

Asian tael: bank stocks shine through asset quality risks

In recent weeks, Chinese banks have found themselves under the spotlight as the media focused on their asset quality risks associated with credit extended to Local Government Financing Vehicles (LGFVs) and property developers.

Not surprisingly, the negative publicity has had a discernible drag on these stocks as they underperformed the broader market over the last four quarters. However, we believe that these concerns are overdone and at current low valuations, Chinese banks offer attractive risk-reward opportunities over a six to twelve month horizon.

Going into 4Q10, we remain positive on Asian Financials as they are expected to benefit from better economic outlook and lower policy risks. That should also shore up market confidence in Chinese banks in the months ahead.

Concerns on Local Government Financing Vehicles (LGFVs) should ease

There have been various media reports that singled out the asset quality risks faced by Chinese banks, due to excessive credit extended to LGFVs last year as part of the overall fiscal stimulus package. However, we believe that the markets have already priced in these risks, as Beijing took steps to curb asset quality risk at Chinese banks early this year.

For example, China has already stopped the approval of new public investment projects for local governments to ease their debt burdens, while allowing ongoing projects to continue. Meanwhile, the bank regulator now requires Chinese banks and local governments to actively negotiate for additional guarantees and collaterals to improve the credit profile of existing LGFV loans. Also, plans are afoot to introduce the issuance of municipal bonds to improve the financial strength of local governments.

Citing local sources, the China Securities Journal said that the latest LGFV loan assessment shows no negative surprises from the earlier figures highlighted by China Banking Regulatory Commission (CBRC) – total outstanding balance of RMB7.66 trillion, among which problematic loans accounted for about RMB2 trillion (26 per cent of LGFV loans but only 4 per cent of total outstanding loans). We believe that not all high-risk loans will default due to the pre-emptive measures taken, and there will be limited additional provisions required. Improved macro outlook in China also reduces the risk of loan default.

Property Tightening

Since the start of 2010, Beijing has implemented a slew of property tightening measures aimed at cooling the market, even as most Chinese banks pared their exposure to property developers over the past three years. According to the banks' management, their mortgage books now consist of mainly loans to owner-occupiers and not speculators, while the loan-to-value ratio is about 60-70 per cent - a comfortable cushion in the event of a property correction. Meanwhile, a recent stress test on property lending by CBRC showed that a 30 per cent drop in property price would result in non-performing loan (NPL) ratio rising just one per cent.

Although we recognize that these measures will create a near-term overhang, we continue to view these initiatives as medium to long-term positives, as they curb runaway prices in the real estate market. Additionally, the domestic property crackdown could lead to more liquidity flowing into stocks.

Easing Policy Risks

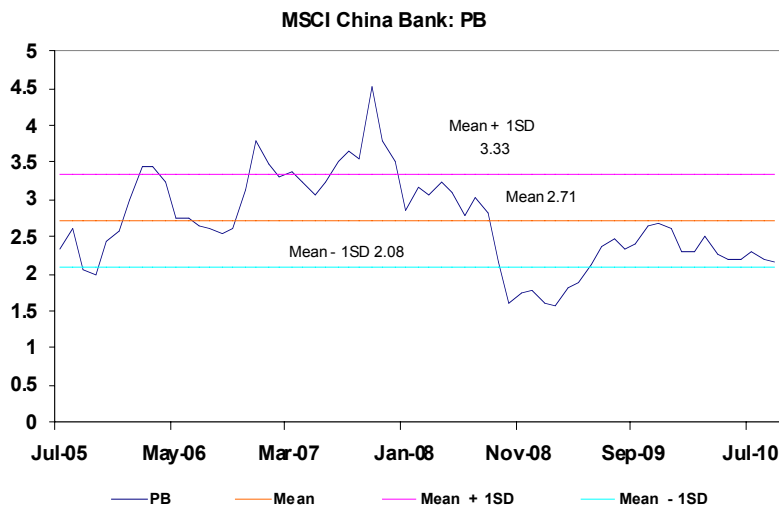
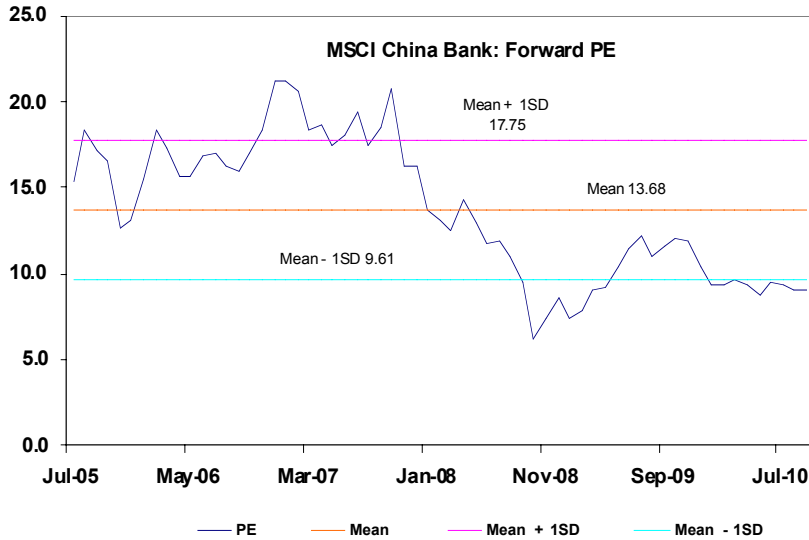
We expect policy noise to continue, but think that most policy risks have already been well flagged and sentiment should gradually improve. The regulator should soon disclose the results of the LGFV asset quality assessment and any remedial actions such as additional provisioning requirements. Although this may hit short-term earnings in 4Q10, we think that any fallout should be limited while the assessment results provide better earnings visibility over the next two years.

CBRC has already specified the capital requirements for Chinese banks, and the banks have already announced equity capital-raising plans to be implemented over the next couple of quarters. We believe that the rights issuance plans for the large Chinese banks will be successful and the Chinese government has committed to fully participating in the equity capital raising plans of state-owned Chinese banks, in a show of confidence to investors. This will remove a major overhang for the China stock markets.

We believe that the China banking sector will soon play catch up with the region as policy risks gradually ease. The steady appreciation of Asian currencies including the Renminbi will make Chinese assets more attractive too. Indeed, Chinese banks are among the cheapest in the region relative to their earnings growth profile, trading at 9x forward P/E¹ and 2.16x P/B² which is around 1 standard deviation below its historical mean valuation.

Notes:

1. P/E: Price-Earnings Ratio
2. P/B: Price-Book Ratio





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Contact Details

Address 80 Raffles Place UOB Plaza 2 Level 3 Singapore 048624
24-hour Hotline 1800 222 2228 (Local) • (65) 6222 2228 (International)
Fax (65) 6532 3868
Email uobam@uobgroup.com
Website uobam.com.sg

Regional Offices

Singapore

Institutional Investments
Dennis Siew
Senior Director

Retail Investments
Norman Wu
Senior Director

Regional Investments
Faizal M. Fazluddin
Senior Director

Structured Investments
Chong Jiun Yeh
Executive Director

International Business (China)
Jasmine Lim
Senior Director

Brunei

Kamal Muhd
General Manager

Japan

Masashi Ohmatsu
Chief Executive Officer

Malaysia

Lim Suet Ling
Chief Executive Officer

Taiwan

Juang San Tay
General Manager

Thailand

Vana Bulbon
Chief Executive Officer

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