth by capturing greater cross-border credit demand on supportive by FX and interest rate spreads

Overall we estimate that OCBC can derive HK$1bn/S$160m of revenue uplift to net-interest income (NII) growth over the next three years, through a combination of three interlinked synergies of accelerating loan volumes, leveraging up WHB's balance sheet, and lowering WHB's underlying funding costs. Synergy #2 discusses loan volume acceleration, synergy #3 balance sheet leverage, and synergy #4 funding costs.

As a stand-alone entity, WHB over the three-year period 2010 to 2013 has seen an average of 10% balance sheet asset growth on similar customer deposits growth, with loans growing at a slightly higher three-year CAGR of 12%. Perhaps slightly surprisingly, the average growth rate of loans for use in HK, mainland China, and Macau for that period remain in a relatively narrow range of 10% to 13%.

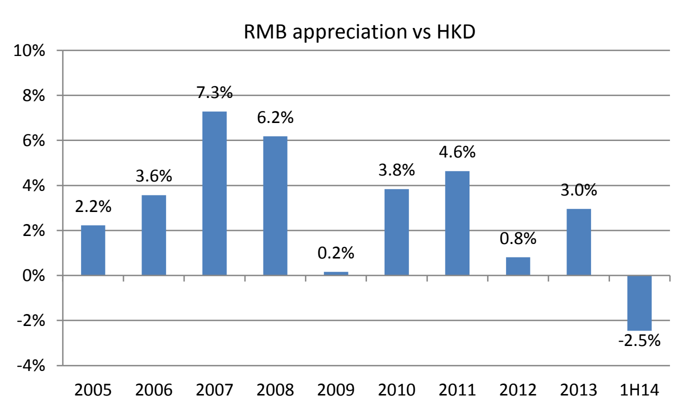
In its recent briefings, OCBC management elaborated at some length as to the specific nature of its China strategy, namely operating an offshore-onshore approach. The tendency for OCBC to bank more with clients offshore is because that's where the bank's competitive advantage lies, but the bank still needs the linkage onshore. OCBC also tends to target large corporates and SOEs, as that is where the greater offshore-onshore opportunities lie.

Figure 19. China vs Hong Kong lending rate gap



Source: Citi Research. DataStream *proxy via the difference between China RMB 1yr benchmark borrowing rate as compared with Hong Kong HKD borrowing rate estimate of HIBOR 1mth plus 250bp spread

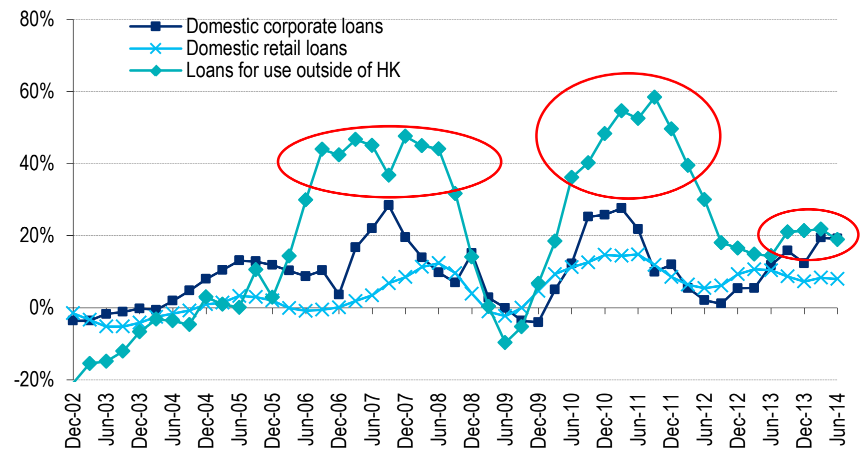
Figure 20. RMB appreciation vs HKD or USD



Source: Citi Research

There is ample supporting evidence that OCBC should be able to exploit this through having a Hong Kong presence through Wing Hang Bank. This is shown below as an analysis of three cross-influencing factors, namely: (i) China-HK lending rate gap (offshore lending rates are more favorable than onshore, currently by a spread of around 400bps), (ii) RMB appreciation expectations, which has generally been the outcome every year from 2005 to 2013 (note, however, that RMB *depreciation* as has been seen thus far in 2014 may make cross-border borrowing less attractive the attractive interest rate differential would be offset by possible currency losses), (iii) Loan growth in Hong Kong but to China related clients and business purposes, predominantly reflected in offshore loans and trade finance.

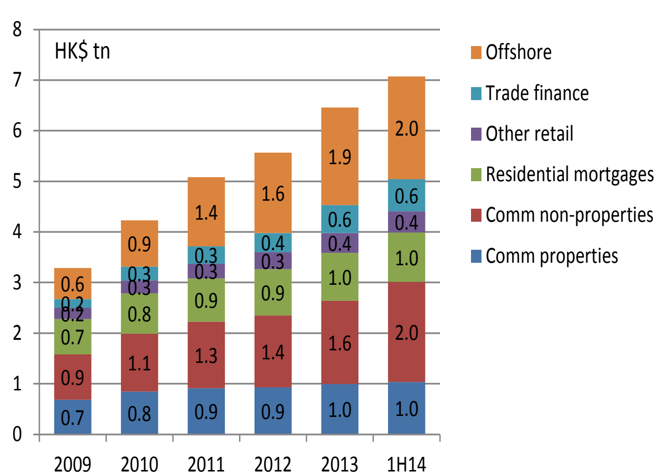
Figure 21. Hong Kong offshore loan growth



Source: Citi Research, HKMA

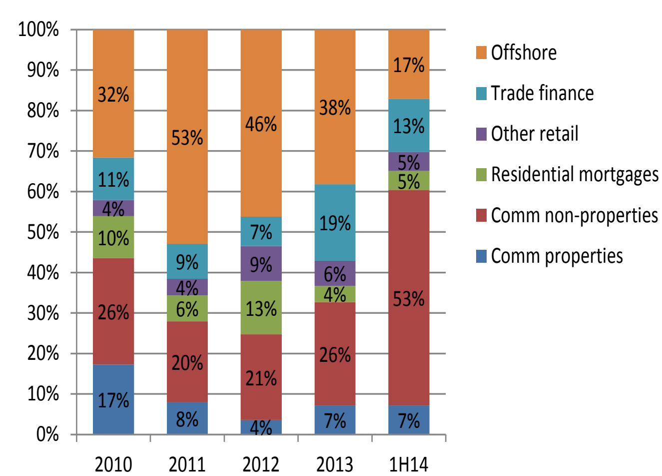
The below figures reveal outstanding loans (Figure 22) and key loan growth drivers (Figure 23) since 2010. In aggregate the two most important growth drivers were offshore loans and trade finance. Over the period 2010 to 2013, WHB has shown a similar contribution pattern, with Macau at 15%, China 17%, and domestic HK 65%.

Figure 22. HK Sector Loan Growth yoy



Source: Citi Research, HKMA

Figure 23. HK Sector – Segment Increase as % Total Loan Increase

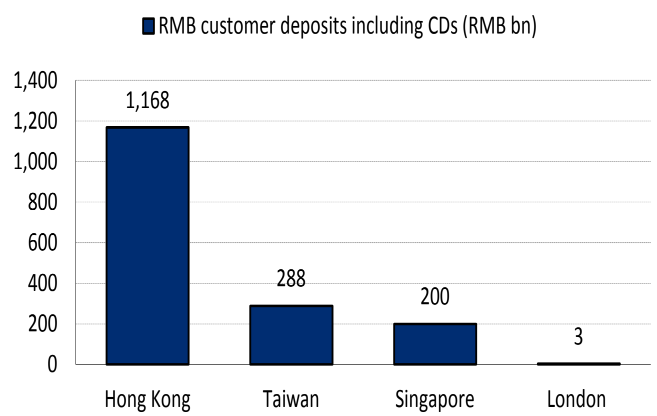


Source: Citi Research, HKMA (*latest sector breakdown — 1Q14)

Aside the economic (arbitrage) benefit from FX and interest rate spread helping fuel Hong Kong loan growth, we also see intangible benefits for China borrowers to obtain financing from Hong Kong:

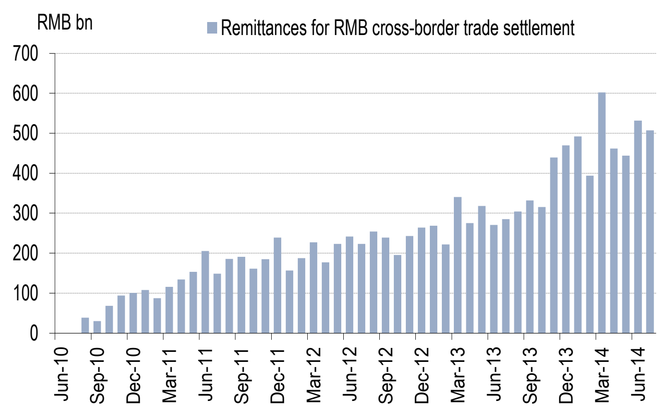
- Low level of regulatory influence and higher level of confidence in credit availability relative to Mainland China,
- HK being a listing destination for major Mainland China companies that have existing representative office or treasury center,
- HK having a relatively low cultural and geographical barrier with Mainland China with relative to Singapore,
- Emerging RMB banking with associate infrastructure including RMB liquidity pool, FX- and rate-related instruments, Dim Sum bonds, QFII/RQFII, and up-coming SH-HK Stock Connect. We believe OCBC will look to exploit all of these factors to pursue its onshore offshore loan strategy.

Figure 24. RMB deposit base (HK, TW, SG)



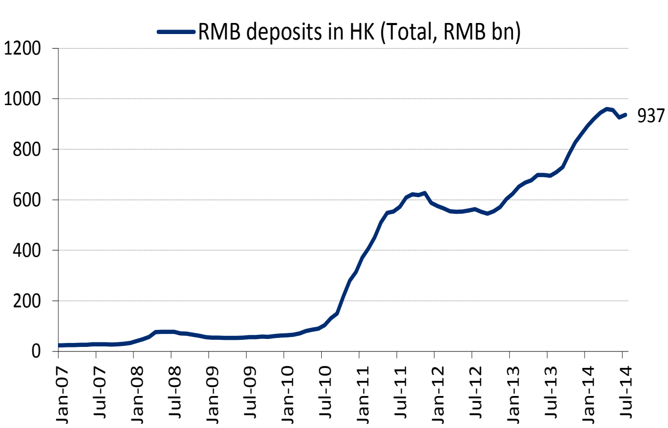
Source: Citi Research Hong Kong: HKMA Apr-2014 deposit data, Feb-2014 CD data; Taiwan: CBC Apr-2014 data, including OBU RMB49bn and DBU RMB166bn; Singapore: MAS deposits data, Dec-2013 RMB200bn; London: City of London Jun-2013 data RMB3.1bn, excluded interbank deposits of RMB11.4bn

Figure 25. HK – remittances for RMB cross-border trade settlement



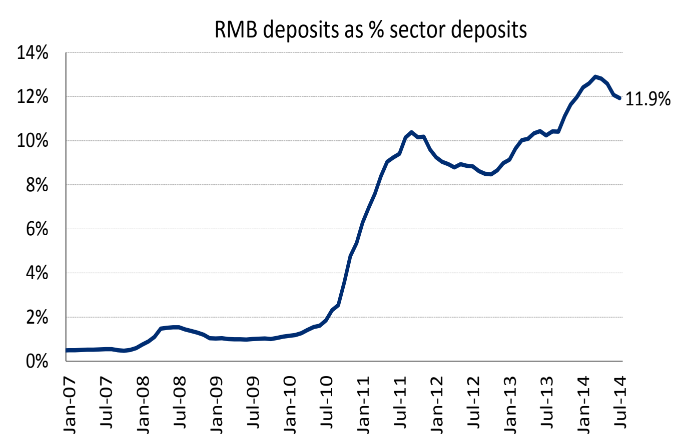
Source: Citi Research, HKMA

Figure 26. HK – RMB deposit



Source: Citi Research, HKMA

Figure 27. HK – RMB deposits as % sector total



Source: Citi Research, HKMA

Why we are more cautious about a pure *onshore* China growth strategy: With this very specific "onshore-offshore" approach to OCBC's China growth strategy, one needs to cast a more critical eye on evaluating WHB's *onshore* China franchise. We have already discussed in the previous sections on how capturing the cross-border loan demand could be a significant upside to both fees and net interest income. On this basis, there is no doubt that when one discusses the overall China corporate banking upside, the *strategic value* of having an onshore China presence for generating client referral/cross-sell will be cited as a key foundation for originating China corporate banking activity.

Figure 28. WHB – segment information by geography (2013)

HK$ mn	Asset	Op income	Op exp	Impairment charges	PBT	PPOP ROA	Pretax ROA	Cost-income ratio	Branch (#)
Hong Kong	**131,774,368**	**3,194,194**	**-1,304,946**	**-21,550**	**1,948,761**	**1.4%**	**1.5%**	**41%**	**42**
Macau	30,554,331	615,441	-276,761	374	395,917	1.1%	1.3%	45%	13
China	**39,466,485**	**665,429**	**-429,424**	**-65,171**	**170,927**	**0.6%**	**0.4%**	**65%**	**15**
Total	**201,795,184**	**4,475,064**	**-2,011,131**	**-86,347**	**2,515,605**	**1.2%**	**1.2%**	**45%**	**70**
Mix (%)									
Hong Kong	**65%**	**71%**	**65%**	**25%**	**77%**		**-**	**-**	**60%**
Macau	15%	14%	14%	0%	16%		-	-	19%
China	**20%**	**15%**	**21%**	**75%**	**7%**		**-**	**-**	**21%**
Total	100%	100%	100%	100%	100%		-	-	100%

Source: Citi Research

But if we are purely talking about onshore China branch presence, then we may need to be more circumspect with regards to the revenue and profit upside that is likely to be realized there. We illustrate WHB's segment income and profitability in Figure 28. This comparison reveals that Hong Kong remains the primary and most profitable segment within WHB. Hong Kong accounted for just over 70% of operating income, with higher PPOP ROA and pretax ROA relative to WHB's Macau and China operations; outperformance is also revealed in a low segment cost-to-income ratio of 41% and minimal impairment charges, meaning that Hong Kong accounted for 77% of group PBT.

The China segment business of WHB, however, looks somewhat weaker on reported metrics. The China segment of WHB reported relative profitability weakness in almost all metrics within group. The cost-income ratio of 65% is relatively high; PPOP ROA and Pretax ROA are both low at 0.6% and 0.4%, respectively, for 2013 (the latter affected by high impairment charges), and China contributed just 7% of group PBT (vs. 20% of group assets). But again, one can argue that reported China segment metrics may not precisely represent the true strategic value of enhancing group capability to channel cross-border corporate businesses into its Hong Kong unit.

Note that these arguments may suffer from distortions in terms of profit booking, since it is probably more favorable for the group to structure and recognize profit in Hong Kong over that of Mainland China given the substantially different tax regime (HK profit tax at 15.5%, China profit tax at 25% plus another 5% of business tax charge on revenue). Lastly, on loan provision and impairment, China regulators mandate a minimum NPL coverage of 150%; and this is likely to put incentive for banks to fully write-off a loan even though future recovery is possible. Nonetheless, OCBC views development of WHB's China SME franchise as an opportunity.

OCBC's strategic goals — " Extend Wing Hang's successful SME lending model and specialty products to OCBC China; Deepen presence across SME segment with a more comprehensive range of products, including RMB products."

Synergy #3 – Leveraging up the balance through a higher loan-to-deposit ratio

Although there is no official regulatory cap to loan-to-deposit (LDR) issued by HKMA (aside from a Oct-2013 stable funding requirement for high loan growth banks), domestic Hong Kong banks all have tended to maintain a LDR ratio of c.65% to 75% over recent years.

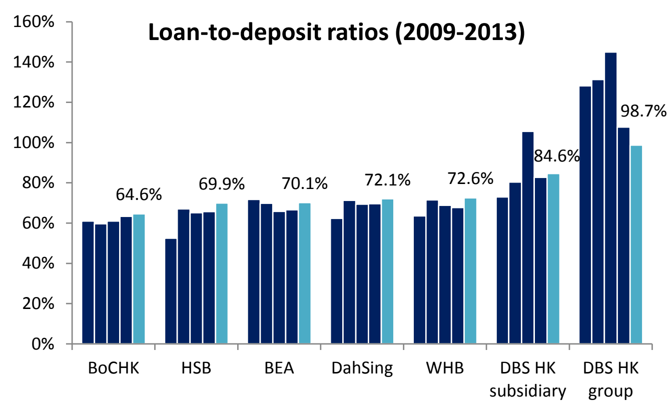
WHB had a 2013 LDR of 76%, but breaking this down into its component part HK$-only LDR was 97% (HK$ deposits were 59% of group), while non-HK$ (mainly USD, and some RMB) LDR was just 47%. While of course HKD and USD currencies are considered fungible, the upside is to leverage the non-HK$ deposit base.

Reverting to the DBS experience, the subsidiary DBS HK appears to have benefited by leveraging up its own balance sheet (FY2013 LDR was raised to 85% from 79% in FY2011). That number also understated the reality, since DBS Singapore would have booked a material amount of loans in its own HK branch entity, leveraging parent DBS' Singapore domestic deposit franchise through the swap market as well as utilizing wholesale USD funding for these HK/China-related loans.

We expect OCBC-WHB could replicate similar funding flexibility. WHB customer deposit by end-2013 was relatively small at HK$178bn (S$29bn), equivalent to 14% of OCBC's 2013 group deposits.

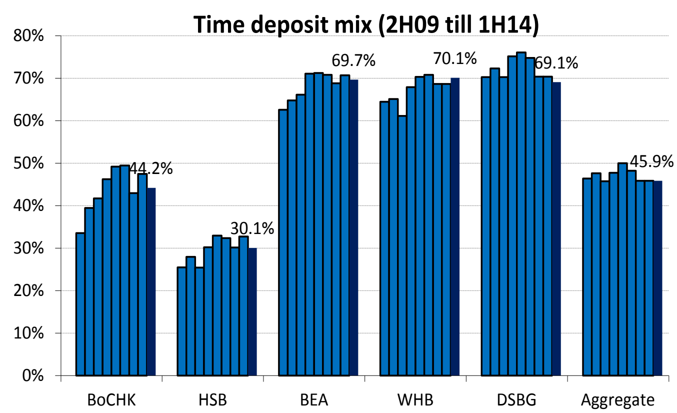
OCBC's strategic goals — "Provide network support to OCBC's customers expanding into Greater China with WHB's broad based branch coverage in the Pearl River Delta region and vice versa; Capture the increasing trade and investment flows between the core markets of Singapore, Malaysia, Indonesia and Greater China; Access USD and RMB customer deposits for OCBC group."

Figure 29. Hong Kong Banks' Loan to Deposit Ratios



Source: Companies, Citi Research

Figure 30. HK banks – time deposit mix (lower large-cap banks, high in mid-cap banks)



Source: Companies, Citi Research

Synergy #4 – capping funding and interbank cost on credit rating lift

The third interlinking factor underpinning our net interest income revenue synergy expectations relates to lowering WHB's absolute cost of funds.

As one of the smaller HK banks (Hong Kong branch network 42, vs. BOCHK 266 and HSB 220), WHB has lacked the distribution to build a leading low-cost deposit franchise, with typically two-thirds of its customer deposits from time deposits.

In July 2014, WHB was able to secure a long-term rating upgrade of two notches to A+ from Fitch, while by comparison OCBC enjoys a AA- long-term rating from S&P. Riding on an improved credit rating due to parent OCBC, WHB's average funding costs may not be as vulnerable to periods of liquidity tightness in the system and potentially better duration matching may also be achieved.

The funding benefit could be particularly noticeable in wholesale funding channels (such as CDs, senior debt, subordinated debt). As a reference, WHB's outstanding step-up perpetual subordinated notes issued on April-2007 bear a fixed rate of 6.0% until Apr-2017, and will turn floating at LIBOR plus 185bp thereafter. We would imagine that such a funding could be retired after the OCBC deal and refinanced with intra-group funding or lower cost new instrument issuances.

Credit rating improvement through OCBC could also benefit WHB's interbank businesses. As a single-A rated banks, and under standardized approach of credit risk weighting, financial institution counterparties shall have a 50% risk weighting on their exposure to WHB; but as an example such a rating could drop to only 20% if the rating can be improved to AA. This could offer incremental benefit to WHB's financial institutions counterparts, to improve interbank position pricing, increase interbank position limits, and to expand possible customer scope in HK/China.

The benefit of this funding strategy will enhance particularly when Hong Kong and Singapore exhibit differ level of liquidity tightness. HKD sector average funding costs averaged to 0.42% in 1H14, and we proxy HKD sector time deposit costs to average at 1.06%. In comparison, 3M SGD SIBOR remains around 0.4%, as typical counter rates for time deposits range from 0.05% to 0.25%.

Synergy #5 - Capital Management Synergy through IRB adoption

WHB reported 12% Tier 1 ratio at end-2013 using the standardized approach of credit risk assessment under Basel III, whereas larger Hong Kong and Singapore banks have already moved the Internal Rating Based approach of credit risk assessment. The standardized measure typically provides for a more punitive assessment of RWA, with WHB's 2013 RWA to total assets at 59%, somewhat higher than HSB or BOCHK with ratios at around 40%.

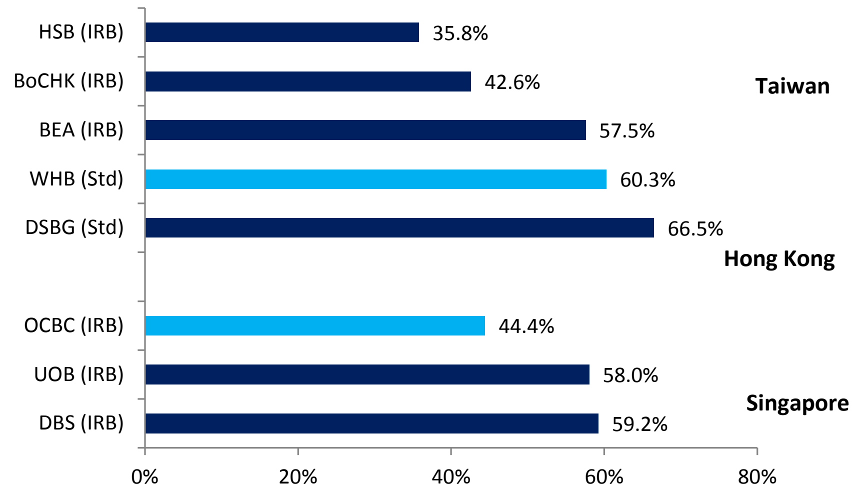
If WHB could migrate from standardized to IRB on RWA computation, there could be room for capital efficiency gains. As an example, the current standardized approach mandates a risk weight of 35% for mortgages; but floor risk weight under IRB is only at 15%. WHB had HK$23bn of mortgages in 2013, meaning a possible HK$4.6bn RWA saving and +0.5%pt impact to the Tier-1 ratio.

In a more blue-sky scenario, if WHB's RWA/assets could migrate from the existing c60% level down to the c43% level of a BOCHK, the Tier 1 ratio could improve substantially by c4.4ppt, to 16.4%, releasing a Common Equity Tier-1 surplus above a 12% ratio of close to HK$4bn (S$665m). WHB mgmt. suggest that a realistic tier-1 ratio improve may be around 1%pt.

In practical terms the migration of WHB from standardized Basel 3 to advanced IRB will take time. OCBC mgmt. indicated that it would take at least six months to ensure the bank's data is at a level that meets the requirements for A-IRB, and from there the regulators would require a further one year of data run parallel before A-IRB can be recognized. Thus, in total this benefit is probably 18 months to 2 years away.

We have not explicitly assigned an earnings synergy estimate to a potential capital management plan but we recognize that this would effectively reduce the effective price that OCBC paid for WHB.

Figure 31. RWA as % total assets (2013)



Source: Citi Research *data for WHB was based on 2012 due to lack of disclosure, all other banks based on 2013 Basel III capital standards

Why we have de-prioritized cost synergies?

We have not built in explicit cost synergies into our projections and rather have focused primarily on revenue synergies. We have done this for three main reasons:

- OCBC has made a commitment to WHB as part of the deal as follows: “Wing Hang’s management and staff are valuable additions to OCBC Group. We intend to reinforce the strong existing management and staff force with experts in specific areas such as wealth management and treasury. We also intend to retain all staff with no redundancies in the near term.” This suggests that cost synergies are not the most immediate priority for OCBC.

- Any incremental cost synergies will largely be mitigated near term by costs relating to the integration, where OCBC put an initial estimate of S$40-50m. OCBC has also committed to make further progressive investments in systems, channels, product capabilities, and also people (through training and development).

- Our initial assessment of WHB based on a peer group comparison is that WHB already operates a relatively lean cost base despite being considerably smaller in scale than some of its peers. Thus we suspect the mode of operation will be to contain cost growth rather than seek major cost cuts.

DBS Hong Kong 2010-2013: a qualified success

The "dual-entity" strategy that we expect OCBC to adopt to extract value from the WHB deal is not dissimilar to approach that DBS has used to capture China growth from 2010 with its DBS HK subsidiary and HK branch. Arguably the overall strategy has been a success; the total HK geography of DBS has seen profits double from HK$2.5bn in 2009 to HK$5.3bn in 2013, and an estimated HK$5.8bn on annualized 1H14 results. In ROA terms Hong Kong is the most profitable geography in the DBS group at 1.39% for 2013 and 1.46% for 1H14. But we qualify this success by pointing out certain business model weaknesses in the HK model.

Figure 32. DBS—Re-Positioning Hong Kong (see Note [1])

Subject	Comments
China mega trends and DBS' strategic priorities	DBS is working on a Greater China strategy including Hong Kong, Taiwan and China. While business will be conducted based on the realities of each region, the goal will be to capture the "mega trends" relating to capital flows in the region and internationalization of Chinese companies.
China-led loan growth	An inherently mature Hong Kong has turned into a growth market because of mainland China. In the near term Hong Kong is benefitting from the lending quotas being imposed on the mainland, but more structurally Hong Kong will play its role in the internationalization of China as Chinese companies go global and the internationalization of the RMB. In 2010, a combination of China loan quotas and tightening reserve requirement ratios helped HK experience one of its strongest periods of offshore loan growth in its history. Overall HK system loan growth reached 29% in 2010. DBS HK loans grew a slower 19%, in large part because it chose to curb the growth of its consumer (particularly low yield HIBOR-pegged mortgage) book. DBS HK expects loan growth to be strong in 2011, with YTD Feb loan volumes already well ahead of target.
But near-term funding constraints	This is an issue that DBS needs to address in both China and Hong Kong. Although Hong Kong is liquid (system LDR c.65%), the large banks hold the bulk of the liquidity, and the dramatic rise in loan demand from China has put upward pressure on both deposit and lending rates. DBS HK has a large branch network that it needs to use to capture funds. Currently DBS HK has an approximate 5% loan market share but only 2-3% deposit share (HK%-only LDR 79%, overall LDR including corporate lending (booked under the HK branch of DBS Singapore) closer to 99%). DBS plans to raise the quality of funding, focusing on institutional current accounts and retail savings accounts. There is greater focus on improving funding products, including building the brand, product development, aligning KPIs all the way down to the branch level, integrating alternative distribution channels and revising sales processes. Management estimates that roughly 31m mainland Chinese go to Hong Kong each year, of which c.6m will establish new current accounts, suggesting ample room from organic growth without having to wrest market share away from incumbents. DBS HK added HS$3bn in incremental savings accounts from Nov 2010 to Feb 2011. China requires its banks to achieve a 75% LDR by end 2011, which DBS is well on the way to being able to achieve. DBS has raised brand awareness through advertising in China, key to improving funding.
Moving into higher margin SME lending	While DBS is historically strong in the traditional SME space, it plans to move into the "sub-SME" segment (akin to "community", "sole proprietor" or "small partnership" business lending, but remains a segment above pure microfinance lending) which requires a departure from the individual credit assessment approach of a regular SME to loan book that is managed on a portfolio basis. This approach requires more granular management of the business and using a scorecard process, and generally will be of a higher risk profile. DBS will be able to mitigate the risk of such lending as it has a detailed 10 year SME history in Hong Kong, which will enable it to determine loss norms. Management estimates that the sub-SME loan space could earn gross spreads that are 100bps higher than normal SME loans, but the loss norms could be 30-40bps higher (net benefit 60bps). This should accelerate growth of SME lending in Hong Kong and eventually the model can be exported into mainland China. DBS is finalizing a lending model and end-to-end process to enter this sub-SME space. DBS HK's current loan mix of corporate loans HK$88bn (40%), commercial/SME HK$81bn (36%), and consumer HK$59bn (26%), the mortgage portion (c.HK$50bn) of which earns a mere 70bps spread having increasingly migrated to HIBOR-priced loans.
Fee strategy — focusing on core competencies	Focus will be on DBS HK's key strengths of SME, wealth management (affluent consumer) and its robust treasury capability. In contrast the HK credit card market was flat, with the business migrating into unsecured consumer lending. Capital markets had a good year in 2010 helped by a major insurance company listing. The fee contribution from RMB business is still small but could take off in coming years.
The offshore RMB opportunity	DBS HK wants to be an important player in this space. In future this could be a strong source of fee business, especially in treasury (interest rate swaps, foreign exchange, derivatives, NDFs), where DBS views that it has superior capabilities. On the wealth management side, the market is beginning to see insurance products denominated in RMB, and the ability to invest in RMB bonds. For trade flows most banks are fairly equally positioned (DBS has an estimated 4-5% market share). For now due to limited lending/asset opportunities, RMB deposits (which currently pay around 80-100bps) are largely placed at Bank of China HK at 86bps, meaning that these deposits are barely break even. The market is waiting for asset-side products to be developed (such as DCM products) to utilize the funds.
Costs likely to rise	2010 cost-income ratio of 49% was impacted by the one-time charge for "Constellation" structured product notes. Normalized cost-income ratio is around 44%. Generally expenses are expected to rise due to rising staff costs and investment in technology. Hong Kong has an adequate branch network but mainland China needs more investment to expand, in both network and people. Depending on the revenue dynamics cost income ratio could range around 45-48% going forward
Overall financial objectives	Management views that current returns are "sub-par" and want to improve the profit growth and overall returns of DBS Hong Kong. DBS HK's CEO has set a target ROE of between 12% and 15% (an ROAA target of 1.3-1.4%). Management does not envision needing fresh capital to drive its growth plans over the next 3-5 years, as sufficient internally generated capital (through net profit) will be generated despite the move toward sub-SME lending being higher risk weighted assets versus mortgages.

Source: Citi Research Note [1]: Extracted from 7 March 2011 report "DBS—Re-Energizing Hong Kong", our meeting with DBS HK CEO Sebastian Parades

The view back in 2010 — re-positioning DBS HK

The 2001 acquisition of Dao Heng Bank for S$10bn (3.2x P/B) endured a difficult first few years, as subsequent financials incorporated c.S$3.4bn of goodwill amortization and impairment charges, with Hong Kong's contribution to DBS group earnings falling from 31% in 3Q2001 to 9% in 2Q2010. "Re-positioning Hong Kong" has been a key focus of DBS' strategic refresh since 2010, when DBS HK CEO Sebastian Parades was appointed. In March 2011, Mr. Parades met with analysts to share his thoughts on the HK-China opportunity and his vision for reviving DBS HK's ROA to 1.3-1.4%, purely from organic growth and franchise re-positioning without having to raise any new capital, which we summarize in Figure 32. DBS—Re-Positioning Hong Kong (see Note [1]). In addition to the CEO's commentaries, we observed that in subsequent years DBS has gradually exited the mass-market HK retail business (most notably ceding share in the highly competitive mortgage business), rationalized its domestic distribution (2013: 50 branches), and repositioned that network to target affluent wealth space, as well as improve customer segmentation (especially in mid-cap and SME space) for more targeted product offerings.

How the HK strategy has played out in 2013-4

We recently met with mgmt. of DBS Hong Kong to get a sense of how the Hong Kong operation is performing and how the 2010 business strategy has played out.

Overview — DBS Group Singapore manages its total Hong Kong banking business as one geography, even though there are two key business units, namely the DBS Hong Kong subsidiary ("DBS HK") and the HK branch of DBS Singapore ("HK branch") (there are some other small entities such as DBS Vickers but this is small). By balance sheet and P&L, the subsidiary DBS HK accounts for about two-thirds of the total HK economics and the HK branch roughly one-third. DBS HK houses the retail consumer banking group, as well as SME and small SMEs for the institutional banking group, while HK branch largely focuses on top-tier corporate business. DBS HK reports in Hong Kong GAAP, while the overall Hong Kong geography reports under Singapore GAAP, a key difference being more conservative provisioning standards at the Singapore level.

Loans & funding — Overall HK geography loan book is 80-90% HKD-USD — hence RMB loans and funding is not very large. HKD-ccy LDR is also close to 100%. DBS HK has a CASA ratio of about 39%. DBS HK loan growth has been more toward SMEs, and based on loan analysis since 2012 has been dominated by trade finance. This may not be surprising, as DBS has strong GTS expertise and in recent years the demand for trade has been very strong, although in the last six months there has been increase demand for corporate (term) loans. DBS HK has been trying to downsize its mortgage book over recent years, but at around HK$28bn (15% of total loans) is starting to plateau. On SMEs, there has been stronger growth in "mini SME" segment.

LDR — DBS HK has to comply with HKMA regulations, and while HK branch numbers are also reported to HKMA, there is a greater degree of regulatory freedom for the branch. As an example, DBS HK as of June 2014 maintained a LDR of 80% including trade bills (65% excluding trade bills, which HKMA monitors) while at the overall HK geography the business is run at close to 100% LDR, implying HK branch can run up to 120%-140% LDR (this is funded cross border likely in USD using DBS Singapore funding and larger capital base).

NIMs — HK geography NIM was 1.53% in 1H14 and has been in the 1.4% to 1.55% for the past 2-3 years. This is surprisingly lower than other mid-sized banks which run weaker CASA ratios (DSB 24%, WHB 30%) and lower LDRs (DSB 70%, WHB 74%). Thus we suspect that DBS HK will have a relatively low benefit from rising

HIBOR and possibly a slight negative impact when domestic deposit funding tightens due to (for example) funding competition pick-up from the HK-based Chinese banks. This is also despite DBS initiatives to grow sticky funding through cash mgmt. and DBS HK benefiting from its parent's AA- credit rating.

Fees/Non-II — Non-II-ROAA at the HK geography is an industry-leading 1.30% and for DBS HK only 1.16%. Analysis at the DBS HK level shows fees dominated by wealth mgmt. and trade fees, and to a lesser extent loan fees and cards, but the entire net fee income is almost equaled by strong foreign exchange/dealing income. Thus while non-II is the key standout of HK ROAA strength, it appears to have a relatively narrow focus that depends on RMB volatility and trade finance demand (in contrast, the wealth mgmt. part is arguably a more sustainable business).

Network — As of Dec 2013, DBS HK has 50 branches and 66 ATMs in Hong Kong (reduced from well over 100 branches in the Dao Heng days), with several branches set up as either wealth mgmt. or SME centers. HK geography CTI ratio is 39% due to strong fee-non-II performance, cost-AA 1.13%. but for DBS HK CTI ratio higher at 46% and cost-AA higher than peers at 1.22%. Mgmt. notes that the bank is still in investment mode, notably in digitalization, suggesting that cost ratios are not likely to fall soon.

Credit costs — HK geography 2013 credit costs 28bps; mgmt. guided that current SPs about 13bps. This remains a low level versus an 8-10 year history of the credit cycle, suggesting negative earnings risk if and when the credit cycle normalizes.

Capital efficiency — DBS HK 1H14 CET1 ratio 14.2% and CAR 16.3%. Despite being on IRB, 2013 RWA to total assets we estimate at close to 70%, which surprisingly high and in line with or possibly higher than mid-sized banks that operate on standardized B3. DBS is looking at RWA optimization.

DBS' Hong Kong profits up sharply on cross-border China growth

Figure 33. Hong Kong Earnings of DBS— 4-yr profit CAGR +20%

	2008	2009	2010	2011	2012	2013	2009-13 % CAGR
HK Geography (S$ m) [1]							
Net Profit	390	464	579	571	716	851	16.4%
ROAA	**0.80%**	**1.01%**	**1.16%**	**0.98%**	**1.19%**	**1.39%**	
Avg Assets	48,484	45,886	50,071	58,179	60,223	61,180	7.5%
SGDHKD	5.51	5.34	5.71	6.20	6.21	6.20	
HK Geography (HK$ m)							
Net Profit	2,149	2,477	3,304	3,538	4,446	5,277	20.8%
ROAA	**0.80%**	**1.01%**	**1.16%**	**0.98%**	**1.19%**	**1.39%**	
Avg Assets	267,188	244,917	285,730	360,436	373,949	379,359	11.6%
DBS HK (HK$ m)							
Net Profit	1,829	2,391	2,444	2,607	3,227	3,524	10.2%
ROAA	**0.81%**	**1.08%**	**1.03%**	**0.99%**	**1.14%**	**1.19%**	
Avg Assets	224,777	221,543	236,739	263,276	282,321	297,086	7.6%
Profit % of Total HK Geography	**85.1%**	**96.6%**	**74.0%**	**73.7%**	**72.6%**	**66.8%**	
Assets % of Total HK Geography	84.1%	90.5%	82.9%	73.0%	75.5%	78.3%	
HK Branch of DBS (HK$ m)							
Net Profit		85	860	931	1,219	1,753	113.0%
Avg Assets		23,374	48,991	97,161	91,628	82,273	37.0%
Profit % of Total HK Geography		**3.4%**	**26.0%**	**26.3%**	**27.4%**	**33.2%**	
Assets % of Total HK Geography		9.5%	17.1%	27.0%	24.5%	21.7%	

Note: [1] DBS Total HK Geography aggregates DBS HK 100%-owned subsidiary (the former Dao Heng Bank) and the HK branch of DBS Singapore Source: Citi Research

Comparing 2013 to 2009, at the bottom line DBS appeared to have made considerable progress, DBS HK enjoying a strong profit pick up as the benefits of capturing China internationalization flows came in.

Total HK geography — At the DBS Group level, the total HK geography profit (which aggregates the DBS HK subsidiary + the HK operations of DBS Singapore) has more than doubled from HK$2.5bn in 2009 to c.HK$5.3bn in 2013. Total HK geography contributed 22.7% of group earnings for 2009; this had risen to 24% by 2013, but if we exclude the impact of HKD depreciation vs. SGD, that portion might have been as high as 28% in 2013.

In terms of profitability, ROA for Hong Kong has improved from just 1% in 2009 (which would be fairly similar to the performance of other HK banks in the peer group) to around 1.4% ROA in 2013, making DBS HK one of the highest ROA banks in Hong Kong and also (in ROA terms) the most profitable geography in the DBS group (2013: Singapore ROA 0.92%, SE Asia 1.19%, Gtr. China 0.23%).

DBS HK subsidiary — 2013 profit of HK$3.5bn is 47% higher than the HK$2.4bn profit of 2009, and ROA has improved from 1.08% to 1.19%. At the revenue level, about 60% of that improvement has been driven be fees/non-II (wealth mgmt, trade and treasury/FX key drivers) with the remainder being top-line NII growth.

HK branch of DBS Singapore — We have estimated how much the HK branch of DBS Singapore by deducting DBS HK results from the HK$ equivalent value of total HK geography. From apparently minimal profits in 2009 (just HK$85m), thanks to the China cross-border business, the HK branch profits accelerated to HK$1.75bn by 2013. Over that period, the HK branch contribution to total HK profit has risen from 3% to 33% of the total (DBS HK subsidiary from 97% to 67%). At the revenue level, more than 70% of the change came from top-line NII growth and <30% from fees/non-II growth.

DBS' overall HK geography combines the results of DBS HK (former Dao Heng), which is still more retail and SME focused, plus the HK branch of DBS Singapore (corporate and markets focused) — not dissimilar to the likely distinction that will be made between OCBC-WHB and OCBC's HK branch operations. Thus, this provides a useful guide as to how OCBC' Hong Kong strategy could play out.

A qualified success — Although DBS has clearly shown impressive bottom-line profit improvement in Hong Kong, looking at DBS' results in more detail leads us to view this as a more qualified success — we make the following observations:

- **Corporate loan growth probably booked in HK branch of DBS Singapore —** The divergence in asset base size between DBS HK and total HK geography shows the rapid growth in the corporate business, probably driven by DBS' China onshore-offshore strategy and booked in the HK branch. From being close to equal in size in 2009, average assets CAGR from end-2009 to end-2013 for DBS HK is 8% compared to 12% for total HK geography (in HK$ terms), suggesting that non-DBS HK average asset growth reached a four-year CAGR of 37%.
- **DBS HK subsidiary deposit franchise remains a potential weak spot —** We note that DBS HK's ROA profitability in 2013 (1.19%) has moved ahead of peer Wing Hang Bank (2013: 1.06%) but still similar to much smaller Dah Sing Bank (1.18%), which is approximately half the assets size of DBS HK. At the revenue level, however, DBS HK 2013 NII ROA at 1.49% is somewhat lower than WHB (1.62%) and DSB (1.73%). This suggests to us that the DBS HK loan and (more likely) deposit franchise, especially for domestic HK, remains a relatively weak part of the franchise. We note that the 2013 NIM of DBS' HK operation of 1.56% remains well below that of mid-cap bank peers (WHB: 1.71%, DSB: 1.79%) despite a higher LDR of 85% (WHB, DSB: 76%) and implied funding support from parent DBS. The higher LDR and possibly weaker funding franchise also suggests that DBS HK would see far less earnings leverage to a rise in HIBOR versus peer banks.

- **Fees (wealth, trade), other non-II (FX) have been major profit drivers —** The more material DBS HK earnings differentiator therefore lies in fees/non-II, where at 1.26% ROAA for 2013 annualized DBS HK profitability has surged to over two times that of its two peers (WHB: 0.47%, DSB: 0.63%). A review of 2013 versus 2010 DBS HK results highlights strong fees growth in wealth mgmt. and trade/ transaction services, and a sharp jump in treasury/foreign exchange income.
- **DBS HK not as cost efficient as HK bank peers —** The strong overall revenue growth has been partly mitigated by DBS HK having a higher cost ROA base (1.27%) than some of its more "cost efficient" HK bank peers (WHB: 1.09%, DSB: 1.13%), DSB and WHB being only 54% and 66%, respectively, of the assets size of DBS HK, which has roughly half the asset base of DBS HK. Despite admirable attempts to "right-size" the domestic retail bank platform in recent years we could argue that more might be done on the cost-efficiency front.

Conclusions — We conclude from this brief analysis that DBS' HK operation has indeed shown significant ROA profitability improvement since the re-positioning strategy began during 2010; however, the improvement in franchise profitability is by no means broad-based. The main engine of profit growth has been in the fees and non-II lines (wealth mgmt, trade/transactions, and FX income stand out). Where the improvement is less clear is in DBS's domestic deposit franchise; and NII growth has been driven by strong volume growth (we caveat that by acknowledging that NII growth has been better at the HK branch of DBS Singapore) but NIM improvement has been minimal and NIMs are still lower than smaller peer banks. Additionally, DBS HK's cost base does not appear to be as efficient as some of its peers.

These are important points in deeming the DBS HK franchise profit rise a *qualified* success. To be able to continue the strong profitability requires DBS to continue to be able to capture the strong cross-border fee and non-II flow businesses, and less directly dependent on the underlying deposit franchise strength and efficiency of the DBS HK operation. Profits are thus arguably more vulnerable to a marked slowdown in key flows businesses.

HK banks — forecasting 9-12% PPOP growth in 2015E

To round off our detailed analysis of the prospects for OCBC-WHB, we have compiled an ROA decomposition of selected listed mid/small-sized peer Hong Kong banks, including Hang Seng Bank (HSB), BOCHK, Bank of East Asia (BEA), Dah Sing Banking Group (DSB) as a peer group to WHB, using 2010 and 2013 performance for comparison.

Figure 34. Hong Kong Banks ROA Decomposition — 2010 Versus 2013

	HSB	HSB	BOCHK	BOCHK	BEA	BEA	DSB	DSB	WHB	WHB	DBSHK	DBSHK	HK-DBS	HK-DBS
	FY10	FY13	FY10	FY13	FY10	FY13	FY10	FY13	FY10	FY13	FY10	FY13	FY10	FY13
Net interest income	**1.64**	**1.68**	**1.30**	**1.44**	**1.56**	**1.68**	**1.54**	**1.73**	**1.73**	**1.62**	**1.63**	**1.49**	**1.43**	**1.66**
Fees and comm.	0.56	0.53	0.49	0.46	0.61	0.55	0.30	0.43	0.44	0.32	1.21	1.26	1.25	1.38
Other non-int. inc.	0.30	0.32	0.12	0.18	0.13	0.15	0.07	0.20	-0.02	0.15				
Operating Income	**2.50**	**2.53**	**1.91**	**2.08**	**2.30**	**2.39**	**1.91**	**2.36**	**2.15**	**2.09**	**2.84**	**2.75**	**2.68**	**3.05**
Staff costs	-0.43	-0.40	-0.37	-0.35	-0.75	-0.75	-0.65	-0.75	-0.68	-0.66				
Other oper. exp.	-0.42	-0.42	-0.29	-0.27	-0.68	-0.58	-0.22	-0.38	-0.38	-0.42				
Operating Exp.	**-0.84**	**-0.82**	**-0.66**	**-0.62**	**-1.43**	**-1.33**	**-0.87**	**-1.13**	**-1.05**	**-1.09**	**-1.56**	**-1.27**	**-1.32**	**-1.17**
PPOP	**1.66**	**1.71**	**1.25**	**1.46**	**0.87**	**1.06**	**1.04**	**1.23**	**1.10**	**1.00**	**1.28**	**1.48**	**1.36**	**1.87**
Loan provision	-0.04	-0.05	0.00	-0.04	-0.06	-0.07	-0.08	-0.21	0.03	-0.04	-0.10	-0.10	-0.13	-0.23
Other provision	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00						
Profit after provision	1.61	1.66	1.26	1.42	0.81	0.99	0.97	1.02	1.14	0.96				
Exceptional	0.37	0.91	0.12	0.02	0.25	0.19	0.17	0.31	0.14	0.28				
Pre-tax profit	**1.99**	**2.57**	**1.37**	**1.43**	**1.06**	**1.17**	**1.14**	**1.33**	**1.27**	**1.24**	**1.18**	**1.39**	**1.23**	**1.64**
Tax	-0.28	-0.16	-0.21	-0.24	-0.17	-0.25	-0.15	-0.15	-0.21	-0.18	-0.15	-0.20	-0.17	-0.25
Net profit	**1.71**	**2.40**	**1.16**	**1.19**	**0.89**	**0.93**	**0.98**	**1.18**	**1.06**	**1.06**				
Minority interest	0.00	0.00	-0.03	-0.04	-0.02	-0.01	0.00	0.00	0.00	0.00				
ROA	**1.71**	**2.40**	**1.13**	**1.15**	**0.80**	**0.87**	**0.98**	**1.18**	**1.06**	**1.06**	**1.03**	**1.19**	**1.06**	**1.39**
Leverage	13.2x	11.1x	13.2x	12.5x	12.2x	12.0x	10.5x	10.0x	11.4x	10.0x				
ROE	**22.57**	**26.66**	**14.85**	**14.37**	**9.78**	**10.40**	**10.30**	**11.72**	**12.13**	**10.61**				
Net Interest Margin	1.78	1.89	1.49	1.68	1.76	1.90	1.68	1.79	1.84	1.71			1.60	1.56
NII as % oper. Inc.	65.5	66.3	68.1	69.2	67.8	70.5	80.6	73.3	80.2	77.6	57.3	54.2	53.4	54.5
Fee income as % oper. Inc.	22.4	21.0	25.6	22.2	26.4	23.1	16.0	18.4	20.6	15.4	42.7	45.8	46.6	45.5
Other non-II as % oper. Inc.	12.1	12.7	6.3	8.5	5.8	6.3	3.4	8.3	-0.8	7.0				
Cost-income ratio	33.7	32.4	34.5	30.0	62.1	55.5	45.4	47.9	48.8	52.0	54.9	46.1	49.1	38.5

DBS HK = DBS Hong Subsidiary (Former Dao Heng Bank)
HK-DBS = Total HK Geography of DBS
Source: Citi Research

For 2013 ROA, a cursory glance at WHB versus both larger and mid-sized peers highlights the banks' relative strengths and vulnerabilities. Despite (like other small banks) having a higher cost of funds due to low a CASA ratio, a higher-yielding SME loan mix means that WHB is not disadvantaged vs peers on NIMs. Fees/non-II is a key ROA weakness; WHB does not have a large wealth mgmt. platform and fees still rely more on traditional loan and credit card fees. Like small banks dealing/treasury income is also low. WHB's cost ROA compare favorably with smaller banks, suggesting that its higher cost-to-income ratio is more an issue of needing to drive higher revenues through its network rather than having an overly heavy cost base. But overall estimated core ROA of 0.92% in 2013 (reported 1.06% includes exceptional items) is at the low end of the range versus HK bank peers.

Figure 35. Major Hong Kong Banks by Asset Size

2013 Data, HK$ m	HSBC	BOCHK	HSB	STAN	BEA	ICBC Asia	DBS HK	NCB	WLB	WHB
Assets	**4,304,451**	**2,046,936**	**1,143,730**	**1,024,232**	**753,954**	**569,800**	**308,659**	**280,384**	**217,186**	**214,376**
Net Profit	**53,286 [1]**	**22,252**	**26,678**	**11,375**	**6,283**	**5,257**	**3,524**	**2,829**	**2,597**	**2,187**
NIM (%)		1.68	1.89		1.90		1.56	1.83	1.58	1.71
ROA (%)		1.15	2.40	1.16	0.93	1.04	1.19	1.06	1.31	1.06
ROE (%)		14.4	26.7	22.3	10.4	12.5	11.5	9.1	14.1	10.6
CTI Ratio (%)	38	30	32	51	56	26	46	40	36	52
Branches										
- HK		266	220	84	105	56	50	42	43	42
- China		41	48		128			37	3	15
- Macau					5				1	13
ATMs				329			66			

[1] Estimate based on PBT less an assumed 15% tax

Source: Company Reports, Citi Research

Hong Kong Banks at a glance

Sector overview — forecasting 9-12% PPOP growth in 2015E

For domestic HK banks, our base case assumptions factored in c9-13% yoy PPOP growth for 2014-15E. Our assumptions reflect c10% growth in net interest income, driven by modest NIM expansion and mid-single-digit AIEA growth. We also factored in high-single to low double-digit levels of fee income growth. These generate in a low double-digit revenue growth, which is higher than our mid-to-high single-digit operating expense growth assumptions. On the flip side, we also estimate credit cost to bottom out from the existing historical lows and to normalize at c15-30bp in the mid-to-long term. In the bottom-line attributable profit basis, we expect c7-14% yoy growth for 2015E in the domestic HK banks.

Figure 36. HK banks 2014-15E P&L assumptions

Yoy % chg.	BoCHK		HSB		BEA		DSBG	
	2014E	2015E	2014E	2015E	2014E	2015E	2014E	2015E
Net interest income	16%	11%	9%	9%	7%	10%	8%	8%
Net fees and commissions	9%	9%	8%	8%	13%	9%	16%	9%
Other income	-31%	8%	13%	2%	35%	-11%	-42%	3%
Total operating income	**10%**	**11%**	**9%**	**8%**	**10%**	**8%**	**5%**	**8%**
Operating expenses	7%	8%	6%	7%	8%	8%	7%	7%
Pre-provision profit	**12%**	**12%**	**11%**	**8%**	**13%**	**9%**	**3%**	**9%**
Impairment charge	77%	40%	79%	28%	75%	18%	27%	-20%
Operating profit	**10%**	**11%**	**9%**	**7%**	**10%**	**8%**	**-2%**	**17%**
Exceptionals	-7%	39%	-96%	54%	-55%	-24%	-118%	0%
Associates	5%	5%	-29%	5%	-10%	6%	7%	8%
Pre-tax profit	**10%**	**11%**	**-27%**	**8%**	**4%**	**7%**	**6%**	**14%**
Tax	18%	7%	84%	8%	0%	8%	-6%	17%
Minority interests & others	-40%	5%	na	na	2%	2%	10%	10%
Attributable profit	**10%**	**12%**	**-34%**	**8%**	**5%**	**7%**	**8%**	**14%**

Source: Citi Research

Hang Seng Bank

HSB is the most profitable HK bank in ROA terms, based on a low-cost deposit franchise (with NIM upside to rate rises), wealth mgmt. (retail unit trusts and brokerage), and low cost base.

HSB delivers a core ROA of 1.45%-1.50% (15-16% ROE on 10.7x leverage). Key business model differentiators are [a] NII-AA 1.68%:Industry low cost of funds (driving high NIMs of 1.9%), CASA ratio c.66%, LDR 69%, meaning high leverage to eventual rate rises (deposit base 94% HKD/USD, RMB base small at 6% of deposits); [b] Non-II-AA 0.85%: Strong fees/non-II led by wealth mgmt. (retail investment funds), broking, credit cards, and forex/treasury; [c] Low cost base (CTI

ratio 32%, cost-AA 0.82%) with recent 2% head count reduction to keep cost growth at c.7%; [d] Credit costs 11bps in line with industry; [e] Capital base — Tier-1 ratio 11.8% (-2%pts hoh) low versus peers, due to fast RWA growth +11% RWA-assets 36% (IRB). Offsetting this, a disposal of the Industrial Bank stake could pro forma boost Tier-1 to over 15%, but such a disposal appears less likely until 2015-16E.

Bank of China HK

BOCHK is the only listed HK-sub. of a mainland bank, 37% share in offshore RMB (34% of deposits). It is a leader in brokerage and beneficiary of SH-HK Connect and has the lowest cost base.

BOCHK delivers an ROA of 1.17% (ROE 14.7% on 12.6x leverage). Key differentiators are [a] NII-AA 1.44%: Relatively low cost of funds for NIMs 1.74%, CASA ratio 50%, LDR 66%. BOCHK is a market leader in offshore RMB deposits, with an approximate 37% share (vs its 15% all currency market share). This probably gives BOCHK a c.40bps spread advantage in RMB deposit taking. It also positions BOCHK well for funding further RMB products growth such as FDI, syndicated loans, and equity IPOs. Syndicated loan re-pricing has started to move up and mortgage growth has picked up; [b] Non-II-AA 0.64%: Fees/non-II are driven by brokerage, cards, credit fees, and forex/treasury. The Shanghai-HK Stock Connect should help drive improved RMB banking opportunities and lift brokerage income; [c] Low cost base (CTI ratio 30%, cost-AA 0.62%), BAU cost growth c.9%; [d] Provisions-AA -0.04%: credit costs 8bps in line with the industry but coverage is relatively low at 47%. BOCHK's loan mix is 74% HK, 14% mainland originated from HK (although some of the strong 1H14 cross-border growth originated from Shanghai FTZ), 6% onshore mainland exposure (as BOCHK avoids direct competition with its parent), 5% other. Thus pure onshore exposure is low even though impaired loans ratio rose to 1.58%. [e] Capital base —Tier-1 ratio 11.8% lifted by RWA savings and conservative asset growth. RWA-assets 43% (IRB). 1H14 BV/S growth +6.3%.

Bank of East Asia

BEA is a corporate bank positioned to capture China-HK flows: 47% of loans is China, 42% HK. This lifts NIMs vs peers, drives corporate advisory and credit fees, but also could imply more credit risk.

BEA delivers an ROA of 0.93% (ROE 10.1% on 10.9x leverage). Key differentiators are [a] NII-AA 1.60%: high yield offset by markedly higher CoF. NIM fell sharply in 1H14 both in China (-24bps hoh, a reversal of the +35bps hoh in 2H13) and also HK (-14bps hoh to an estimated 1.55% on rising funding costs, perhaps due to higher use of longer-term non-deposit funding). Both China and HK loans growing at 8-9% in Jun-14. HK loan book 70% business, limited consumer growth; [b] Non-II-AA 0.70%. Fess/non-II driven by corporate advisory and credit fees (which should continue to be have strong growth trends as more China companies establish a presence in HK) but trade finance fee growth helped 1H14; [c] Highest cost base (CTI ratio 53%, cost-AA 1.26%) of peers (China CTI ratio 57%, HK CTI ratio 33%, others 125%), target to keep CTI ratio below 55%; [d] provisions-AA 8bps: credit costs 15bps in 1H14. Asset quality deterioration in China in mfg, wholesale & retail; [e] Capital base — Tier-1 ratio 12.2%, (some AT1), in 1H14 some RWA optimization. RWA-assets 56% still high vs large bank peers.

Dah Sing Bank

DSB is a profitable, well-run bank. Mainly a niche spread lender, although with a clear focus it has a better fee base than mid-sized peers. Rights issue in 2Q14 raised Tier-1 but will dilute ROE.

DSB delivers an ROA of 1.21% (ROE 11.6% on 9.6x leverage), but this will be diluted from 2H14 by the end-May HK$1.2bn/US$155m rights issue and tier-2 sub-debt issue (US$225m/HK$1.74bn). Key differentiators are [a] NII-AA 1.70%: NIM 1.79% on stable and relatively (for a mid-sized bank with a low CASA ratio) low CoF and some re-pricing of loans (loan mix 79% HK [46% resi. & comm. property), 9% China, 10% Macau). DSB will be a fairly healthy NIM and profit beneficiary of a rise in interest rates. Loan growth 6% (7% incl. trade bills). LDR 72%, CASA c.24%); [b] Non-II-AA 0.62%, commendable for a small bank. Fees/non-II relatively balanced between wealth mgmt. (incl brokerage) operating a "supermarket model," cards,

credit/trade fees, and forex/dealing; [c] Cost base fairly lean (CTI 50%, cost-AA 1.15%) and more a reflection of its small scale than cost inefficiency. 1H14 cost growth a touch high at +10% driven by staff cost. [d] provisions-AA 0.26%, credit costs 45bps, worst of all HK peers, and a key weakness of the 1H14 results. Overall NPL ratio 0.45%, cover 124%, but China NPL ratio up 60bps hoh to 2.18%, attributable to onshore (not cross-border) loan exposure; [e] Capital base — Tier-1 ratio 10.9% post rights issue (2H14 may be slightly higher as RWA growth for 2014 front loaded). RWA-assets 67% (standardized B3). Mgmt. doesn't want to do another major capital raising for next few years – but admits everything is a moving target on regulatory side (although any top up to Tier-1 is likely to be achieved through AT1); [f] Associate Bank of Chongqing (BoCQ, 80 branches in Chongqing) is a major driver of DSB profit at 30% of 1H14 pretax profit (adding a healthy 0.41% to PBT-AA). BOCQ had a HK IPO in late 2013.

Figure 37. Banks ROA key business model differentiators in brief

Bank	Comments and peer group relative rankings 1-5 (based on 2013 data unless stated)
Hang Seng Bank(HSB)	**ROA-ROE:** 2013 ROA 1.54% (#1 in peer group), ROE 17.1% on 11x asset-equity leverage. (Note: ex-Industrial Bank exceptional item) **NIM:** High NIM 1.89% (#2) on low cost of funds 0.59% (#1) and high 70% CASA ratio; hurt by low asset yields in current rates backdrop but highest NIM sensitivity to an eventual rise in HIBOR (low LDR of 69% with excess funds likely parked in HIOBR/LIBOR sensitive securities. **Loans:** About 45% of +9% 2013 loan growth from China, 38% from HK corporate and 17% from consumer. Funding: Deposit growth 6% in 2013. Composition 94% HKD, 6% in RMB (2013: HK$58bn). **Fee franchise:** Dominant in retail mutual funds, and strong dealing profits (in other income). Strong in stockbroking and credit cards (#2 to BOCHK) and good in trade & remittance & loans services (#3 to BOCHK and BEA). **Distribution:** Operates 220 outlets in HK and 48 in China Staff 9,856 (HK 8,001, mainland 1,855). HK customer base 3 million **Capital:** Low RWA-Assets 36% (#1), using A-IRB. Historically strong internal capital generator (supports estd. RWA growth of 15%), 2013 dividend payout around 60% for 4.5% to 5% yield.
Bank of China Hong Kong (BOCHK)	**ROA-ROE:** 2013 ROA 1.15% (#2 in peer group), ROE 14.4% on 12.5x asset-equity leverage **NIM:** Lower NIM (1.68%) versus larger peers, despite low cost of funds (0.65%, #2 after HSB), thus due to an industry low asset yield (2.24%) and low LDR (65%). Enjoys 40bps wider margin v. peers on RMB deposit taking. High NIM sensitivity to rising HIBOR (#2 to HSB). **Loans:** Leader in cross-border corporate banking services with corporate 65% of total HK domestic loans. Strong RMB deposit base means BOCHK is well positioned for opportunities in RMB foreign direct investment, syndicated loans or a facility provider for RMB IPOs. **Funding:** Good CASA ratio (56%). Largest RMB deposit base (roughly 37% market share). **Fee franchise:** Dominant in stock broking, credit cards. Very strong in loan fees (along with BEA). Strong in insurance distribution. Growing in retail mutual funds. **Distribution:** Operates 266 outlets in HK and 41 in China **Capital:** Historically strong internal capital generator vs RWA growth. Historic dividend payout \62% but in 2013 cut to 48% for 4.2% yield.
Bank of East Asia (BEA)	**ROA-ROE:** 2013 ROA 0.87% (#5 in peer group), ROE 10.4% on 12x asset-equity leverage. **NIM:** NIM 2013 1.90% (# 1 in peer group) with China NIM 2.29%. High cost of funds 1.95% (#5) reflects its China presence, as does it high asset yield 3.79% (#1). NIM & earnings sensitivity relatively low to a rise in HIBOR (LDR 76%, HK 93%, China 64%). **Loans:** About 47% of +16% loan growth from China, 47% from HK/other (wholesale, consumer) and X% from other **Funding:** Deposit growth 7% in 2013. Estd. composition 48% HKD, 48% China **Fee franchise:** key strength in corporate cross-sell, loans & trade services (half of all fees). Mid-small competitor in cards and stock broking. WM & private bank focus on wealthy mainland Chinese, plus HK affluent/MPF services. **Distribution:** CTI ratio 55%, cost-AA 1.33% (#5) Operates 240 outlets (105 in HK, 128 outlets in 42 cities in China, 5 outlets in Macau, 2 in Taiwan), 12,000 employees. **Capital:** CAR 15.9%. High RWA-Assets (56%, #3). Historical capital growth (equity +6-7%) sufficient to fund RWA growth of c.10%.
Dah Sing Bank (DSB)	**ROA-ROE:** 2013 ROA 1.1% (#4 in peer group), ROE 10.8% on 10x asset-equity leverage. **NIM:** NIM 1.79% (#3): reasonable cost of funds 1.08% (#3) despite 24% CASA ratio; and aided by higher asset yields (3.02%, #3), likely due to SME dominated loan portfolio. Relatively low NIM & earnings sensitivity to a rise in HIBOR (LDR 78%) and like other mid-caps more exposed to tightening in deposit funding. **Loans:** About 6% of +14% 2013 loan growth from China, 65% from HK (29% wholesale, 26% consumer) and 15% from Macau. **Funding:** Deposit growth 10% in 2013. Estd. composition 63% HKD, 11% USD, 15% in RMB (2013: HK$19bn). **Fee franchise:** Driven by cards, then mutual funds/stock broking, and loan fees. Growing insurance from small base. Other income largely FX dealing. Low fees/non-II ROA is the key weakness, although stronger than WHB. **Distribution:** CTI ratio 52%, cost ROAA 1.23% (#4). Operates 45 outlets in HK, 7 in China (in 6 cities) plus associate stake in Bank of Chongqing (BOCQ – 17% stake after Nov-13 IPO), 14 branches in Macau (Banco Commercial Macau - BCM). **Capital:** High RWA-Assets 67% (#5) using standardized. CAR 14.5%, CET1 10.4%. Historical capital growth (equity +6-7%) barely sufficient to fund RWA growth of c.11-12%. DSB and DSF announced in March a HK$1.2bn rights issue
Wing Hang Bank (WHB)	**ROA-ROE:** 2013 ROA 1.06% (#3 in peer group), ROE 11.0% on 10x asset-equity leverage. Core net profit ROA ex-one-off divestment gains closer to 0.81%. (#5) **NIM:** NIM 1.70% (#4): high cost of funds 1.37% (#4) and 30% CASA ratio; but mitigated by higher asset yields (3.06%, #2), likely due to SME dominated loan portfolio. Relatively low NIM/earnings sensitivity to a rise in HIBOR (LDR 74%) and like other mid-caps more exposed to tightening in deposit funding. **Loans:** About 18% of +19% 2013 loan growth from China, 78% from HK and 13% from Macau. **Funding:** Deposit growth 7% in 2013. Estd. composition 59% HKD, 18% USD, 24% in RMB (2013: HK$42bn). **Fee franchise:** Driven by loan fees and cards, then stock broking. Growing insurance from small base. Other income largely FX dealing. Low fees/non-II ROA is the key weakness, although not out of line with other smaller banks. Most notable is a weak wealth mgmt. line **Distribution:** Operates 42 outlets in HK, 15 in China (12 in Guangdong) and 13 in Macau. Staff 3,446 (HK 2,165, mainland 804, Macau 477). Cost ROA significantly better than other small banks but of course lower than the larger names; this may therefore reflect a lack of revenue scale rather than a heavy cost base. **Capital:** High RWA-Assets 63% (#4), using standardized. 2013 dividend payout around 30%.

Source: Citi Research

China's Internationalization: Opportunities & Challenges

RMB internationalization — progress as of mid-2014

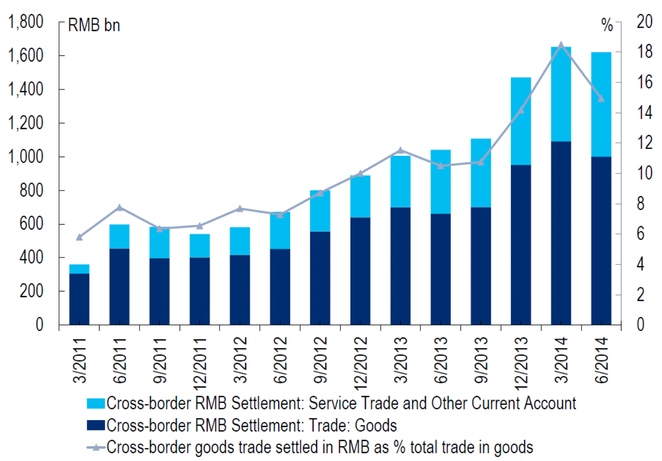
This section excerpts heavily from the report "China Macro View — RMB Internationalization: Progress and Prospects", by Shuang Ding and Minggao Shen, 28 August 2014.

Hong Kong remains the dominant market for China and RMB internationalization flows and offshore RMB liquidity, providing banking opportunities for cross-border loan growth, bond market issuance and fee-related businesses such as payments, foreign exchange, and trade finance. Competing international financial centers such as Taiwan and Singapore will also continue to develop and new centers (such as free trade zones in China) will be added.

RMB Internationalization latest data points

Trade settlement flows — The initial goal of the PBOC was to promote an international role for the RMB focused on trade settlement, due to China's increasingly important status in global trade and rising intra-Asian trade, and would enable Chinese companies to conduct trade in their own currency, eliminating currency risk. RMB internationalization gathered pace after the 2008-09 global financial crisis which highlighted the weakness of the international financial system when the availability of Dollars temporarily dried up, but another more recent phenomenon is the unconventional US monetary policies, which makes global financial conditions excessively lax from China's perspective. Trade in goods and services settled in RMB reached RMB3.3tr in 1H2014, of which RMB2.1tr was attributed to trade in goods, or 16.8% of China's total trade in goods. RMB payments exceeded RMB receipts by 66%.

Figure 38. Cross-Border Trade Settlement in RMB



Source: CEIC, Citi Research

Figure 39. Bilateral Local Currency Swap Agreements

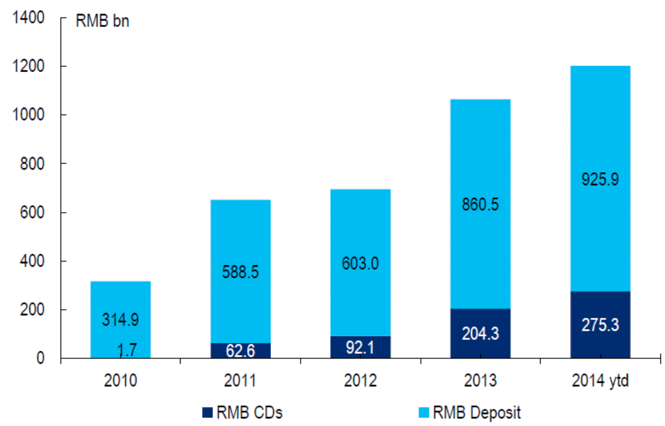
Country China vs.	Partner	Year started	Month	Amount (Rmb bn)	Tenors (Years)
	New Zealand	2011	Apr	25.0	3
	Uzbekistan	2011	Apr	0.7	3
	Kazakhstan	2011	Jun	7.0	3
	Korea	2011	Oct	360.0	3
	Hong Kong	2011	Nov	400.0	3
	Thailand	2011	Dec	70.0	3
	Pakistan	2011	Dec	10.0	3
	the United Arab Emirates	2012	Jan	35.0	3
	Malaysia	2012	Feb	180.0	3
	Turkey	2012	Feb	10.0	3
	Australia	2012	Mar	200.0	3
	Ukraine	2012	Jun	15.0	3
	Brazil	2013	Mar	190.0	3
	Singapore	2013	Mar	300.0	3
	England	2013	Jun	200.0	3
	Hungary	2013	Sep	10.0	3
	Iceland	2013	Sep	3.5	3
	Indonesia	2013	Oct	100.0	3
	ECB	2013	Oct	350.0	3
	Switzerland	2014	Jul	150.0	3
	Mongolia	2014	Aug	15.0	3

Source: PBOC, Citi Research

Bilateral swap lines — Originally intended to deal with potential fallout from financial crises, bilateral local currency swap lines with other countries can help to encourage the use of the RMB offshore by ensuring adequate RMB liquidity and reduce market volatility. To date, PBOC has signed bilateral swap lines (typically for renewable three-year terms) with central banks in 23 countries totaling over RMB2.5tr.

Offshore RMB (CNH) liquidity/deposits — Hong Kong continues to be the dominant market for offshore RMB liquidity. As of mid-2014, HK RMB deposits reached RM926bn (+33%yoy,12% of HK system deposits and c.60% of global offshore RMB deposits) with another RMB275bn in CDs. Other offshore RMB centers include Taiwan (RMB292bn, 19% of total), Singapore (RMB220bn, 14%, Luxembourg (RMB79bn, 5%), and London (RMB15bn, 1%).

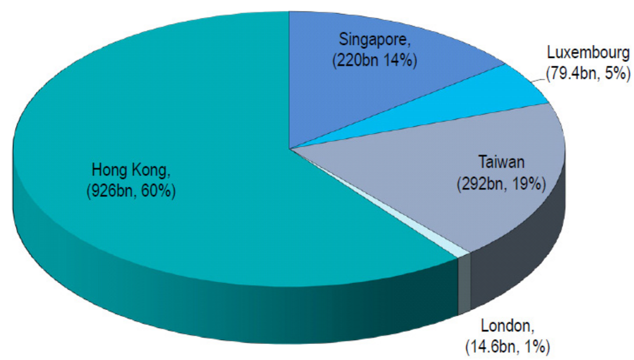
Figure 40. Hong Kong Offshore RMB Customer Deposits & CDs



*Deposit as of Jun 2014, CDs as of Jul 2014

Source: Thomson Reuters, Citi Research

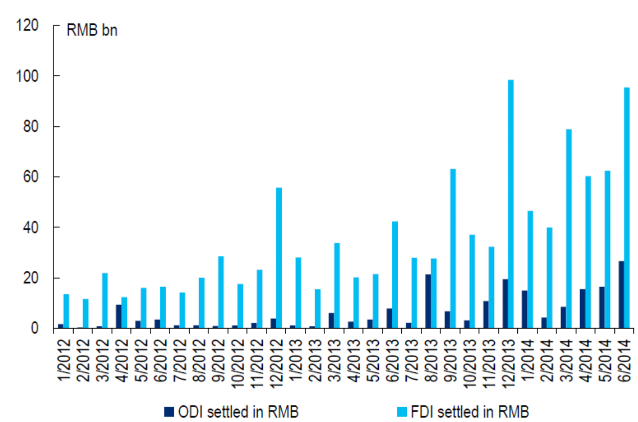
Figure 41. Offshore RMB Deposits at Key Global Centers



Source: Citi Research

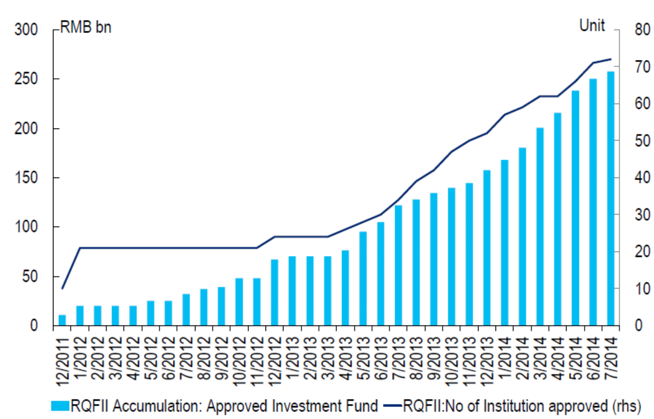
Direct and portfolio investment flows— RMB internationalization in the financial markets goes hand in hand with capital account liberalization, with selective easing of components of the capital account. Direct investment — foreign direct investment (FDI) inflows into China and outward direct investment (ODI) outflows from China — settled in RMB for 1H2014 reached RMB383bn for FDI and RMB87bn for ODI, respectively. For RMB portfolio investment, inflows into Chinese equities and bonds are controlled through R-QFII (RMB qualified foreign institutional investor) quotas governed by the State administration of Foreign Exchange (SAFE). Currently a total quota of RMB640bn has been assigned to six offshore centers, of which RMB279bn (c.US$46bn) has been approved for specific institutions (by comparison: Aug-2014 quota for QFII US$60bn, QDII US$82.5bn). Shanghai HK Stock Connect, to take effect Oct-2014, is set to allow total securities investment of RMB550bn, RM300bn into Shanghai (SSE) and RM250bn into HKEx.

Figure 42. FDI and ODI settled in RMB



Source: CEIC, Citi Research

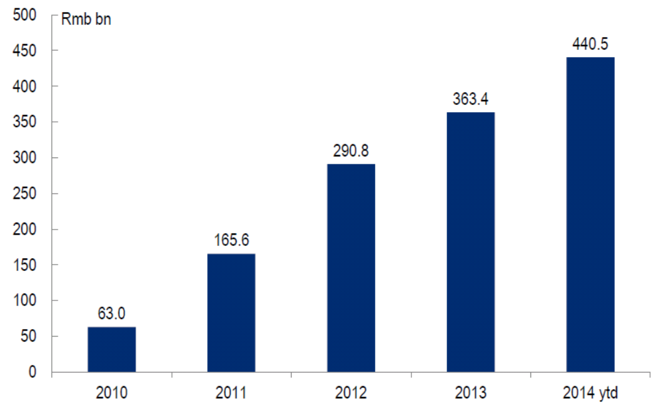
Figure 43. RQFII quotas approved for qualified institutions



Source: CSRC, Citi Research

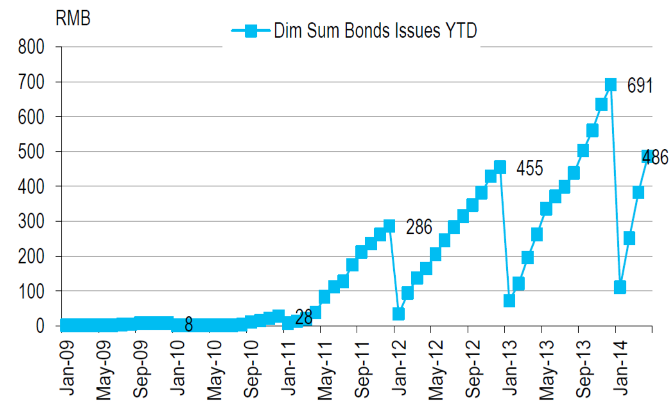
Loans and bonds— RMB assets in HK has developed more slowly than the growth in deposits. Although data is not regularly published, RMB-denominated loans in HK reached RMB123bn in Feb-2014, or less than 3% of total outstanding loans. Dim Sum bonds outstanding reached RMB440bn by July 2014. Panda bonds remain small, at RMB3.6bn by July 2014.

Figure 44. Dim Sum Bonds Outstanding, Jul-2014



Source: Thomson Reuters, Citi Research

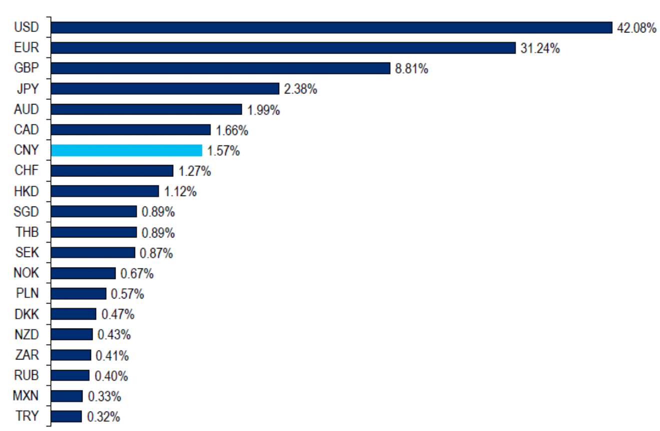
Figure 45. Dim Sum Bond Issuance



Source: CEIC, Citi Research

Payments and FX — Improved two-way flow between offshore and onshore markets has helped tighten the spread between CNY and CNH, reducing basis risk. This in turn has encouraged growing use of RMB for international payments and FX trading (whereas earlier in the development of offshore RMB, offshore treasury operations tended to operate in dollars, being developed, deep and liquid, which in turn enabled effective hedging of interest rate and other risks). According to SWIFT, over 1,050 financial institutions in over 90 countries are doing business in RMB, and the RMB is the seventh-most active currency for global payments, accounting for 1.57% of payments worldwide. A 2013 BIS survey estimated daily FX volume of RMB was US$120bn or 1.1% of the global total and ninth in the world. A number of countries are actively holding RMB assets as part of the FX reserves, due to close trading links with China and helped by bilateral swap agreements, preferential treatment in the QFII program, and ability to invest in China's interbank market, subject to quotas.

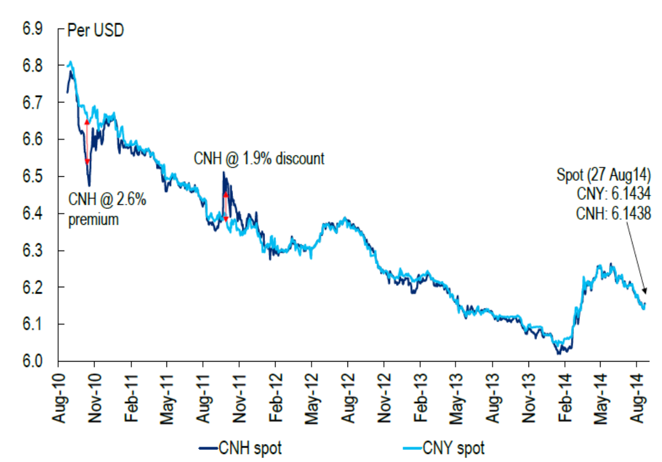
Figure 46. RMB as a Currency for Global Payments 1/



1/ Customer initiated and institutional payments. Inbound + Outbound traffic

Source: SWIFT, Citi Research

Figure 47. CNY vs. CNH



Source: CEIC, Citi Research

What's next for RMB internationalization?

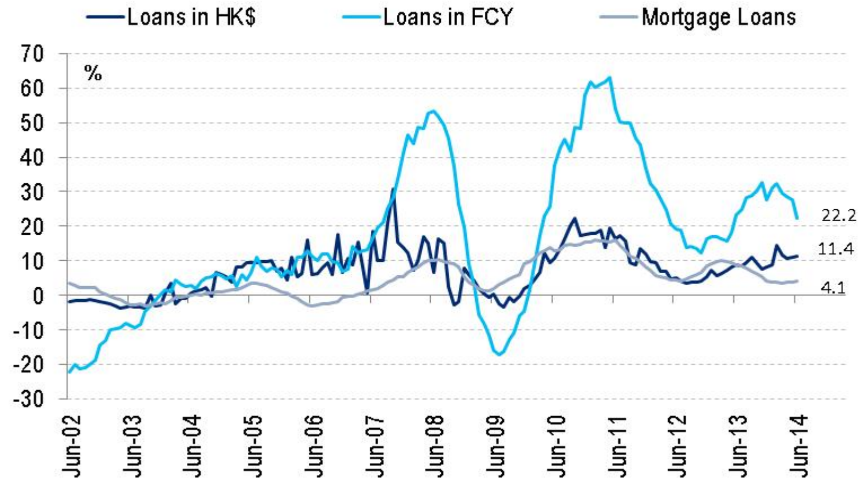
RMB as a reserve currency? — China is now the second-largest economy in the world, and already the largest trading nation with extensive trade linkages. China has had generally steady macroeconomic growth and policies. However, rapid credit expansion since 2009 has called into question the stability of China's financial system, which remains banks-dominated. Even with a widening of the trading band to ± 2% since Mar-2014, the exchange rate arguably lacks flexibility.

Full liberalization of the capital account? — Capital account controls remain extensive (there are 40 sub-items according to the IMF), despite higher convertibility in selected areas as discussed above. Full liberalization of the capital account may take another 5-10 years, prioritizing inflows over outflows, long-term flows over short-term flows, and direct investment over portfolio investment. Speculative flows may not be liberalized at all, for fear of destabilizing the economy and undermining monetary policy.

Onshore financial sector developments — Strengthening the onshore financial system is a necessary precursor to full capital account liberalization and RMB internationalization. This could include full interest rate liberalization within the next two to three years and further growth of the financial markets to exceed the size of the banking sector.

Capturing cross border loans/fee flows: key growth driver

Figure 48. HK System Loan Growth by Currency and Mortgage Growth



Source: HKMA, Citi Research

A table analyzing the change in composition of HKMA system loans data from June 2010 to June 2014 shows the significant impact that China's internationalization has had on Hong Kong's loan volumes in the past four years. Four key insights:

- The domestic HK$ loan market remains a mature one, averaging 10% loans growth over the four-year period (mortgages 8% four-year CAGR, more recently growth has slowed to +4%yoy).
- The growth in foreign currency loans outstanding has almost tripled in size over four years — but in a backdrop of RMB internationalization, this is not RMB-denominated loan growth, rather it is primarily in USD. Thus far, RMB-denominated loans remain a very small part of the pie.
- Breaking down FCY loan growth, close to 40% is for FCY loans used in Hong Kong, reflecting growth in funding demand over the past four years from mainland China (and related) companies that have set up operations in Hong Kong.
- It is this opportunity that provides the attraction to international banks to want have critical mass in Hong Kong, particularly the Singapore banks, whose superior credit ratings (equals access to cheaper USD funding) and larger capital bases provide them a competitive entry point.

Figure 49. Hong Kong System Loans Composition and Change June 2010 to June 2014

HKD mill.	Loans Total	Loans for Use in HK	Loans Use Outside HK	Loans in HK$	Retail Loans	Mortgage Loans	Loans in FCY	Loans in RMB [1]	Loans in USD [2]	Loans in FCY for Use in HK
Jun-10	3,772,531	2,971,098	801,433	2,620,076	966,507	679,545	1,152,454	0	1,152,454	351,022
Jun-14	7,073,679	5,040,550	2,033,130	3,889,193	1,398,088	934,078	3,184,486	154,980	3,029,506	1,151,357
Change	3,301,148	2,069,452	1,231,697	1,269,117	431,581	254,533	2,032,032	154,980	1,877,052	800,335
4-yr CAGR	**17%**	**14%**	**26%**	**10%**	**10%**	**8%**	**29%**		**27%**	**35%**

[1] RMB loans outstanding data is quoted infrequently. Latest data point Feb-2014 RMB123bn or c. HK$155bn.
[2] Derived number: assumes all FCY ex-RMB loans are denominated in USD, which is largely the case
Source: CEIC, Haver, HKMA, Citi Research

Despite the strong cross-border loan growth over the past four years there probably remains significant demand from mainland China companies for foreign currency loan credit through Hong Kong. To put this into a larger context, the HK$2 trillion growth in foreign currency loans in Hong Kong over the past four years represents less than 2% of the Jun-2014 loans outstanding in mainland China of RMB83 trillion.

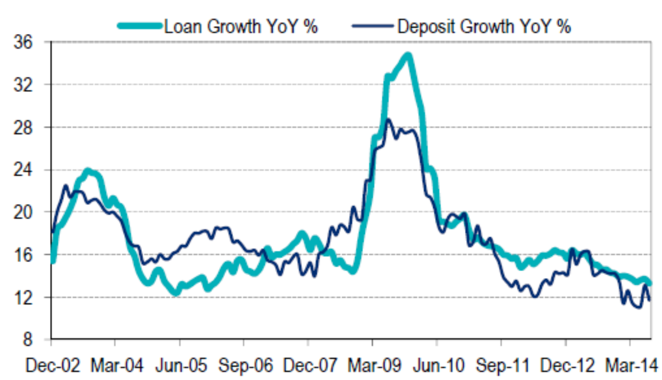
Figure 50. Mainland China Loan Trends and Composition

	Jul-13	Aug-13	Sep-13	Oct-13	Nov-13	Dec-13	Jan-14	Feb-14	Mar-14	Apr-14	May-14	Jun-14	Jul-14
Total Loans (Rmb'bn)	73,461	74,132	74,991	75,498	76,127	76,633	78,116	78,904	80,116	80,914	81,779	82,879	83,260
YoY Growth Rate (%)	*15.0*	*14.6*	*14.6*	*14.3*	*14.2*	*13.9*	*14.0*	*13.9*	*13.7*	*13.4*	*13.6*	*13.7*	*13.3*
MoM Growth Rate (%)	*0.8*	*0.9*	*1.2*	*0.7*	*0.8*	*0.7*	*1.9*	*1.0*	*1.5*	*1.0*	*1.1*	*1.3*	*0.5*
YTD Growth Rate (%)	*9.2*	*10.2*	*11.4*	*12.2*	*13.1*	*13.9*	*1.9*	*3.0*	*4.5*	*5.6*	*6.7*	*8.2*	*8.6*
MoM growth (Rmb'bn)	584	671	859	507	629	506	1,483	788	1,212	798	864	1,101	381
YTD growth (Rmb'bn)	6,174	6,845	7,703	8,210	8,839	9,345	1,483	2,272	3,483	4,281	5,146	6,247	6,628
RMB Loans (MoM Growth)													
Growth Amount (Rmb'bn)	699.7	712.8	787.0	506.0	624.6	482.4	1,319.0	644.8	1,049.7	774.5	870.8	1,079.3	385.2
Consumer loans	306.7	338.7	354.6	204.9	261.5	173.6	491.9	49.2	388.2	280.7	312.5	357.5	206.2
Short Term consumer loan	111.6	147.9	164.7	51.4	79.7	58.9	179.8	-74.6	195.4	90.6	110.4	158.5	25.9
Med./Long term cons. loan	195.1	190.8	184.1	153.5	181.8	114.7	312.1	123.8	192.8	190.1	202.1	199.1	180.3
Corporate loans	392.0	373.2	434.8	301.0	363.9	305.1	826.2	594.6	659.2	494.8	558.6	726.6	177.3
Short term corporate loan	228.4	146.4	335.2	214.8	240.7	324.5	358.8	316.3	258.3	56.8	35.6	354.2	-235.6
Medium/long term corp. loan	243.1	231.2	245.7	144.0	85.8	30.2	504.2	290.5	325.3	323.4	347.9	268.7	208.2
Bills financing	-103.8	-12.5	-152.7	-70.6	19.1	-48.4	-82.8	-33.6	40.8	86.0	154.5	78.3	172.6
Other corporate loan	24.3	8.1	6.6	12.8	18.3	-1.2	46.0	21.4	34.8	28.6	20.6	25.4	32.1

Source: CEIC, Citi Research

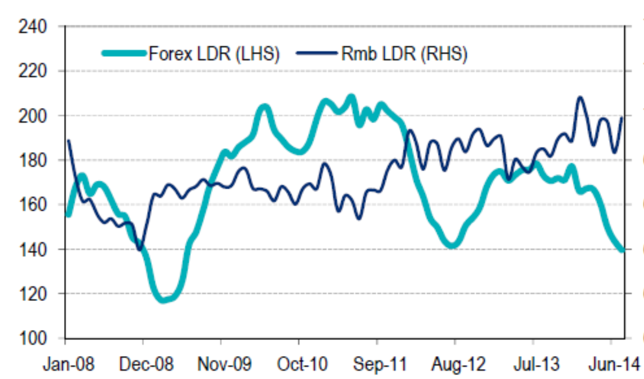
Mainland China loans growth continues to slow, constrained by both funding availability and M2 growth, and overall financing availability remains beholden to regulators' attempts to purge the excesses of off-balance sheet financing.

Figure 51. China — Loans +13.3% vs. Deposits +11.7% yoy July 2014



Source: CEIC, Citi Research

Figure 52. China — RMB LDR 69.9% July 2014



Source: CEIC, Citi Research

At the same time the attraction of borrowing in Hong Kong to arbitrage the wide cross-border lending rate differentials looks likely to remain for the foreseeable future (albeit on an assumption of continued appreciation of the RMB). Our prior analysis suggested that opportunities outweigh risks in this regard.

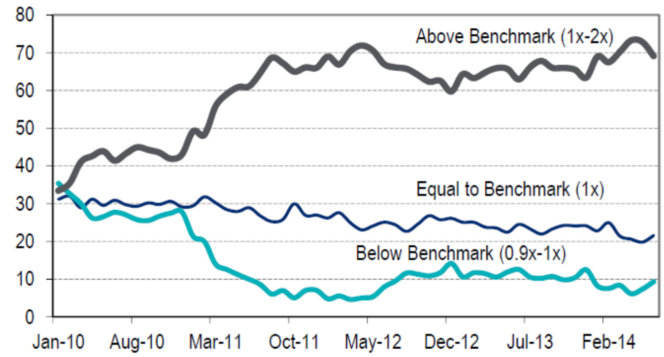
As an example of this, on current pricing China onshore prime lending rates are at 6% (adding a spread, the actual lending rate may be closer to 7%), while offshore loans denominated in USD are still probably priced around 2-2.5% (plus roughly another 30bps-50bps for hedging costs) still leaving a lending rate differential of 4-4.5%pts. Even several years forward, assuming USD rates rise 150bps, there is still an onshore-offshore lending rate spread of about 3%pts.

Figure 53. China — Onshore Lending and Deposit Rate Trends

	24 Oct 2010	26 Dec 2010	13 Feb 2011	10 Apr 2011	10 Jul 2011	10 Jun 2012	08 Jul 2012
Lending rates (%)							
6 month	5.10	5.35	5.60	5.85	6.10	5.85	5.60
1 year	5.56	5.81	6.06	6.31	6.56	6.31	6.00
1-3 year	5.60	5.85	6.10	6.40	6.65	6.40	6.15
3-5 year	5.96	6.22	6.45	6.65	6.90	6.65	6.40
Over 5 year	6.14	6.40	6.60	6.80	7.05	6.80	6.55
Deposit rates (%)							
Savings	0.36	0.36	0.40	0.50	0.50	0.40	0.35
3 month	1.91	2.25	2.60	2.85	3.10	2.85	2.60
6 month	2.20	2.50	2.80	3.05	3.30	3.05	2.80
1 year	2.50	2.75	3.00	3.25	3.50	3.25	3.00
2 year	3.25	3.55	3.90	4.15	4.40	4.10	3.75
3 year	3.85	4.15	4.50	4.75	5.00	4.65	4.25
5 year	4.20	4.55	5.00	5.25	5.50	5.10	4.75

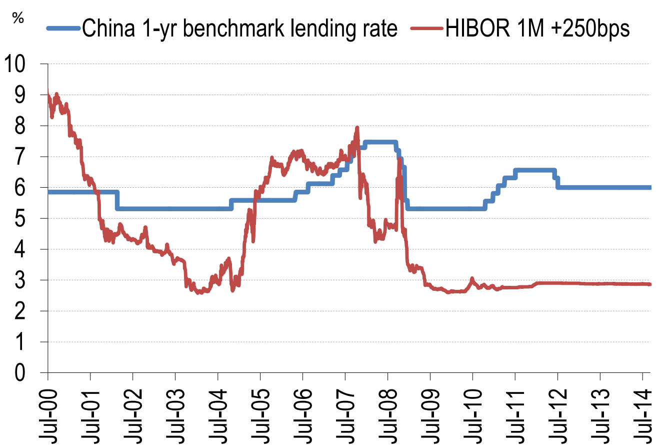
Source: Bloomberg, Citi Research

Figure 54. China — Distribution of Loan Pricing vs. Benchmark



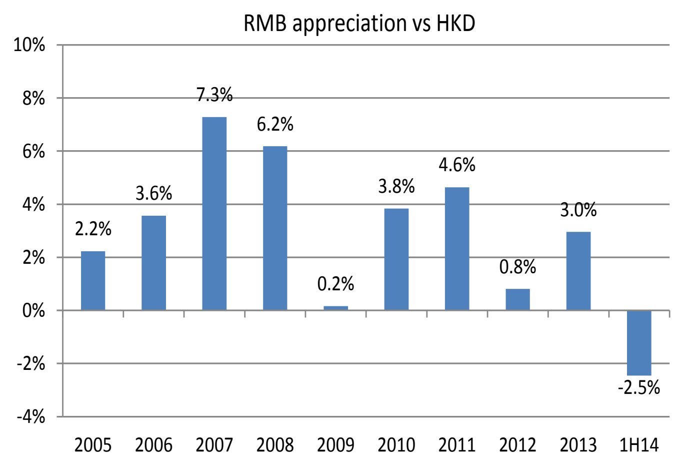
Source: CEIC, Citi Research

Figure 55. China vs Hong Kong lending rate gap



Source: Citi Research. DataStream *proxy via the difference between China RMB 1yr benchmark borrowing rate as compared with Hong Kong HKD borrowing rate estimate of HIBOR 1mth plus 250bp spread

Figure 56. RMB appreciation vs HKD or USD



Source: Citi Research

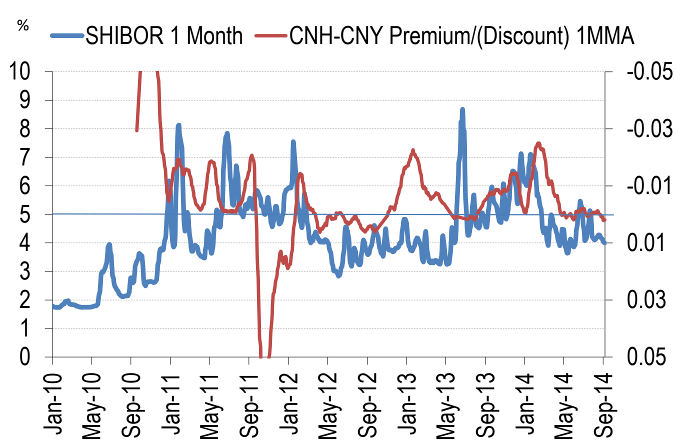
Figure 57. China — Loans Represent 63% of Total System Credit

Outstanding Balances (Rmb bn)	2008	2009	2010	2011	2012	2013	1Q14	2Q14
RMB & FX Loans	32,010	42,560	50,920	58,190	67,290	76,630	80,120	82,880
Trust Assets *	1,946	2,238	2,765	4,390	6,664	9,840	10,494	12,478
Corporate Bonds	1,483	2,680	3,965	5,327	7,623	9,446	9,958	10,880
Undiscounted BABs	1,211	1,965	4,115	4,955	5,922	6,697	7,256	7,484
Entrusted Loans **	1,922	2,505	3,395	4,553	5,833	8,383	9,098	9,733
Letter of credit #	3,217	3,798	4,750	6,222	6,877	7,740	7,972	8,211
Total System Credit	**41,789**	**55,746**	**69,909**	**83,637**	**100,209**	**118,736**	**124,899**	**131,667**
Nominal GDP	31,405	34,090	39,798	47,156	51,932	56,884	57,820	58,987
Bank credit / GDP	102%	125%	128%	123%	130%	135%	139%	141%
Total system credit / GDP	133%	164%	176%	177%	193%	209%	216%	223%

Mix of balance	2008	2009	2010	2011	2012	2013	1Q14	2Q14
RMB & FX Loans	77%	76%	73%	70%	67%	65%	64%	63%
Trust Assets *	5%	4%	4%	5%	7%	8%	8%	9%
Corporate Bonds	4%	5%	6%	6%	8%	8%	8%	8%
Undiscounted BABs	3%	4%	6%	6%	6%	6%	6%	6%
Entrusted Loans **	5%	4%	5%	5%	6%	7%	7%	7%
Letter of credit #	8%	7%	7%	7%	7%	7%	6%	6%
Total System Credit	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

Source: PBOC, Wind, China Trust Association, Citi Research

Figure 58. 1M SHIBOR vs. CNH-CNY Spread



Source: Bloomberg, Citi Research

Figure 59. China Corporates Opportunities

	Hong Kong/International (offshore)	Mainland China (onshore)
Loans	Trade loan / Term loan Project loan / Synd loan	Onshore loans
Debt	USD bonds / Dim Sum bonds	Onshore bonds
Equities	H-share	A-share

Source: Citi Research

OCBC's entry into WHB will be about capturing the significant cross-border revenue opportunities while managing potential (largely domestic HK) earnings risks.

Cross-border credit demand from mainland Chinese companies could migrate from short-term trade facilities to term facilities and project financing, which should also provide banks room to earn add-on cross sell, treasury, and advisory fees. Citi HK banks analyst Gary Lam conducted studies of three leading China corporates (Hengan International, China State Construction Int'l and Mengniu) and developed increased confidence in the ability of Hong Kong to address the structural increase in China borrowers' needs. There is also expected to be significant foreign currency flows, with a majority of those emerging in USD/HKD and additional demand in CNH.

The concern going forward is less that the volume of demand may not be as large as in the past four years (although growth rates will naturally ease as the base gets larger) and but that the spreads to be earned by banks (interest and also fees) may generally be less attractive than before (for example trade finance spreads came off in 2012). Finally, the quality of the companies fuelling credit demand may be different going forward.

Hong Kong's domestic banks have clearly benefitted from the China cross-border loan demand, with offshore loans even for smaller banks like WHB and DSB now around 30% of the total loan book, much in line with the system average (28.7% as of June 2014).

But given the need for balance sheet size, capital strength, IB/advisory, and multi-currency capabilities, it may also suggest that the small/mid-cap banks could be "left behind" in continuing to capture such offshore growth opportunities. Given the associated fee opportunities, this probably also suggests why the smaller HK banks tend to have weaker fee franchises than the larger banks.

Figure 60. HK banks loan mix

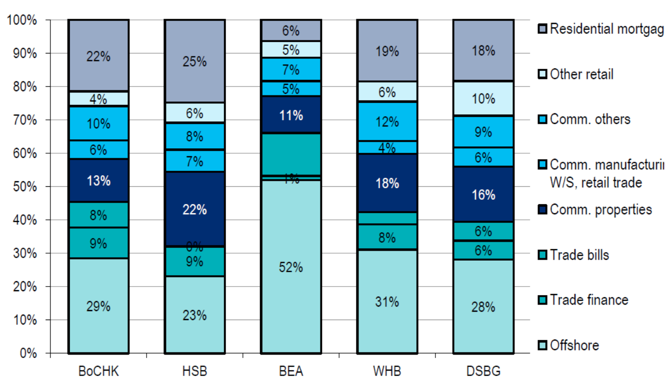
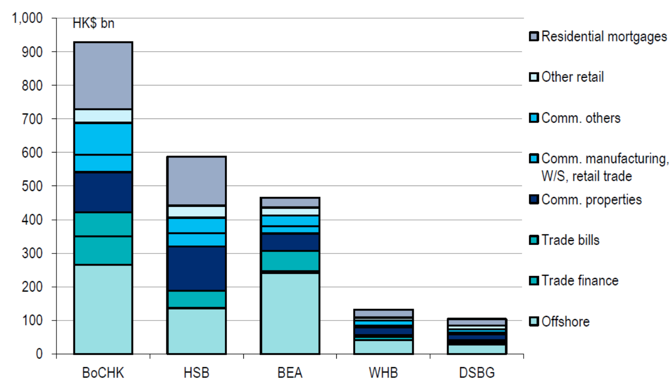


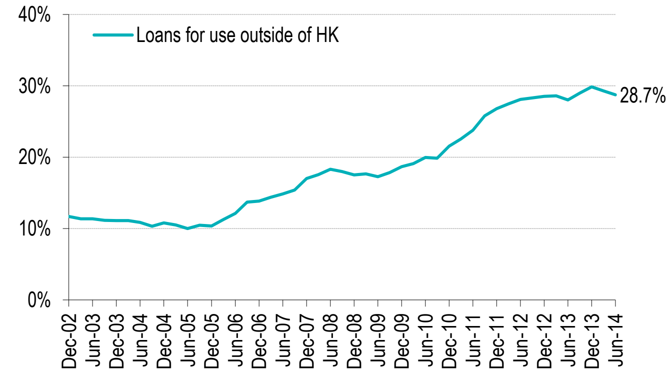
Figure 61. HK banks loan size



Source: Companies, Citi Research

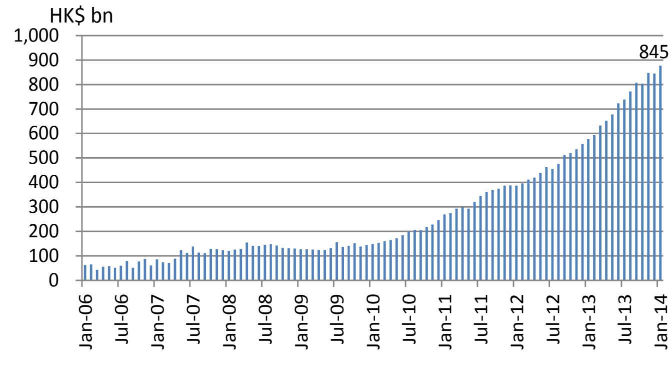
Source: Companies, Citi Research

Figure 62. Loans for use outside Hong Kong as % total loans



Source: CEIC, Citi Research

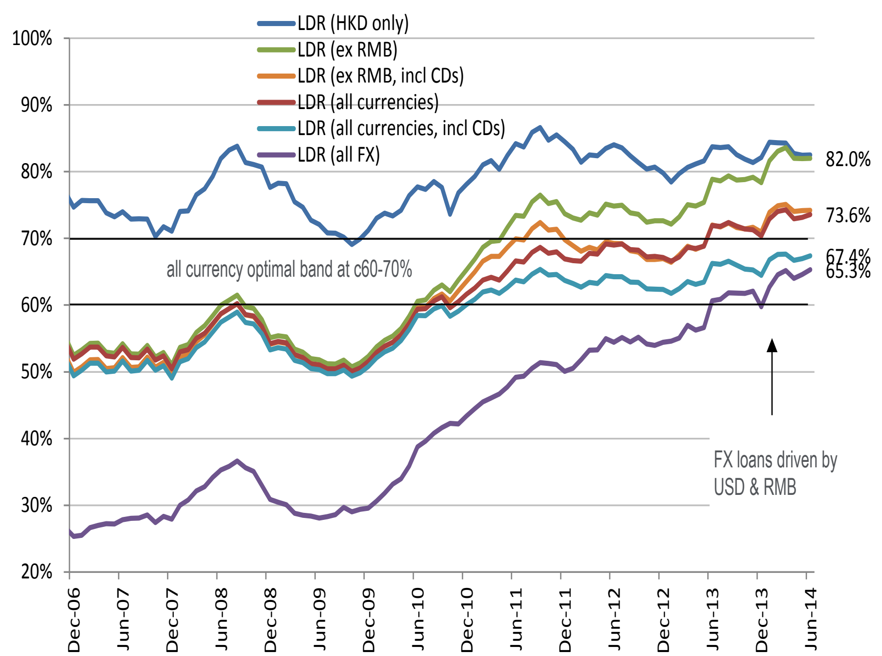
Figure 63. HK banks non-bank Mainland China exposure on the rise



Source: CEIC, Citi Research

HK funding and LDR — most headroom is in FX LDR

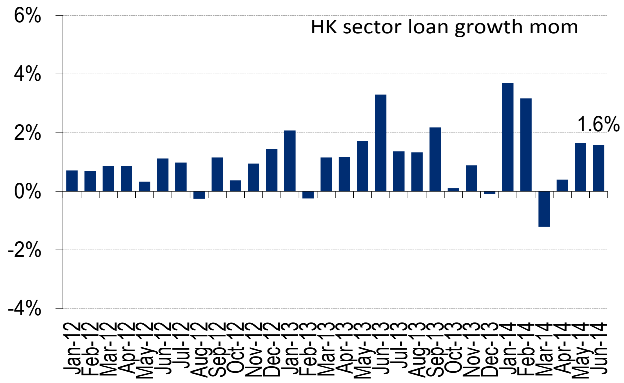
Figure 64. HK sector loan to deposit ratio trends by currency (including CDs)



Source: HKMA, Citi Research

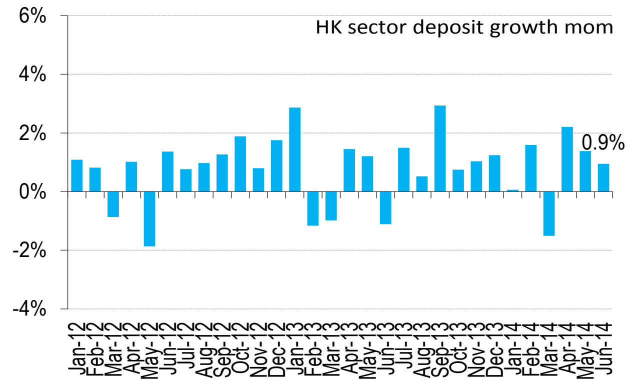
Funding in Hong Kong is also an important consideration. Overall HK system LDR remains comfortable in the 74% range, inclusive of all currencies (and 67% including CDs). HKD-only LDR is relatively high at 82%, but this alone is not a major concern given the relatively mature loan growth domestically and that HKD and USD are fungible. The fastest area of loan demand is in FCY (mainly USD and some RMB) loans but the still low LDR suggests further headroom. Again the ability to capture this opportunity is biased to the larger banks, given issues of counterparty concentration limits as well as access to cheaper USD funding.

Figure 65. HK sector loan growth mom



Source: HKMA, Citi Research

Figure 66. HK sector deposit growth mom



Source: HKMA, Citi Research

Trade finance and direct investment

China and Hong Kong — Despite market concerns to the contrary at the start of 2014, trade finance remains a growing and attractive opportunity for banks.

Figure 67. Hong Kong Trade Finance Growth

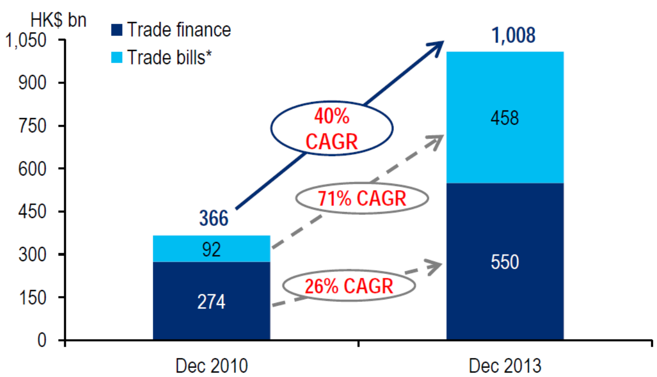


Figure 68. HK Banks – Trade Finance & Trade Bills Mix (2013)

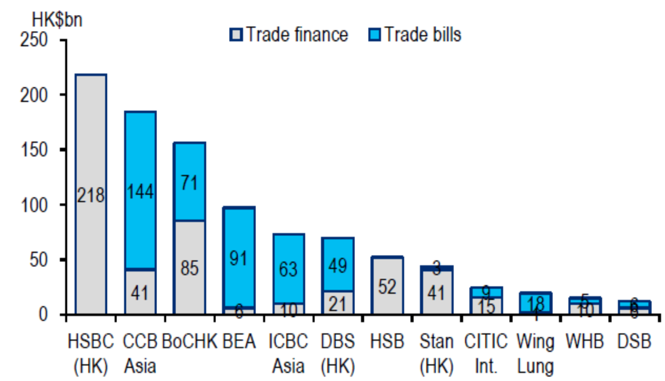
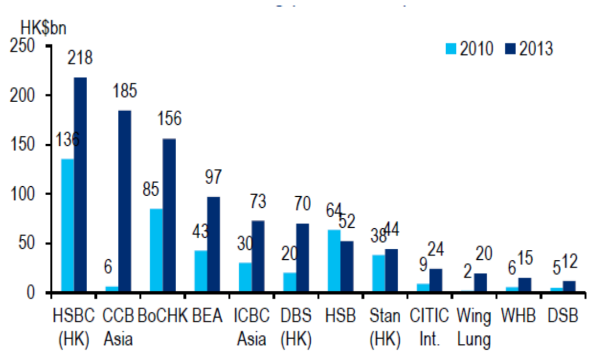
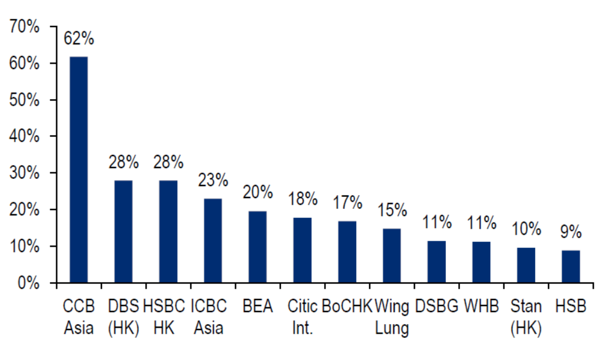


Figure 69. Trade finance/trade bills outstanding (2013 vs 2010)



Source: Companies, Citi Research

Figure 70. Trade Finance & Trade Bills as % Total Loans* (2013)



Source: Datastream, Citi Research

While investors have expressed concerns about the risks of China trade finance, HKMA stated (on 14-April-2014) that it was “satisfied” with underwriting quality for HK banks’ Mainland exposures; and financing was generally backed by “genuine

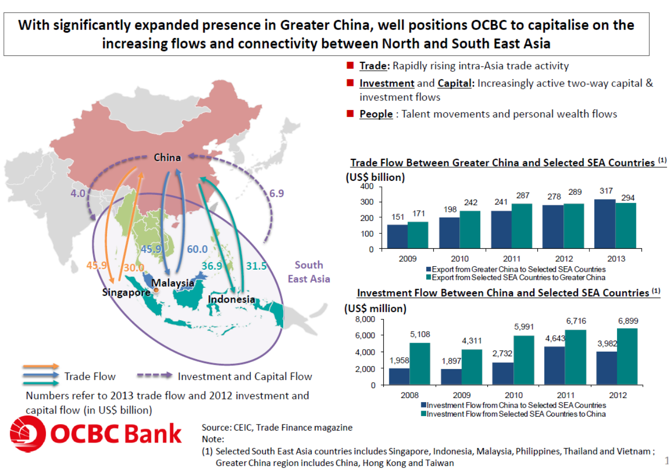
economic activity." Outstanding trade finance in Hong Kong was HK$550bn (or US$71bn). This accounted for 8.5% of sector total loans by end-2013; of this, only 4.8% points were Mainland-related and 3.7% points non-Mainland related. Hong Kong banks' trade finance represents client exposure to finance a specified trade with three-to-six month maturity. Primary recourse of trade finance goes to the borrowing customer. In the case of a credit event, the absence of normal client payback could mean additional overheads for the lending bank to recourse through guarantees.

HKMA does not separately report the amount of outstanding sector trade bills, but our bottom-up analysis suggests that aggregate trade bill exposure from 10 major domestic banks totaled HK$458bn (or US$59bn). Different from trade finance, the primary recourse of trade bills goes to a counterparty bank instead of the borrowing customer. Banks are taking a counterparty bank risk by offering trade bills, but remain liable to conduct sufficient KYC and due diligence to ensure genuine trades are involved.

China and Asean — Beyond pure China-to-Hong Kong flows, the Singapore banks (OCBC, UOB, and DBS) are looking to tap (corporate and SOE) China relationships in Hong Kong that are looking to expand into SE Asia, both on rising trade flows and also outward-bound direct investment.

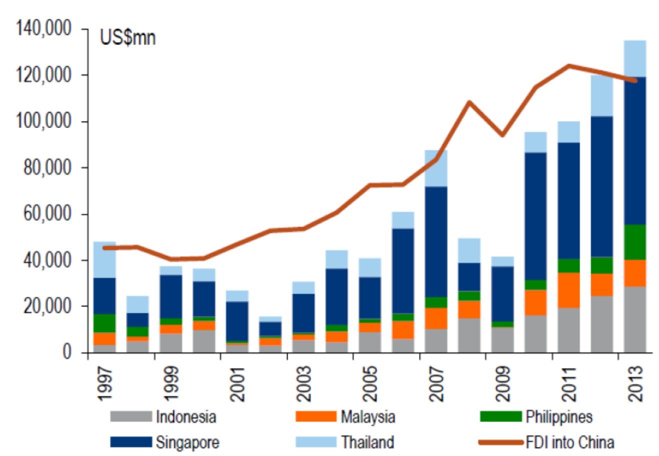
For OCBC, 2013 marked the first full year of operations for OCBC Bank's China Business Office, a unit established in September 2012 to support OCBC China's efforts on this front. Based in Singapore and working in tandem with OCBC China, China Business Office recorded strong growth in 2013. The number of large Chinese corporations and state-owned enterprises banking with OCBC China increased, and the number of accounts opened for Chinese corporates in Singapore more than quadrupled from January to December 2013. OCBC China also helped more non-Chinese corporates expand their businesses in China, leading to an increase of about 31% of loans to such customers banking with OCBC China.

Figure 71. China and Intra-Asian Trade Flows



Source: OCBC Presentation May 2014

Figure 72. FDI — Asean-5 versus China



Source: UOB FDI Presentation Sept 2014

In Oct 2011, UOB launched "UOB FDI Advisory Service" to try to cultivate corporate business riding on increased FDI flows in to the region. UOB currently has nine dedicated FDI centers in Asia (including China and Hong Kong) to try to facilitate cross border FDI opportunities.

Challenges — China's Pearl River Delta region

We are less sanguine about the near-term prospects for developing onshore domestic China business, even if the gross lending spreads are superior to those that can be earned in HK. At the macro level, this goes back to the ongoing macro slowdown, funding capacity, and likelihood that overall credit growth is set to ease.

Asset quality deterioration also needs to be monitored. Although NPL ratios remain very low (just over 1%), the change in absolute NPL quantum has been steep —+29%yoy at the system level as of June 2014, and even higher for smaller banks, a key negative for a HK-based bank with a small onshore China operation.

Figure 73. China — System NPLs up 7.5% qoq and 28.7% yoy; NPL ratio at 1.08%

	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	YoY %	QoQ %	YTD %
Non-performing loans (Rmb bn)														
Commercial banks	427,900	438,200	456,400	478,800	492,900	526,500	539,500	563,600	592,100	646,100	694,400	28.7%	7.5%	17.3%
- Large banks	299,600	299,400	302,000	307,000	309,500	324,100	325,400	336,500	350,000	377,100	395,700	21.6%	4.9%	13.1%
- Share Hldg banks	56,300	60,800	65,700	74,300	79,700	89,600	95,600	102,600	109,100	121,500	136,600	42.9%	12.4%	25.2%
- City banks	33,900	35,900	40,300	42,400	41,900	45,400	49,600	52,600	54,800	61,921	68,000	37.1%	9.8%	24.1%
- Rural banks	34,100	37,400	42,600	48,700	56,400	61,200	62,500	65,600	72,600	79,500	87,200	39.5%	9.7%	20.1%
- Foreign banks	4,000	4,800	5,800	6,300	5,400	6,200	6,300	6,200	5,600	6,000	6,800	7.9%	13.3%	21.4%
NPL ratio (%)												(in bps)		
Commercial banks	0.96%	0.94%	0.94%	0.95%	0.95%	0.96%	0.96%	0.97%	1.00%	1.04%	1.08%	12	4	8
- Large banks	1.10%	1.04%	1.01%	1.00%	0.99%	0.98%	0.97%	0.98%	1.00%	1.03%	1.05%	8	2	5
- Share Hldg banks	0.60%	0.63%	0.65%	0.70%	0.72%	0.77%	0.80%	0.83%	0.86%	0.92%	1.00%	20	8	14
- City banks	0.80%	0.78%	0.82%	0.85%	0.81%	0.83%	0.86%	0.87%	0.88%	0.94%	0.99%	13	5	11
- Rural banks	1.60%	1.52%	1.57%	1.65%	1.76%	1.73%	1.63%	1.62%	1.67%	1.68%	1.72%	9	4	5
- Foreign banks	0.41%	0.49%	0.58%	0.62%	0.52%	0.59%	0.60%	0.57%	0.51%	0.52%	0.59%	-1	7	8
Loan-loss provisions (Rmb bn)												(in %)		
Commercial banks	1,190	1,259	1,324	1,388	1,456	1,537	1,578	1,618	1,674	1,768	1,825	15.7%	3.2%	9.0%
Provision coverage (%)												(in % pts)		
Commercial banks	278.1%	287.4%	290.2%	290.0%	295.5%	292.0%	292.5%	287.0%	282.7%	273.7%	262.9%	-30	-11	-20

Source: CEIC, Citi Research

More specifically for the Pearl River Delta region where Wing Hang Bank's China branches are mostly located, we note that NPLs have been rising faster than many other provinces and overall NPLs.

Figure 74. China — NPLs by Region

1H14 NPL Ratio	ICBC	CCB	ABC	BOC	BoCom	CMB	CNCB	MSB	CRCB	HSB
Head office	1.14%	1.05%	0.00%	na	na	0.96%	na	na	na	na
Yangtze River Delta	1.11%	2.26%	1.27%	1.54%	na	1.93%	2.08%	1.11%	na	na
Pearl River Delta	1.27%	1.15%	1.47%	na	na	1.01%	1.33%	na	na	na
Bohai Rim	1.06%	0.53%	1.21%	1.02%	na	0.55%	1.21%	1.49%	na	na
Central China	1.10%	1.00%	1.59%	1.47%	na	1.24%	0.58%	0.59%	na	na
Western China	0.74%	0.47%	1.21%	0.56%	na	0.49%	0.40%	0.26%	na	na
North-eastern China	0.95%	0.87%	1.49%	0.88%	na	1.18%	1.10%	na	na	na
Overseas and others	0.48%	0.11%	0.21%	0.16%	na	0.09%	0.27%	na	na	na
GROSS CUST NPLs	**0.99%**	**1.04%**	**1.24%**	**1.02%**	**1.13%**	**0.98%**	**1.19%**	**0.93%**	**0.85%**	**0.67%**

NPL Ratio Chg HoH (bps)	ICBC	CCB	ABC	BOC	BoCom	CMB	CNCB	MSB	CRCB	HSB
Head office	9	11	0	na	na	-36	na	na	na	na
Yangtze River Delta	2	-4	18	25	na	12	-14	5	na	na
Pearl River Delta	9	28	24	na	na	34	50	na	na	na
Bohai Rim	10	7	-11	-2	na	5	43	27	na	na
Central China	3	11	1	7	na	52	16	21	na	na
Western China	8	-2	-2	-2	na	15	1	-12	na	na
North-eastern China	-1	-3	-28	-4	na	68	-21	na	na	na
Overseas and others	-1	1	-8	-1	na	-3	3	na	na	na
GROSS CUST NPLs	**5**	**5**	**3**	**6**	**8**	**14**	**16**	**8**	**5**	**13**

NPL Growth YoY (%)	ICBC	CCB	ABC	BOC	BoCom	CMB	CNCB	MSB	CRCB	HSB
Head office	47.6%	44.3%	0.0%	na	na	-22.8%	na	na	na	na
Yangtze River Delta	20.3%	4.6%	25.7%	40.5%	na	59.9%	5.5%	7.0%	na	na
Pearl River Delta	52.9%	40.1%	44.4%	na	na	85.8%	91.2%	na	na	na
Bohai Rim	37.8%	34.3%	7.9%	3.0%	na	68.1%	281.3%	67.3%	na	na
Central China	17.7%	48.0%	5.2%	13.9%	na	128.9%	131.2%	31.7%	na	na
Western China	35.1%	17.1%	-4.1%	15.0%	na	62.4%	178.0%	77.1%	na	na
North-eastern China	6.4%	6.1%	-12.1%	4.1%	na	249.8%	-23.2%	na	na	na
Overseas and others	13.9%	14.3%	229.5%	27.5%	na	42.1%	-26.2%	na	na	na
GROSS CUST NPLs	**29.3%**	**19.1%**	**12.4%**	**23.6%**	**22.4%**	**58.8%**	**54.2%**	**36.9%**	**36.8%**	**21.1%**

Source: Companies, Citi Research Note: BoCom, CRCB and HSB do not disclose NPLs by geography

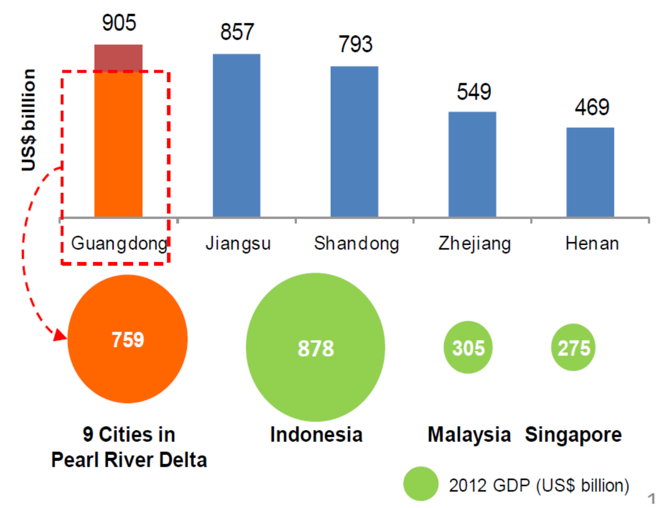
Longer term — OCBC will look at the strategic value of an increased presence in Southern China. In addition to its 42 branches in Kong Kong, WHB has a further 15 branches in China (to complement OCBC's 15 China branches) as well as 13 branches in Macau under Banco Wing Hang.

While OCBC's China network is largely spread across China's eastern coastal cities (plus Chongqing, Chengdu in central China), WHB's network focuses on the major cities in the Pearl River Delta region of Guangdong province in the south. OCBC's China strategy has been largely corporate focused while WHB's capabilities are in SME banking. Guangdong is one of the largest provinces in China by GDP. While Macau would present an entirely new business to OCBC, the goal would be to tap wealth mgmt. and private banking opportunities.

Figure 75. WHB's China network in the Pearl River Delta region

Source: OCBC (Numbers in brackets = No. of WHB branches / sub branches)

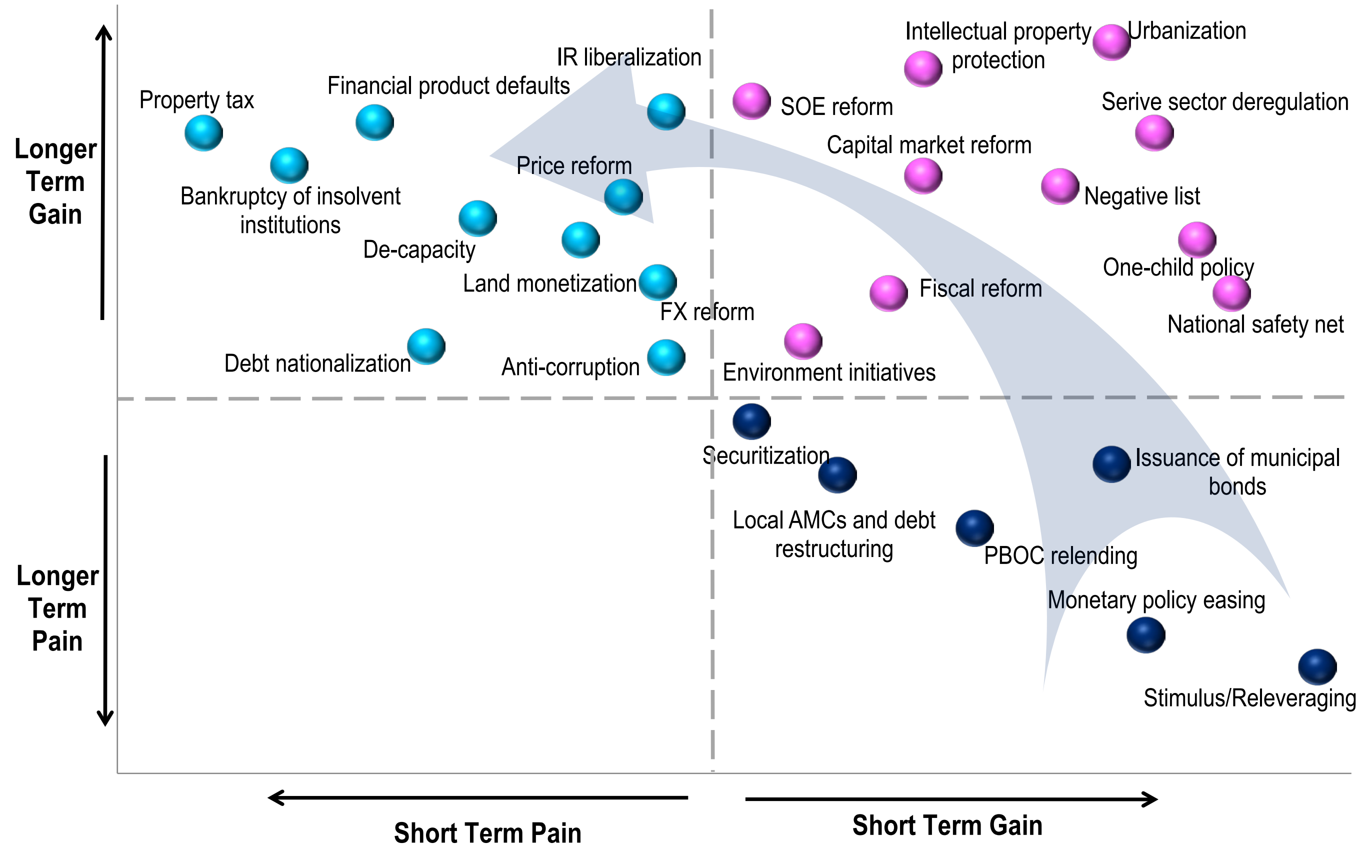
Figure 76. Top 5 provinces in China by 2012 GDP



Source: OCBC

Challenges — Valuing China Reform

Figure 77. China — The Reform map: Balancing Between Short-Term and Longer Term



Source: Citi Research

What must change for China banks' PERs to re-rate? China bank stocks remain something of an anomaly in valuation terms. Despite being an average 18% ROE and 1.25% ROA sector, markets continue to de-rate the banks, affording a PER multiple typically around 5x PER and 0.9x price-to-book.

We believe the key to this depressed multiple is that the markets are pricing in a significant China economic growth slowdown, a necessary consequence of having to endure painful reforms that could take a number of years. The economy is coming off of multiple years of excessive credit expansion and economic imbalances (i.e. overly reliant on fixed asset investment). For the banks, this has manifested in book value uncertainty due to NPL concerns and balance sheet leverage that is being amplified by the rapid growth in off-balance sheet lending. This also raises concerns about capital adequacy in the longer run. Rate liberalization on the other hand adds to NIM uncertainty. All this leads to uncertainty over profitability and ROE.

Why does this matter for the Singapore banks? We have argued in past research a view that the Singapore banks' Greater China earnings growth may also be being priced at a China multiple; for example the seemingly high correlation in 2014 between DBS' price performance and that of China banks being a case in point. It remains to be seen if OCBC's PER multiple also suffered a rating impact for tilting its business model toward Greater China earnings.

How WHB Fits into OCBC's Business Model

Since late-2009, OCBC has been for the most part the best-performing Singapore bank on price performance, commanding a premium PER and P-Book multiple over DBS and UOB. A large part of that premium was lost from late 2013, coincident with the time OCBC's interest in WHB began. On a 2013 pro forma basis, OCBC cum-WHB has the most balanced geographic mix of its peers between Singapore, SE Asia, and Greater China. To regain a premium, we view that OCBC will have to deliver on WHB synergies to prove that the deal will become earnings accretive.

OCBC business model review & ROA/ROE performance

Figure 78. OCBC Corporate Strategy

Source: Company

Geography — Like its peers, OCBC derived c.60% of its 2013 earnings (PBT) from Singapore, regional earnings still dominated by Asean (31%) with just 6% of PBT derived from Greater China. The addition of WHB raises pro forma 2013 Greater China PBT contribution to 16% and represents a material shift, reducing Singapore to 55% and SE Asia to 25%. Within Asean, OCBC's core markets are Malaysia, Indonesia, with (we believe) little appetite to explore countries such as India or even Thailand.

Business mix — Broader wealth mgmt. (including insurance, private banking) is OCBC's distinguishing characteristic at 29% of 2013 revenues. At the PBT level, insurance alone contributes 20%. Despite investor questions to the contrary, it appears that life insurance under Great Eastern Holdings (GEH) is a core holding for the group, underpinning OCBC's leading bancassurance share.

Figure 79. OCBC — ROA-ROE Decomposition & Key Ratios

		OCBC								
		FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16
ROA-ROE DECOMPOSITION	**Net interest income**	**1.56**	**1.50**	**1.39**	**1.35**	**1.31**	**1.22**	**1.27**	**1.28**	**1.29**
	Fees and comm.	0.43	0.39	0.47	0.45	0.42	0.43	0.41	0.43	0.46
	Other non-int. inc.	0.38	0.69	0.65	0.42	0.59	0.44	0.47	0.41	0.40
	Operating Income	**2.38**	**2.58**	**2.51**	**2.22**	**2.32**	**2.09**	**2.15**	**2.12**	**2.14**
	Staff costs	-0.59	-0.53	-0.61	-0.57	-0.58	-0.54	-0.54	-0.55	-0.56
	Other oper. exp.	-0.45	-0.43	-0.46	-0.39	-0.36	-0.34	-0.34	-0.36	-0.35
	Operating Exp.	-1.04	-0.96	-1.06	-0.96	-0.94	-0.88	-0.88	-0.91	-0.92
	PPOP	**1.34**	**1.63**	**1.45**	**1.26**	**1.38**	**1.21**	**1.28**	**1.21**	**1.23**
	Loan provision	-0.25	-0.23	-0.06	-0.09	-0.09	-0.08	-0.09	-0.10	-0.10
	Profit after provision	1.09	1.40	1.39	1.17	1.28	1.13	1.18	1.11	1.13
	Exceptional	-0.02	-0.02	-0.03	-0.02	-0.01	0.00	0.01	0.01	0.01
	Pre-tax profit	**1.07**	**1.37**	**1.36**	**1.15**	**1.27**	**1.12**	**1.19**	**1.12**	**1.14**
	Tax	-0.17	-0.23	-0.20	-0.19	-0.21	-0.19	-0.21	-0.20	-0.19
	Net profit	**0.90**	**1.15**	**1.16**	**0.97**	**1.06**	**0.94**	**0.98**	**0.92**	**0.94**
	Minority interest	-0.06	-0.11	-0.09	-0.07	-0.08	-0.06	-0.06	-0.05	-0.05
	ROA	**0.81**	**1.01**	**1.02**	**0.86**	**0.95**	**0.84**	**0.90**	**0.85**	**0.88**
	Leverage	10.1x	9.3x	9.3x	10.3x	10.6x	11.2x	11.8x	11.6x	11.7x
	ROE	**8.18**	**9.44**	**9.53**	**8.93**	**10.11**	**9.43**	**10.56**	**9.90**	**10.26**
P&L RATIOS	**Net Interest Margin**	**2.27**	**2.23**	**1.98**	**1.86**	**1.77**	**1.64**	**1.67**	**1.67**	**1.67**
	NII as % oper. Inc.	65.6	58.2	55.3	60.7	56.4	58.6	59.1	60.3	60.2
	Fee income as % oper. In	18.3	15.0	18.7	20.2	18.0	20.5	19.2	20.4	21.3
	Other non-II as % oper. In	16.1	26.7	26.0	19.1	25.6	20.9	21.7	19.3	18.5
	Cost-income ratio	43.7	37.0	42.3	43.2	40.6	42.0	40.7	43.0	42.7
	Dividend Payout	60.1	48.1	45.5	46.5	41.8	43.7	40.6	42.0	40.4
B / S RATIOS	**Loans / Assets**	**44.8**	**42.4**	**46.4**	**48.7**	**48.7**	**50.1**	**52.1**	**53.4**	**55.4**
	Placement with banks / As	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	Investments / Assets	34.8	36.7	34.4	30.5	30.3	27.6	27.9	28.0	26.5
	Int. Earning Assets / Tot. A	65.7	68.9	71.4	72.8	74.8	74.9	77.2	75.8	78.2
	Deposits / Assets	**51.9**	**51.8**	**53.8**	**55.6**	**55.8**	**57.9**	**60.0**	**60.3**	**62.4**
	Other IBL / Assets	7.4	11.1	12.0	12.6	13.4	12.9	13.4	10.6	11.5
	Equity / Assets	10.2	11.2	10.3	9.1	9.7	8.3	8.7	8.5	8.6
	Deposits / Liabilities	57.8	58.3	60.0	61.2	61.8	63.1	65.8	65.9	68.3
	Int. Bearing Liab. / Tot. Lia	66.1	70.8	73.3	75.1	76.6	77.2	80.4	77.6	80.9
	Loans / Deposits	**86.5**	**81.8**	**86.3**	**87.4**	**87.2**	**86.6**	**86.8**	**88.5**	**88.8**
ASSET QUALTY	**NPL Ratio**	**1.45**	**1.72**	**0.93**	**0.87**	**0.79**	**0.73**	**0.67**	**0.66**	**0.63**
	Credit cost charge	0.58	0.52	0.14	0.18	0.19	0.17	0.18	0.18	0.17
	Prov. / NPLs	129.3	103.4	146.7	134.4	144.5	140.5	139.2	135.1	137.7
	Prov. / Total loans	**1.88**	**1.78**	**1.37**	**1.17**	**1.15**	**1.03**	**0.93**	**0.89**	**0.86**
CAPITAL RATIOS	**Tier 1 Ratio**	**14.9**	**15.9**	**16.3**	**14.5**	**16.7**	**14.6**	**13.3**	**13.2**	**13.2**
	Capital Adequacy Ratio	15.2	16.4	17.6	15.7	18.6	16.3	15.6	15.3	15.2
	RWA / Assets	52.7	51.5	45.8	46.3	43.8	44.4	47.4	47.9	48.7
	Equity / RWA	19.4	21.8	22.5	19.8	22.1	18.7	18.3	17.8	17.6
	Equity / Assets	**10.2**	**11.2**	**10.3**	**9.1**	**9.7**	**8.3**	**8.7**	**8.5**	**8.6**
GROWTH RATIOS	**Revenue Growth**	**1.3**	**14.4**	**9.7**	**5.6**	**18.2**	**-0.4**	**18.9**	**9.8**	**8.0**
	Cost Growth	10.4	-3.2	25.5	7.8	10.9	3.3	15.0	16.2	7.2
	Cost "Jaws"	-9.1	17.6	-15.8	-2.2	7.3	-3.7	3.9	-6.4	0.7
	Loan Growth	**11.8**	**1.2**	**29.3**	**26.9**	**6.6**	**17.8**	**20.7**	**10.4**	**10.0**
	Deposit Growth	6.0	7.0	22.5	25.3	6.8	18.7	20.4	8.3	9.7
	Total Asset Growth	3.9	7.1	18.0	21.1	6.5	14.4	16.1	7.8	5.9
	RWA Growth	**-3.9**	**4.7**	**5.0**	**22.3**	**0.9**	**15.9**	**23.9**	**8.8**	**7.7**
CAPITAL GENERATION	Capital Generated (% chg in equity)	3.3	4.9	5.2	4.8	5.9	5.3	6.3	5.7	6.1
	Potential RWA growth (@ 10x)		9.5	11.3	10.8	11.6	11.8	11.7	10.5	10.9
	Actual RWA growth		4.7	5.0	22.3	0.9	15.9	23.9	8.8	7.7
	Excess/(Shortage)		**4.8**	**6.3**	**-11.6**	**10.7**	**-4.2**	**-12.2**	**1.7**	**3.2**

[1] Internal capital generated % of equity - computed as return on equity times retention ratio
[2] Excess of potential RWA growth supportable by internal capital generation over actual RWA growth. Insufficient capital generation eventually requires fresh capital raising
Source: Citi Research

ROA-ROE analysis: Although historical PER and P-B cycle ranges afford OCBC a premium multiple to its peers, historical ROA and ROE performance has not been materially different (broadly, OCBC enjoyed ROA/ROE trends better than DBS but not as good as UOB). Surprisingly in ROA terms, OCBC has the lowest NII of its peers (1.31% in 2012 and 1.22% in 2013). But stronger non-core fee non-interest income, in part due to insurance, helps to mitigate, as does better cost ROA metrics. But the standout characteristic for OCBC throughout the past decade has been superior credit costs. From 2009 to 2013, OCBC has seen a decline in PPOP ROA to a low of 1.21%.

Key business model differentiators post 2009

[1] Improved low-cost deposit franchise: Arguably the NIM profile might have been worse had it not been for OCBC's efforts to materially improve its low-cost funding base. At the group level, the bank's CASA ratio was below 30% as recently as 2007, but by 2013 the group's CASA ratio had improved to 47%. Over five years, vs an annualized 16% growth in total deposits, savings accounts grew 15% and demand/operating account grew an impressive 30% annualized. In Singapore OCBC has worked hard in garnering savings from different demographics, including children's and student accounts (the latter by offering a separately branded savings cum debit card product "Frank by OCBC"). Operating accounts probably benefitted from OCBC's success in attracting new SME customers, which number over 100,000 in Singapore and at one point OCBC was able to claim that one out of every two new SME start-ups was opening their first account with OCBC.

Figure 80. Estimated Impact of Assumed 100bps Change in SGD Interest Rates

2013 Data	DBS	OCBC	UOB	Comments
Group LDR	**83.9%**	**86.6%**	**90.1%**	
SGD	73.2%	80.3%	95.4%	DBS has the lowest SGD LDR
Non-SGD	93.0%	92.1%	84.2%	
USD	109.8%	99.7%	81.1%	High LDR mitigated by USD wholesale fund (CP, MTN)
HKD	99.4%			
MYR		89.6%	90.2%	
THB			99.1%	
IDR		94.7%	98.2%	
Other Ccy	65.6%	82.0%	73.4%	
	DBS	**OCBC**	**UOB**	
Group CASA	**55.1%**	**46.6%**	**39.4%**	
SGD	87.3%	57.8%	49.1%	Citi Estimates (aside DBS)
HKD	35.0%			
MYR		26.2%	21.2%	Large (GLC) banks CASA Ratio >30-40%
THB			43.0%	
IDR		47.0%	26.5%	UOB looks exposed to funding pressures in IDR
S$ Millions	**DBS**	**OCBC**	**UOB**	
Loan Re-pricing <1Yr	**88%**	**94%**	**93%**	Derived from Annual Report data
SGD Loans <1 Yr	86,429	69,768	94,836	DBS has widest gap between SGD loans re-pricing and
SGD TDs/Other	17,120	38,787	54,172	SGD deposits re-pricing due to strong CASA
Net Impact	**693**	**310**	**407**	**SGD SIBOR Chg Assumed 100bps**
Tax	14%	17%	16%	2013
Net Profit	3,501	2,768	3,008	2013
Profit Impact	**17.0%**	**9.3%**	**11.4%**	
Net Interest Income	5,569	3,883	4,120	2013
NIM (Bps)	162	164	172	2013
NIM Impact (Bps)	**20**	**13**	**17**	

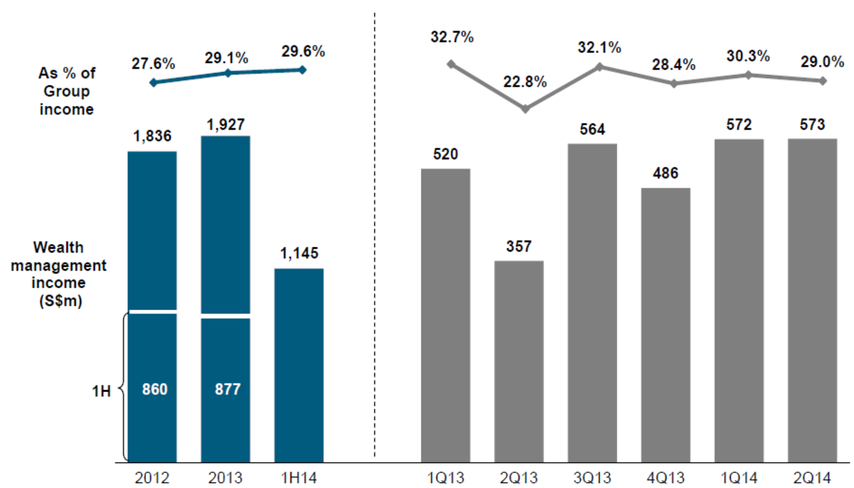
Source: Company Data, Citi Research Estimates

[2] Loan drivers: From 2009 to 2013 at the group level, OCBC has seen the annualized loan growth rate of close to 20%.vs deposits growth of 18% and RWA growth of 11%. The variance between loans and RWA growth highlights the skew

toward low-RWA loans, probably dominated by USD trade finance. By contribution: 24% of loan volumes were from mortgages, 23% from commerce (includes trade finance), and 11% from property/construction. By currency 40% of loan volumes by contribution were USD-denominated and 32% SGD-denominated.

[3] Fees and non-interest income — wealth mgmt leader: From a non-II perspective, OCBC is usually considered to have the broadest and most well defined wealth mgmt platform, with leadership in insurance, bancassurance, and separate entities for a private bank and funds management. This is also borne out in non-interest income trends, with wealth/fund mgmt fees (excluding insurance) driving c.60% of the impressive annualized 17% core fees growth from 2009 to 2013. Other income — mainly net trading income, AFS gains, and fair value adjustments — saw flattish growth over the same period, suggesting that this is not a strong growth focus for the bank.

Figure 81. Wealth Management (incl. Insurance) is a Major Revenue Driver for OCBC



Note: Comprises the consolidated income from insurance, asset management, stockbroking, and private banking subsidiaries, plus the Group's income from the sales of unit trusts, bancassurance products, structured deposits and other treasury products to consumer customers.
Source: Company, Citi Research

Private Bank (Bank of Singapore): OCBC Bank completed the acquisition of ING Asia's private bank portfolio in Jan-2010 and was rebranded under Bank of Singapore (BoS). Since then the private bank's AUM havs more than doubled to US$49bn as of March 2014. BoS' growth strategy has been to bring in proven RMs, but it may take 18-24 months for a new RM to bring in commensurate AUMs so C-I ratio is relatively high compared to the rest of the group but below some private bank peers. BoS operates an open architecture meaning that it can sell any product, but does not take positions. Primary customer base are self-made wealthy people including SME owners, with clients in up to 50 countries. OCBC brings products capability to BoS including for example mortgage overseas. There are also attempts to cross-sell product between OCBC and BoS.

Insurance (Great Eastern Holdings): OCBC is the only one of the three banks to report a direct non-interest income revenue line from insurance through its 87% stake in life insurer GEH. The broad growth strategy for GEH mgmt is to drive higher value new business regular premium growth in its key markets (Singapore and Malaysia), building in force business for strong embedded value growth. In terms of contribution to OCBC's performance, from 2009 to 2013, annualized

growth from insurance showed a modest rise of 3%, largely due to a high 2009 base, when life profits were lifted by exceptionally strong non-par profits. Despite consistent growth in premiums and NBEV (in recent years, embedded value has risen around 8% annually), GEH earnings are also driven by a non-par fund performance which can be volatile. This is due to the accounting for unrealized MTM adjustments of the life portfolio assets vs. liabilities, which in recent years tended to give strong positive adjustments during falling rates and narrowing credit spreads, and conversely for rising rates and widening credit spreads. This is because life fund liabilities are very long term (up to 40 years), while assets (mainly fixed income securities and some equities) are shorter term. The relative valuation for these can be affected by changes in shorter-term credit spreads. But there are unrealized MTM adjustments and it does not impact the business long term. OCBC analyzes this by splitting the insurance earnings between operating and non-operating earnings components, although it is difficult to forecast the likely impact on OCBC's overall earnings with taking a view on rates and credit spreads.

Figure 82. OCBC Quarterly Non-Interest Income

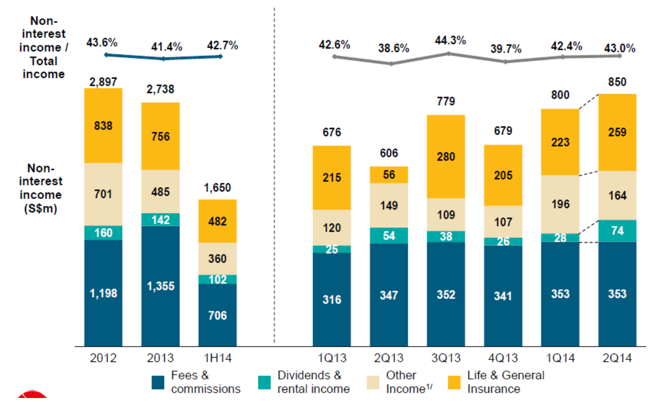
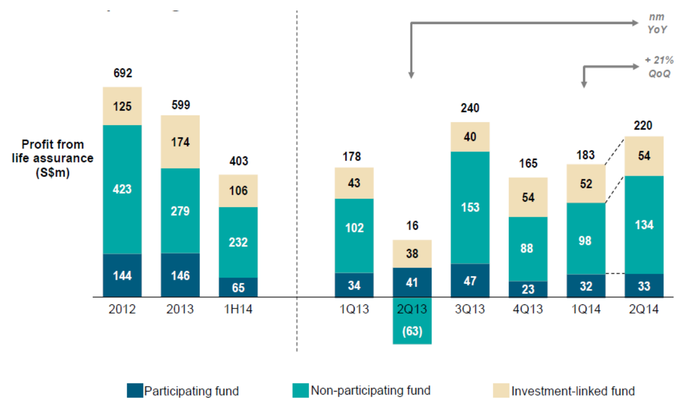


Figure 83. Insurance Income—Non-Par Fund Most Volatile



Source: OCBC Note: Excludes gains from divestment of non-core assets

[4] Cost efficiency: Based on an ROA analysis, OCBC enjoys the lowest operating cost ROA of its peers at 0.88% in 2013 (DBS: 1.04%, UOB 1.08%), but over the period 2009-2013 OCBC's total costs growth was the highest of its peers, averaging 12% over the period (head count +7% CAGR to 25,123); partly due to overseas expansion and also the acquisition of BoS in 2010. Aside from adding to the private bank, OCBC is still investing in regional growth.

[5] Asset quality and provisions: Superior credit cost throughout the past decade has been a standout characteristic for OCBC, which mgmt attributes to a strong credit process. As for its peers, OCBC's PPOP ROA decline from 2009 until the end of 2013 was mitigated by improvements in asset quality, as overall cost of credit fell from 55bps (specific charge 52bps) in 2009 to just 17bps (specific charge just 5bps) by 2013. In contrast to peers, OCBC tends to make provisions as and when they are actually needed and do actively not smooth provisions through use of general buffers. Mgmt acknowledges that present provision charges are exceptionally low and that the credit environment could prove more challenging going forward.

Regional — Malaysia largest, Greater China growth fastest

Figure 84. OCBC FY2008 PBT By Geography

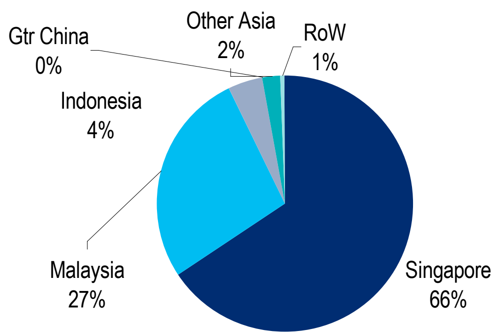
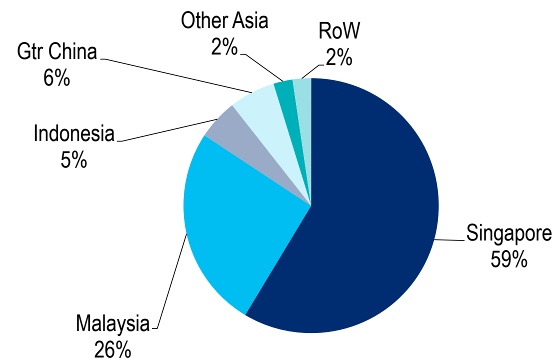


Figure 85. OCBC 2013 PBT By Geography



Source: Company, Citi Research estimates

Comparing 2013 PBT to 2009 levels, earnings have been fairly broad-based across most of OCBC's key geographies, but, in order, the largest dollar contributions have come from Singapore (49%), Greater China (20%, having been negligible in 2009), and Malaysia (11%). In terms of the overall pie, Singapore's PBT percentage contribution has fallen the most, taken up by Greater China and an improved Indonesia proportion.

Figure 86. OCBC — Profit Before Tax Trend By Geography and Contribution

S$ m	2009	2010	2011	2012	2013	4-Yr chg.	% CAGR
Group Profit Before Tax	2,543	2,880	2,917	3,646	3,567	1,024	9%
Singapore	1,594	1,958	1,710	2,264	2,091	497	7%
Malaysia	800	768	773	812	916	116	3%
Indonesia	125	60	125	159	182	57	10%
Gtr China		34	195	264	208	208	83%
Other Asia	41	53	92	94	87	46	21%
RoW	(17)	7	22	53	83	100	
Contribution	**2009**	**2010**	**2011**	**2012**	**2013**	**4-Yr chg.**	
Singapore	63%	68%	59%	62%	62%	49%	
Malaysia	31%	27%	26%	22%	22%	11%	
Indonesia	5%	2%	4%	4%	4%	6%	
Gtr China	0%	1%	7%	7%	7%	20%	
Other Asia	2%	2%	3%	3%	3%	4%	
RoW	-1%	0%	1%	1%	1%	10%	
%yoy Growth	**2009**	**2010**	**2011**	**2012**	**2013**		
Singapore	34%	13%	1%	25%	25%		
Malaysia	28%	23%	-13%	32%	32%		
Indonesia	54%	-4%	1%	5%	5%		
Gtr China	54%	-52%	108%	27%	27%		
Other Asia			474%	35%	35%		
RoW	-9%	29%	74%	2%	2%		

Source: Company, Citi Research (excludes WHB to provide like-for-like comparison)

Malaysia: A simple comparison of profit, average asset and ROA versus selected local bank peers suggests that OCBC Malaysia is quite profitable at around 1.3% ROA. Like other foreign banks, OCBC is constrained in a relatively low CASA ratio, but non-interest income is fairly strong and as for the group as a whole, credit costs in Malaysia have been exceptionally low.

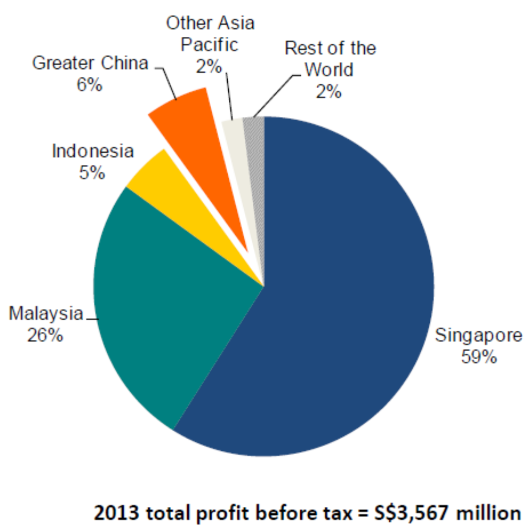
Figure 87. OCBC Malaysia Operations— Comparison to MY Bank Peers

	2007	2008	2009	2010	2011	2012	2013
OCBC Malaysia (RM m)							
Net Profit	512	617	608	706	779	811	946
ROAA	**1.30%**	**1.37%**	**1.21%**	**1.30%**	**1.30%**	**1.18%**	**1.22%**
Avg Assets	39,343	45,030	50,418	54,335	60,142	68,725	77,286
UOB Malaysia (RM m)							
Net Profit	483	388	520	619	833	926	1,040
ROAA	**1.45%**	**1.00%**	**1.23%**	**1.32%**	**1.39%**	**1.24%**	**1.22%**
Avg Assets	33,313	38,721	42,213	46,852	59,876	74,742	85,220
AMMB (RMm)							
Net Profit	669	861	1,009	1,343	1,484	1,621	1,782
ROAA	**0.83%**	**0.99%**	**1.08%**	**1.31%**	**1.34%**	**1.35%**	**1.37%**
Avg Assets	80,907	86,542	93,187	102,358	110,678	120,248	129,963
Alliance Financial Gp(RM m)							
Net Profit	380	229	301	409	503	538	564
ROAA	**1.41%**	**0.77%**	**0.95%**	**1.21%**	**1.33%**	**1.29%**	**1.23%**
Avg Assets	27,033	29,761	31,755	33,868	37,895	41,705	45,883
Public Bank (RM m)							
Net Profit	2,124	2,581	2,517	3,048	3,684	3,827	4,065
ROAA	**1.32%**	**1.39%**	**1.22%**	**1.37%**	**1.55%**	**1.46%**	**1.40%**
Avg Assets	160,972	185,159	206,650	221,733	238,444	262,692	290,275

Note: FYMar-14 Results for AFG and AMMB
Source: Citi Research

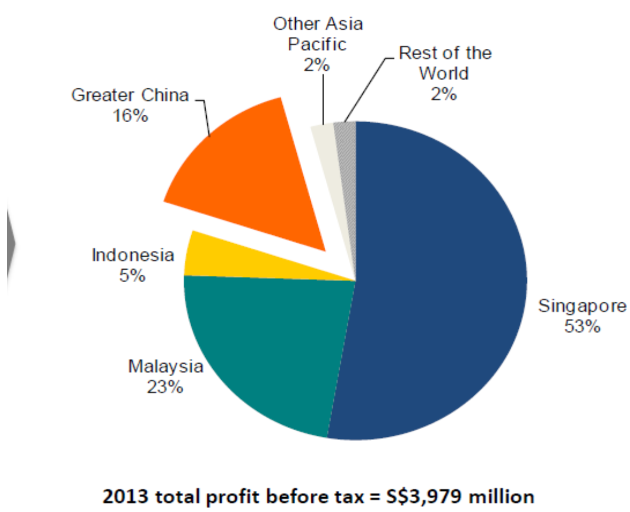
WHB boosts Greater China to c.16% of 2013 PBT

Figure 88. OCBC FY2013 PBT By Geography



Source: OCBC

Figure 89. OCBC 2013 PBT Pro-Forma Including WHB



Greater China includes China, Hong Kong, Macau, and Taiwan

Enhancing the onshore-offshore strategy — Given OCBC CEO Sam Tsien's background and expertise in the mainland China banking market, it may not be a surprise that Greater China is taking on a more prominent role in OCBC's regional strategy beyond the original offshore trade finance-led growth in 2011, which took advantage of nascent demand from the initial China/RMB internationalization as well as the currency and rates carry trade opportunities that existed at the time.

The basic mainland China strategy has been an onshore-offshore integration approach, with a broad focus on OCBC's network customers, and also large Chinese corporates (state-owned companies) in essential and strategically important industries such as oil & gas, to capture flows as these Chinese companies go regional (for example if a China power company buys a Singapore power plant). OCBC does not go down to provincial or city level companies. In 2012 OCBC established a China Business Office in Singapore to support its Chinese customers as they venture into Singapore and the region, facilitating their cross-border trade, treasury, and capital flows, and investment banking activities. Within Greater China (including Hong Kong and Taiwan), OCBC has also sought to expand its corporate and wealth management customer base and leverage its strategic partnerships with Bank of Ningbo, the latter expected to become a financial associate of OCBC by end-2014 once OCBC raises its stake in the bank to 20%.

Figure 90. OCBC-WHB — Pro forma summary of merged group

	OCBC Bank	永亨銀行 WING HANG BANK	Pro forma	Wing Hang contribution
General				
Market Capitalisation (S$bn) (1)	32.6	6.1		
Total branches	>450	70	>520	<13.5%
Branches in China	16	15	31	48.4%
Branches in Hong Kong	1	42	43	97.7%
Branches in Macau	0	13	13	100.0%
Financial				
Net Loans (S$bn)	167.9	23.2	191.1	12.1%
Net Loans in Greater China (S$bn)	27.2	23.2	50.4	46.0%
Deposits (S$bn)	196.0	29.0	225.0	12.9%
Assets (S$bn)	338.4	34.9	373.3	9.4%
Profit Before Tax (S$mm)	3,567	412	3,979	10.4%
Profit Before Tax from Greater China (S$mm)	208	412	620	66.5%
Net Profit (S$mm) (2)	2,768	353	3,121	11.3%
Ratios				
Tier 1/Total Capital Adequacy Ratio	14.5%/16.3%	12.0%/15.9%	11.0%/12.5%(3)	
Net Interest Margin	1.64%	1.71%	1.64%	
Non-Interest Income / Total Income	41.4%	22.4%	39.6%	
Loans-to-Deposits Ratio	85.7%	73.0%	84.9%	
NPL Ratio	0.7%	0.44%	0.7%	
Cost-to-Income Ratio	42.0%	52.0%	43.0%	

OCBC Bank

Note: Financials as at 31 December 2013. Based on 2013 average exchange rate of S$1.00 = HKD6.2007 for income statement items and 31 December 2013 exchange rate of S$1.00 = HKD6.1388 for balance sheet items
(1) As at 28 March 2014
(2) Core net profit attributable to shareholders
(3) Based on latest reported financials and based on total consideration of HK$38,688 million / S$6,276 million, which includes consideration paid for options and awards

Source: Citi Research

Enhanced China distribution — In addition to 42 branches in Kong Kong, WHB has a further 15 branches in China (complimenting OCBC's 16 China branches) as well as 13 branches in Macau under Banco Wing Hang. While OCBC's China network is largely spread across China's eastern coastal cities (plus Chongqing, Chengdu in central China), WHB's network focuses on the major cities in the Pearl River Delta region of Guangdong province in the south. OCBC's China strategy has been largely corporate focused while WHB's capabilities are in SME banking. Guangdong is one of the largest provinces in China by GDP. While Macau would present an entirely new business to OCBC, the goal would be to tap wealth mgmt. and private banking opportunities.

OCBC CEO Samuel Tsien — Mr Samuel N Tsien has over 30 years of working experience in the banking industry. Born in Shanghai and raised in Hong Kong, Mr Tsien majored in Economics at the University of California, Los Angeles. Shortly after his graduation in 1977, he joined Bank of America (Hong Kong) as a management trainee. He had held various key positions in corporate banking and credit risk management in Hong Kong and the US.

In 1995, he was appointed Chief Executive Officer of Bank of America (Asia). Prior to this, he was named Senior Vice President of Bank of America Corporation in 1993, and subsequently Executive Vice President in 1996. When China Construction Bank fully acquired Bank of America (Asia) in December 2006, Mr Tsien assumed the position of President and Chief Executive Officer of China Construction Bank (Asia) Corporation following the equity transfer.

He joined the Oversea- Chinese Banking Corporation (OCBC Bank) in Singapore in July 2007 as Global Head of Business Banking, and was promoted to Group Chief Executive Officer of the bank in April 2012.

Notes and Assumptions:

[1] OCBC will end up owning 100% of WHB post compulsory acquisition of remaining shares at a cost of S$6.2bn.

[2] Capital-raising plans — S$3.37bn rights issues (54% of WHB purchase price), remainder debt financing.

[3] This table shows pro forma adjustments assuming NO synergies or integration costs have been built in — purpose being to illustrate the immediate implications of adding 100% of WHB earnings less the funding costs of new equity + debt.

Please also see notes and assumptions as per Figure 2.

OCBC-WHB Rights Issue Math

Overall WHB + equity raising dilution roughly 4-5%

By 29 July 2014, having received acceptances of 97.52% of the shares of Wing Hang Bank ("WHB"), OCBC is proceeding to compulsorily acquire the WHB Shares not yet acquired, with a subsequent delisting of WHB in the next two to three months.

WHB is set to become a wholly owned subsidiary of OCBC and be consolidated from 3Q2014. Based on Citi's 2015E OCBC estimates, simple addition of WHB stand-alone profits would enhance OCBC's pro forma profit by c.11%.

WHB's purchase price of S$6.2bn is about 17% of OCBC's current market capitalization (S$36bn at S$10.20 per share). Simplistically therefore a full 100% equity financed deal would have amounted to 6-7% earnings dilution.

Incorporating a S$3.37bn rights issue

Financing details: OCBC announced that the S$6.2bn price will be S$3.37bn equity financed (54% of the total) and the remaining S$2.85bn debt/cash financed which as we show below amounts to an overall 4-5% dilution for the WHB deal, prior to any assumptions for integration costs and future earnings synergies.

Figure 91. Summary Math — OCBC – WHB Deal + Equity Raising Plans

OCBC — WHB Deal Math	
Offer Price Per WHB Share	**HK$ 125**
# WHB Shares (m)	309.8
Total Consideration (HK$ m)	38,723
Total Consideration (S$ m)	**6,219**
SGD-HKD Rate 18 Aug 2014	6.23
WHB 2013 NAV HK$	21,700
WHB 2013 Profit HK$	2,187
Acquistion P/B	**1.78x**
Acquistion PER	**17.7x**
Estimated Goodwill (S$ m)	**2,684**
SGD-HKD Rate 31 Dec 2013	6.14
SGD-HKD Rate 2013 Average	6.20
OCBC Market Capitalization Pre-Deal (S$ m)	**35,908**

Citi Assumptions for Deal Financing				
Assumed Portion Financed via Equity		54%		
- Equity to be Raised (S$ m)		3,366		
- Financed by Cash/Debt (S$m, Balance)		2,852		
Assumed Equity Issue price (S$)		**7.65**	**TERP (S$)**	**9.92**
New Shares at Assumed Issue Price (millions)		440.048		
OCBC Forecast Impact	**2014E**	**2015E**	**2016E**	**2017E**
EPS	-3.0%	-5.1%	-4.5%	-4.0%
BV/S	0.9%	0.1%	-0.7%	-1.5%
PER	0.68x	0.26x	0.18x	0.11x
P/B	-0.05x	-0.04x	-0.03x	-0.02x
CET1	-1.08% pts	-1.14% pts	-1.23% pts	-1.31% pts
Net Profit	3.1%	6.7%	7.4%	7.9%
ROE	-1.36% pts	-0.72% pts	-0.54% pts	-0.37% pts
OCBC Mkt. Cap. Chg	9%			

Notes:

[1] OCBC will end up owning 100% of WHB post compulsory acquisition of remaining shares at a cost of S$6.2bn
[2] OCBC has announced a 1 new for 8 old rights issue at S$7.65 per rights share to raise S$3.37bn new equity. The remainder we have assumed will be debt financed at a cost of 4.125% (approx. S$118m annual interest cost).
Source: Citi Research estimates

Figure 92. OCBC Pro Forma Forecasts Cum WHB and Assumed Equity Raising

OCBC Forecasts Cum WHB	2014E	2015E	2016E
Net Profit (S$ m)	3,230	3,210	3,410
- Cum WHB / New Equity	3,352	3,472	3,687
FD EPS (S$)	0.93	0.92	0.98
- Cum WHB / New Equity	0.91	0.90	0.96
BVPS (S$)	7.02	7.58	8.18
- Cum WHB / New Equity	7.31	7.81	8.35
ROE (%)	13.9%	12.8%	12.6%
- Cum WHB / New Equity	12.5%	12.1%	12.0%
CET1 Ratio [Full 2019] (%)	11.0%	11.2%	11.5%
- Cum WHB / New Equity	10.3%	10.4%	10.6%
PER at Curr. Share Price	10.9x	10.9x	10.3x
- Cum WHB / New Equity	11.6x	11.2x	10.5x
PBV at Curr. Share Price	1.42x	1.31x	1.22x
- Cum WHB / New Equity	1.36x	1.27x	1.19x

Source: Citi Researchestimates

OCBC announced a rights issue of 440,047,710 new shares (1 new for 8 old shares) at S$7.65 per rights share (a discount of 25% to the 15 Aug 2014 closing price of S$10.20, and 22.9% discount to the theoretical ex-rights price of S$9.92 per share). OCBC's substantial shareholder (Lee Group of companies, which collectively holds 26.87% of existing OCBC shares) gave an irrevocable undertaking to subscribe for 26.66% of the rights shares. We estimate that this rights issue will restore OCBC's common equity tier-1 ratio to 10.3% post the WHB deal, based on our 2014 forecasts.

The remainder of the deal is set to be funded through S$2.5bn of debt that has already been raised and the balance in cash. We note that on 19 June 2014 OCBC raised US$1bn (S$1.25bn) of Tier-2 qualifying fixed rate subordinated notes at a coupon of 4.25%.15 April 2014 OCBC raised US$1bn of Tier-2 qualifying fixed rate subordinated notes at a coupon of 4%.

Figure 93. OCBC's Basel 3 Tier-2 Qualifying Subordinated Note Issues

Date	Comments
15 April 2014	**US$1 billion of fixed rate subordinated notes** ("Notes") under its US$10 billion Global Medium Term Note Program ("Program"). The Notes represent OCBC Bank's first Basel III capital instrument and are expected to **qualify as Tier 2 capital** of the Bank under the Monetary Authority of Singapore ("MAS") Basel III framework. The net proceeds from the issue of the Notes will be used for general corporate purposes of OCBC Bank. The Notes are priced at 99.40%, and will **bear a coupon of 4.00 % per annum** from the issue date to the **call date on 15 October 2019** ("Call Date"). If the Notes are not redeemed on the Call Date, the interest rate from the Call Date to the **maturity date on 15 October 2024** will be reset to a fixed rate per annum equal to the aggregate of the then-prevailing 5-year U.S. dollar mid swap rate and 2.203%. As a Basel III capital instrument, the Notes can be written off in whole or in part if the Bank was determined by the MAS to be non-viable. The Notes are expected to be rated A2 by Moody's Investors Service, BBB+ by Standard & Poor's Rating Services and A+ by Fitch Ratings Ltd, and to be issued on 15 April 2014.
19 June 2014	**US$1 billion of fixed rate subordinated notes** ("Notes") under its US$10 billion Global Medium Term Note Program ("Program"). The Notes are expected to **qualify as Tier 2 capital** of the Bank under the Monetary Authority of Singapore ("MAS") Basel III framework. The net proceeds from the issue of the Notes will be used for general corporate purposes of OCBC Bank. The Notes are priced at 99.108%, and will **bear a coupon of 4.25% per annum** from the issue date to the **maturity date on 19 June 2024**. As a Basel III capital instrument, the Notes can be written off in whole or in part if the Bank was determined by the MAS to be non-viable. The Notes are expected to be rated A2 by Moody's Investors Service, BBB+ by Standard & Poor's Rating Services and A+ by Fitch Ratings Ltd, and to be issued on 19 June 2014.

Source: Company

An overall deal dilution of 4-5% is relatively modest in our view and would require approximately S$170m of addition earnings synergies to be earnings neutral. Thus, the stated mgmt view that the WHB deal can be earnings and EPS accretive by 2017E, assuming earnings synergies are added, seems plausible, in our view.

Asset divestment or dividend policy change seem unlikely

Given the expected modest dilutions, there appears to be no case for OCBC to consider divesting stakes in key assets such as Great Eastern (which OCBC regards as a strategic holding), nor any need to change to the group's current dividend policy. In recent years, around 40-45% of profits have been paid as dividends, and we would expect this to continue, although we would also not be surprised if OCBC continued with its scrip dividend scheme arrangements.

When questioned on asset divestments, mgmt confirmed that while there may be an ongoing process of divesting non-core assets, it was not necessary for the purpose of funding the WHB deal.

Bank of Ningbo

Figure 94. Bank of Ningbo 2013 Profit

Bank of Ningbo	
2013 profit (RMB m)	4,847
SGD-CNY Exchange Rate	4.9573
2013 Profit (S$ m)	978
20% thereof (S$ m)	196

Source: Company, Citi Research

OCBC has committed to increasing its stake in Bank of Ningbo ("Ningbo ") from 15.34% to 20% for a consideration of RMB1.8bn (S$383m). The transaction is expected to be completed in late-2014 (pending regulatory approvals), upon which OCBC can account for the profits of Ningbo as an associate company. For 2013 Ningbo posted a net profit of RMB4.85bn (S$978m), suggesting a net c.S$180m lift to OCBC's bottom line (accounting for assumed dividends) if the stake is raised to 20%. The S$383m consideration represents 20bps of OCBC's 2014E RWA.

OCBC 2Q 2014 Results

- **Strong consensus beat, good in quality —** OCBC's 1H14 results was 60% of consensus. Growth was broad-based and of good quality, although slightly flattered by the continued strong non-par performance boosting Great Eastern's earnings. OCBC continues to enjoy ample deposit funding, with an overall LDR of 88% and SGD LDR of 82%. Focus remains on CASA growth (CASA ratio 47%) but mgmt did acknowledge deposit competition domestically and regionally. Mgmt gave extensive details of OCBC's China loan exposure (Jun-14: S$27bn, S$8bn being trade loans) with no exposure to Qingdao. At a current price of S$9.95, OCBC is trading on a trailing P/B of 1.35x and PER of 9.4x

- **Deposits and funding —** The bank remains well funded, with a group LDR of 88.1%, and SGD LDR of 81.6%. Although SGD deposits fell slightly qoq, CASA funds still rose. OCBC has seen good early success with its "360 deposit" offering, which seeks to capture the operating funds of a working customer. Since launch the product has garnered over 60,000 accounts (30% of which are entirely new customers to the bank) and about S$500m in deposits. OCBC's core focus remains on growing transactional deposit accounts, but the bank has to also stay visible in the market for FDs. With LCR coming there has been rising costs on FDs. The deposit cost impact of the "360 account" has not yet fully reflected in numbers but it is more than compensated by the amount of cross sell the product brings. OCBC is comfortably above the forthcoming LCR minimum levels prescribed by MAS.

- **China country exposures —** Overall Greater China loan exposure was S$27.3bn, down S$2bn qoq, of which S$8bn was trade (there is also some trade finance within interbank but what is there is just a BAU level). The c.S$19bn of non-trade China loans are typically loans to offshore companies making investments into China in areas such as power plants, resources, and utilities, where OCBC underwrites on a project basis based on the strength of the customer relationship. This overall China exposure is defined as where the credit risks reside, not the booking center. By booking centers, just S$3.6bn is booked onshore China, S$7bn in HK, S$1bn in Taiwan, and S$15bn in Singapore and other centers.

- **China country exposures —** This distribution by booking center reflects OCBC's China strategy of operating an offshore-onshore model; the tendency for OCBC to bank more with clients offshore is because that where the bank's competitive advantage lies, but the bank still needs the linkage onshore. OCBC also tends to target larger corporates and SOEs, as that is where the greater offshore-onshore opportunities lie. Thus OCBC's portfolio is not representative of the whole of China, and the NPL ratio in the China book is just 0.3%. On China trade, OCBC finances the movement of goods (not storage of goods) and was not involved with Qingdao.

- Even for financing the movement of goods the underlying transaction has to make sense, trade finance cannot be done on a peripheral understanding of the transaction. The fall in trade finance qoq was in part a function of the interest rate

differential between onshore rates and offshore. This was high during 4Q and 1Q (as much as 3%), so then a rising portion of China importers sought their funding offshore. Starting in 2Q that rates gap fell to 1.8% (the peak was about 2.8%), reducing at the margin incentives for China importers to seek funding from offshore. So the qoq fall in trade loans simply reflects a natural development of the trade pattern, not a pullback due to any specific concerns. Mgmt. thinks that the interest rate gap could narrow further to just 1%, which would potentially limit further trade growth opportunities. OCBC is still awaiting regulatory approval to take its stake up in Bank of Ningbo to a planned 20% from about 15% now. When done, OCBC plans to equity account the profits of Bank of Ningbo into the group.

- **Loans —** Loans grew +12%yoy and +1%qoq. Loan growth appears to be broad-based including mortgages +8%yoy, +2%qoq. But trade loans fell 11%qoq (still +22%yoy). By currency loan growth came from SGD, USD, and MYR, but fell in IDR and other currencies.

- **NIM —** Mgmt. project 2014 NIMs will end up somewhere above the 2013 level of 1.64% but below the 1H14 figure of 1.70%. Some of the rise in NIM in 1H14 was to do with the trade loans in China, but corporate loan spreads (aside in Malaysia) have also improved (this is broadly down to improved pricing discipline across the industry helping to lift spreads) and that continues to contribute. However, deposit funding costs are also up, due to competition in domestic Singapore but also overseas. It is difficult to derive strong conclusions on the improved yield on interbank placements, given that the book is a combination of countries and currencies, but China did contribute.

- **Non-II —** Bank of Singapore private bank AUMs continued grow, reaching US$51.2bn as of June 2014. GEH banca sales were a little soft in 2Q14, this was in part due to higher than expected staff turnover and an early start in implementing the fair dealing rules.

- **Operating costs —** Opex remained well managed up 6%yoy with a CTI ratio of 38.5% in 2Q14.

- **Asset quality —** 2Q14 specific provisions rose to S$36m, still just 8bps of loans. Mgmt. stressed that within the overall NPL ratio of 0.7%, mortgage NPLs were just 0.6%, and Singapore only mortgage NPL ratio was even lower. The Singapore mortgage book is about 76% owner occupier and 24% investment. But the key is how the portfolio and credit risk is managed. NPL ratios on the investment side are similar to the owner-occupier side. The overall mortgage book LTV ratio is around 60%, so on a stress test the book can manage assumed property price falls of 20-30%. Overall, given how low the NPL ratio is it would not be a surprise to see some deterioration, but at present mgmt. do not see such concerns within the overall book. Cumulative loan loss provisions are 1.1% of gross loans. Mgmt. is comfortable with this given that provisions cover of NPLs is 153% and at 423% of unsecured NPAs.

- **Capital —** CET1 on a full 2018 B3 basis is 11.3%. The scrip dividend scheme will apply to the 1H14 interim DPS of S$0.18, the issue price to be set at a 10% discount to the market price. Mgmt's general policy on capital is to keep a comfortable buffer above regulatory minimum levels and in line with peer banks, as well as to maintain a strong credit rating. Capital is managed on transitional B3 rules but with an eye on fully implemented 2018 B3 rules, knowing that the market focuses on full B3.

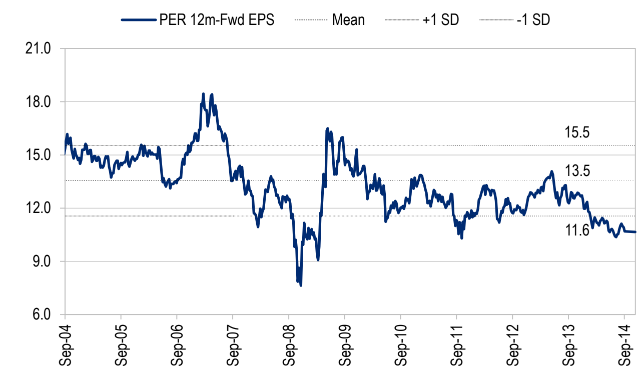
- **Malaysia —** NIMs fell to 4.09% (-14bps qoq and -16bps yoy), attributed to both lower asset yields and higher cost of funds. The sharp fall in NIMs is partly because funding costs rose in 2Q in anticipation of a BLR rate hike, which should help mitigate NIM fall in 3Q. Mgmt view that a further OPR rate hike could be

coming up and banks are already reacting to this by again pricing up FDs. Overall, the Malaysia results were satisfactory despite the NIM pressure. Although M&A may change the Malaysian domestic landscape, OCBC is happy with its exiting presence as one of the larger foreign banks.

- **Indonesia —** NPL ratio rose to 1.1% from 0.8%, largely attributable to a single account being downgraded. This account is being restructured (the restructuring process should be completed by year end) and by domestic regulations provisions have to be made for the collateral shortfall. Mgmt continue to have high confidence in the outlook for Indonesia.

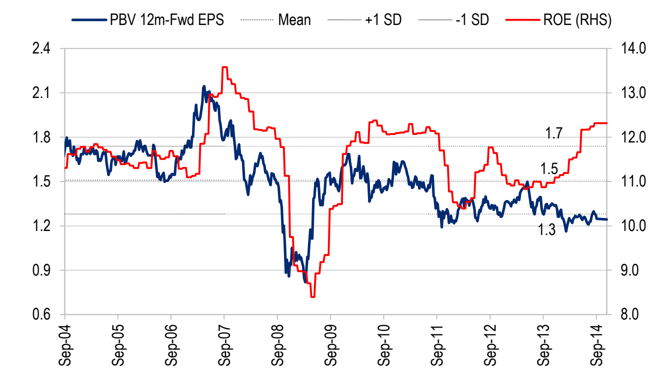
- **1H/2Q14 numbers in brief —** 1H14 result was 60% of consensus 2014E S$3.04bn. 2Q14: S$921m +3%qoq. Results were driven by good loan growth, stable NIMs, better life insurance, and trading profits. 2Q14 NII S$1.13bn +4%qoq on loans S$177bn +12%yoy, +1%qoq on NIMs 1.70%, flat qoq (loan yield 2.87% -2bps qoq, interbank yield +10bps qoq, deposit cost 1.04%, +4bps qoq; loan yield to deposit cost spread 1.83% -6bps qoq). Non-II S$850m +6%qoq: Fees S$353m flat qoq; life insurance profit S$220m +21%qoq; net trading income S$133m (+35%qoq), investment gains S$13m (1Q: S$52m). 2Q14 revenue S$1.98bn +5%qoq vs. costs S$760m +8%qoq for PPOP S$1.21bn (+3%qoq). Provisions S$66m (1Q: S$41m), c.16bps of net loans; NPLs S$1.17bn -1.6%qoq; NPL ratio 0.7%, 153% coverage. Group LDR 88.1%, SGD LDR 81.6%, CASA ratio 47% (1Q: 47%). CET1 11.3% (full-B3 basis). 2Q BV/shr S$7.31 (1Q: S$7.18), EPS S$1.06 (1Q: S$1.04), ROE 14.8% (1Q: 14.9%). 1H14 interim DPS S$0.18 (1H13: S$0.17), c. 35% payout.

Figure 95. 12M-Forward Consensus PER



Source: Datastream, Citi Research

Figure 96. 12M-Forward Consensus P/B vs ROE



Source: Datastream, Citi Research

Figure 97. Results at a Glance (S$ Millions, Percent)

	1H 2014	1H 2013	YoY %	2Q2014	2Q2013	YoY %	1Q2014	QoQ %
Net Interest Income	**2,213**	**1,873**	**18.2**	**1,126**	**961**	**17.2**	**1,087**	**3.6**
Fee-Based Income	706	663	6.5	353	347	1.7	353	0.0
Insurance Income	482	271	77.9	259	56	362.5	223	16.1
Other Non-Interest Income	462	348	32.8	238	203	17.2	224	6.3
Non Interest Income	1,650	1,282	28.7	850	606	40.3	800	6.3
Operating Income	**3,863**	**3,155**	**22.4**	**1,976**	**1,567**	**26.1**	**1,887**	**4.7**
Operating Expenses	-1,466	-1,390	5.5	-760	-718	5.8	-706	7.6
Pre-Provision Profit	**2,397**	**1,765**	**35.8**	**1,216**	**849**	**43.2**	**1,181**	**3.0**
Charges for Bad Debts	-107	-104	2.9	-66	-83	-20.5	-41	61.0
Operating Profit	**2,290**	**1,661**	**37.9**	**1,150**	**766**	**50.1**	**1,140**	**0.9**
Goodwill	-28	-29	**-3.4**	-14	-15	**-6.7**	-14	**0.0**
Other Non Operating Items	35	36	-2.8	18	23	-21.7	17	5.9
Pre-Tax profit	**2,297**	**1,668**	**37.7**	**1,154**	**774**	**49.1**	**1,143**	**1.0**
Tax	-357	-291	22.7	-172	-149	15.4	-185	-7.0
Minorities	-120	-84	42.9	-61	-28	117.9	-59	3.4
Net Profit	**1,820**	**1,293**	**40.8**	**921**	**597**	**54.3**	**899**	**2.4**
Cash EPS (annualized)	1.07	0.75	42.1	1.07	0.69	55.7	1.06	1.0
GAAP EPS (annualized)	1.05	0.73	43.2	1.06	0.67	57.3	1.05	1.1
DPS (S$)	0.18	0.17	5.9	0.00	0.00	-	0.00	-
Customer Advances	**177,415**	**158,869**	**11.7**	**177,415**	**158,869**	**11.7**	**175,245**	**1.2**
Customer Deposits	201,297	176,265	14.2	201,297	176,265	14.2	199,403	0.9
Non-Performing Loans (NPL)	1,172	1,151	1.8	1,172	1,151	1.8	1,191	-1.6
Loan Loss Reserves (LLR)	1,795	1,697	5.8	1,780	1,685	5.6	1,767	0.7
Non-Performing Assets (NPA)	1,215	1,177	3.2	1,215	1,177	3.2	1,230	-1.2
Total Assets	**348,414**	**313,225**	**11.2**	**348,414**	**313,225**	**11.2**	**343,638**	**1.4**
Risk-Weighted Assets	159,184	148,131	7.5	159,184	148,131	7.5	157,078	1.3
Shareholders' Funds	26,893	25,467	5.6	26,893	25,467	5.6	26,043	3.3
NTA Per Share	6.25	5.61	11.3	6.25	5.61	11.3	6.09	2.7
Book Value Per Share	7.31	6.72	8.8	7.31	6.72	8.8	7.18	1.9
Key Ratios (%)	**1H 2014**	**1H 2013**	**Bps**	**2Q2014**	**2Q2013**	**Bps**	**1Q2014**	**Bps**
ROAA (annualized)	**1.27**	**1.02**	**25**	**1.27**	**0.92**	**35**	**1.27**	**0**
ROAE (annualized)	**14.9**	**10.9**	**400**	**14.8**	**9.9**	**490**	**14.9**	**-10**
Net Interest Margin (bps)	**170**	**164**	**6**	**170**	**164**	**5**	**170**	**-1**
Loan Yield - Deposit Cost Spread (bps)	185	191	-6	183	189	-6	189	-5
Fee Inc/Operating Income	18.3	21.0	-274	17.9	22.1	-428	18.7	-84
Non Int Inc/Operating Income	42.7	40.6	208	43.0	38.7	434	42.4	62
Op. Cost/ Operating Income	37.9	44.1	-611	38.5	45.8	-736	37.4	105
Provisions bps of loans	12	14	-2	15	22	-7	10	5
Loan-to-Deposit Ratio (LDR)	**88**	**90**	**-199**	**88**	**90**	**-199**	**88**	**25**
NPL/Loan Ratio	0.7	0.7	-6	0.7	0.7	-6	0.7	-2
LLR/NPL Ratio	153	147	572	153	146	676	148	479
Tier-1 Capital Ratio	14.7	14.9	-26	14.7	14.9	-26	14.4	30
Total Capital Ratio	**17.4**	**16.9**	**58**	**17.4**	**16.9**	**58**	**15.7**	**178**

Source: Company

Wing Hang Bank 1H14 Profit HK$933m, -7%yoy,-21%hoh

- **Citi's Take** — WHB 1H14 net profit was 47% of the HK$2bn 2014 profit assumed within our OCBC 2014 forecast. Flattish NII and core fee revenues; but operating costs fell 14%hoh (up 4%yoy), but a fair value loss adjustment (in other income) and absence of property disposal gains from prior periods led to the softer bottom line result.

- **Details —** Gross loans +5% hoh (+16%yoy) driven largely by residential mortgages and wholesale-retail loans, but offset by a shrinkage in trade finance loans. Loans to China and Macau were up strongly yoy but only modestly qoq. NII rose +0.9%hoh and +9.5%yoy, suggesting some cost of funds pressure. NIM was not provided (FY2013: 1.71%) but likely a slight slippage. Overall LDR stable at 76%. Core fee income flat hoh; broadly soft aside a pick-up in WM and insurance, while +4%yoy fee growth was largely driven by trade fees and WM. The hoh fall in costs was mainly on staff cost and the absence of onetime costs from 2H13. Impaired loans remain low at 0.35% of loans (61% coverage). Tier-1 ratio 11.7%, CAR 15.4%.

- **Comparison to other HK bank 1H results —** We think WHB results reflect an overall conservative stance as the company is preparing for the merger with OCBC. Loan, deposit, and fees growth all look slower than peer average. NIM pressure was partly expected given WHB's relatively high time deposit mix and overall increase in funding cost (as reference, peer mid-cap bank BEA was estimated to have 14bp hoh decline in NIM). Tier 1 ratio remains sufficient and on par with peer average.

Figure 98. Wing Hang Bank 1H 2014 Profit & Loss Summary

Year-end Dec, HK$m	1H13	2H13	1H14	1H14 hoh	1H14 yoy
Interest income	2,877	3,055	3,222	5.5%	12.0%
Interest expense	-1,276	-1,317	-1,469	11.5%	15.1%
Net interest income	**1,601**	**1,738**	**1,753**	**0.9%**	**9.5%**
Net fees and commission	325	336	337	0.1%	3.7%
Other dealing income	99	85	87	2.0%	-11.9%
Gain (losses) from FVTPL	12	105	-66	-163.6%	-647.5%
Other operating income	436	526	357	-32.1%	-18.0%
Total operating income	**2,036**	**2,264**	**2,111**	**-6.8%**	**3.6%**
Salaries	-584	-696	-620	-10.9%	6.2%
Pensions	-45	-43	-44	2.4%	-2.5%
Premises and equipment	-130	-141	-142	0.6%	9.0%
Depreciation	-110	-105	-102	-3.0%	-7.2%
Other	-141	-243	-146	-39.9%	3.7%
Operating expenses	-1,009	-1,227	-1,053	-14.2%	4.4%
Operating profit pre-provisions	**1,027**	**1,037**	**1,058**	**2.0%**	**2.9%**
Impairment provisions	-43	-43	-31	-27.7%	-27.7%
Operating profit	**984**	**994**	**1,026**	**3.3%**	**4.3%**
Properties revaluation disposal	96	219	-1		
Disposal gain on AFS/HTM	90	121	49		
Exceptionals	186	340	49	-85.7%	-73.8%
Associates	13	39	26	-32.3%	107.1%
Pre-tax profit	1,183	1,373	1,101	-19.8%	-6.9%
Tax	-175	-193	-168	-12.8%	-3.9%
Post-tax profit	1,007	1,180	933	-20.9%	-7.4%
Attributable net profit	**1,007**	**1,180**	**933**	**-20.9%**	**-7.4%**

Source: Company, Citi Research

Figure 99. Wing Hang Bank 1H 2014 Balance Sheet Summary

Year-end Dec, HK$m	1H13	2H13	1H14	hoh	yoy
Cash & interbank	22,094	26,781	32,665	22.0%	47.9%
Investment securities	47,034	44,086	40,612	-7.9%	-13.7%
Gross customer advances	122,649	135,323	141,783	4.8%	15.6%
Collective impairment allowance	-218	-224	-217	-2.9%	-0.4%
Individual impairment allowance	-61	-58	-84	45.4%	36.6%
Net customer advances	122,370	135,042	141,482	4.8%	15.6%
Accrued interest, other interest earnings assets	2,355	2,446	2,402	-1.8%	2.0%
Associates	242	253	279	10.3%	15.1%
Fixed assets	5,662	4,427	4,551	2.8%	-19.6%
Goodwill	1,306	1,306	1,306	0.0%	0.0%
Tax assets	41	36	41	13.0%	-0.1%
Total assets	**201,104**	**214,376**	**223,339**	4.2%	11.1%
Liabilities					
Interbank deposits	1,681	3,258	2,120	-34.9%	26.1%
Customer deposits	167,868	177,910	186,102	4.6%	10.9%
CDs issued	2,824	4,186	5,090	21.6%	80.2%
Trading liabilities	715	773	603	-22.1%	-15.8%
Subordinated liabilities	4,900	3,169	3,275	3.3%	-33.2%
Other accounts and provisions	2,707	3,379	3,814	12.9%	40.9%
Shareholders' funds	**20,410**	**21,700**	**22,337**	2.9%	9.4%
Total liabilities & shareholders fund	**201,104**	**214,376**	**223,339**	4.2%	11.1%

Source: Company, Citi Research

OCBC

Company description

OCBC is Singapore's second-largest bank by group assets (Jun-2014: S$348bn). Its main focus is Singapore (60% of 1H14 PBT) and Malaysia (19%). OCBC is present in other countries, notably Indonesia (4%) and Greater China (11%). OCBC is a leader in life insurance and wealth management, the latter accounting for 29% of 1H2014 group revenue, insurance alone accounting for 22% of group PBT. Group CEO Samuel Tsien joined OCBC in July 2007 and was appointed CEO in April 2012.

Investment strategy

We rate OCBC shares as Buy (1), target of S$11.50 (FY15E: 1.5x P/B vs 12.3% ROE, 12.8x PER). OCBC is viewed as a "quality" stock, historically trading at a premium to, and typically with less price volatility, vs. bank peers. OCBC is differentiated by a superior credit cost history, and its wealth mgmt. platform, which continues to enjoy strong growth, although insurance profit is subject to accounting mark-to-market volatility. Despite the prospect of US recovery, Singapore is facing domestic growth challenges, and hence regional strategies may differentiate banks' performance. Our OCBC forecasts build in the acquisition of 100% of Wing Hang Bank (WHB) from 3Q 2014 at a cost of S$6.2bn, funded by S$3.37bn new equity, the remainder debt & cash. We believe that near term earnings dilution of 4%-5% is manageable, and will not impact dividend policy, while we view that OCBC can deliver more than the S$170m net earnings synergies that would make the deal accretive as part of its China growth strategy. We have factored in S$280m synergies by 2017 based on a bottom-up analysis of the OCBC-WHB model.

Valuation

Our target for OCBC is S$11.50. (1) Using a dividend discount model (DDM), assuming a 2015E DPS of S$0.385, cost of equity of 9.3% and 5.95% long-term growth rate, applied to our 2015E EPS of S$0.89, derives a fair value of S$11.50. This equates to a 2015E P/E of 12.8x, P/B of 1.5x (vs. 12.3% ROAE). We use DDM as we view it reflects sustainable earnings/dividends and returns relative to cost of equity, and can factor in liquidity/sentiment impact on valuations. It is also consistent with the methodology underpinning our P/E investment-cycle analysis framework. (2) Using our P/E cycle analysis, which suggests a 1SD trough-peak P/E range for OCBC of 11.6x-15.5x, mean 13.5x on one-year forward consensus estimates (P/B range 1.3x-1.7x, mean 1.5x), our target P/E is set at -0.4SD below mean.

Risks

The key risks to our investment thesis on OCBC are: 1) The extent of impact of the US/global economy on Singapore's domestic economy, rates and loan growth; 2) MAS exchange rate policy, the level of short-term interest rates and shape of the yield curve (affects net interest margins); 3) Changes to the asset quality position and in turn provision charges; 4) Capital flows, market liquidity risk appetite; 5) Dividend policy/capital ratio strength; and 6) Ability to execute on earnings synergies for WHB and regional (especially China) growth. If such factors have a greater upside/downside impact than we anticipate, the share price may trade above/below our target price.

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

OCBC (OCBC.SI)

Ratings and Target Price History
Fundamental Research

Analyst: Robert P Kong, CFA

	Date	Rating	Target Price	Closing Price
1	2-Oct-11	1L	*9.03	7.89
2	7-Oct-11	Stock rating system changed		
3	7-Oct-11	*1	9.03	7.66
4	4-Nov-11	*2	*8.35	8.28
5	20-Feb-12	2	*9.12	8.69
6	4-May-12	*1	*9.73	8.70
7	2-Aug-12	*3	*8.88	9.16
8	26-Nov-12	*2	*9.46	8.88
9	16-Feb-13	*3	*9.32	9.70
10	22-Aug-13	*2	*9.71	9.65
11	7-Nov-13	2	*10.00	10.14
12	18-Aug-14	2	*10.68	9.90

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

OCBC (OCBC.SI)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Robert P Kong, CFA

	Date	Rating	Target Price	Closing Price
1	25-May-12	*ADD MP	-	8.26
2	6-Aug-12	*REM MP	-	9.23

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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	12 Month Rating			***Relative Rating***		
Data current as of 30 Jun 2014	**Buy**	**Hold**	**Sell**	**Buy**	**Hold**	**Sell**
Citi Research Global Fundamental Coverage	49%	40%	12%	0%	100%	0%
% of companies in each rating category that are investment banking clients	55%	53%	46%	0%	54%	0%

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