

# China Banking Sector

## Scenario analysis on banks' balance sheet

Although weak macro data evidenced that the pandemic has serious negative impacts on the economy, we think that the market is overreacted. Currently, large banks' valuation implies an assumed 10% NPL ratio and we think that the default rate is overestimated. Maintain **OUTPERFORM** on banking sector, top pick is PSBC (1658 HK, BUY) with a target price of HK\$8.40. The recovery on economy should be the key catalyst on sector re-rating.

■ **Scenario analysis shows that China's banking system is still stable in current weak economy.** We analysed historical NPL data (1997 - current) of over 100 countries or regions. Generally, for most of the countries' banking system, the most serious loan default happened during the 1998-2002 global financial crisis (Southeast Asian financial crisis, Russian financial crisis, US tech stock bubble burst, etc.) and the 2008-2009 financial crisis.

During these two rounds of global financial crisis, the banking systems of developed countries showed strong resilience to risks. During the financial crisis in 1998-2002, NPL ratio in Japan, Korea, Singapore, France, Germany and other high-income countries was 5%-8%. And during the 2008 financial crisis, NPL ratio of the US banking sector was 4.96%. The highest historical NPL ratio in the UK, Australia, Canada and other countries was even lower than 5%.

On the contrary, developing countries and ASEAN (excluding Singapore) showed the vulnerability of their banking systems during the Southeast Asian financial crisis, with NPL ratio generally above 15%, while in Thailand and Indonesia, the NPL ratio even exceeded 40%. According to the World Bank, during global financial crisis (1998-2002), among the developing countries, the average peak NPL ratio is 17.2%. Given that China's GDP per capita has just reached the global average, we believe that the changes in banking asset quality in developing countries are more informative as a benchmark to analyse China's situation. Meanwhile, the performance of the banking sector in Malaysia, Portugal, and Russia during the financial crisis also has implications for our analysis of the extreme scenarios in China.

■ **Maintain OUTPERFORM on banking sector and PSBC as our top pick.** Our target price of PSBC at HK\$8.40 implies 0.91x 2022E and 0.85x 2023E P/B. The stock is trading at 0.66x/0.61x FY22/23E P/B, almost equivalent to +1SD of 3-yr historical mean.

### Valuation Table

Name	Ticker	Mkt Cap (LC bn)	Rating	Closing price	TP (LC)	Upside	P/E	P/B	Yield
PSBC	1658 HK	529	BUY	5.73	8.40	47%	5.0	0.6	6.0%
CCB	939 HK	1,367	BUY	5.48	8.10	48%	3.6	0.4	8.2%
SPDB	600000 CH	233	HOLD	7.94	9.00	13%	4.1	0.4	6.7%
BOSH	601229 CH	91	BUY	6.38	8.68	36%	3.7	0.5	7.7%
CQRC	3618 HK	34	HOLD	3.03	3.40	12%	2.6	0.2	11.2%
BOCS	601577 CH	29.9	HOLD	7.45	8.30	11%	3.8	0.6	6.7%

Source: CMBIGM estimates based on 2022E earnings. Note: All closing prices are as of 18 May

## OUTPERFORM (Maintain)

### China Banking Sector

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### Stocks covered

Ticker	Rating	TP (LC)	Upside
1658 HK	BUY	8.40	47%
939 HK	BUY	8.10	48%
600000 CH	HOLD	9.00	13%
601229 CH	BUY	8.68	36%
3618 HK	HOLD	3.40	12%
601577 CH	HOLD	8.30	11%
601658 SH	BUY	7.07	37%
601939 SH	BUY	7.5	26%
601077 SH	HOLD	3.6	6%

Source: CMBIGM estimates

### Recent Reports:

- China Banking – Looking for the safe harbour ([link](#))
- China Banking – 4Q21 Quarterly Review ([link](#))
- China Financials Weekly – Deposit rate cuts to support NIM ([link](#))

■ **Based on the above, we conducted a scenario analysis of the asset quality of China's banking sector.** The following are our assumptions:

Extremely bearish scenario: NPL ratio increases to 20%. The reference is NPL ratio of comparable developing countries in a financial crisis.

Worst case: NPL ratio increases to 4.04%. This NPL ratio implies all the SML defaulted.

Base case: NPL ratio increases 43 bps to 2.16%. The 43 bps jump referred to the biggest YoY NPL jump in history, which occurred in 3Q14-3Q15.

Best case: NPL ratio rises to 1.85%, referring to the NPL ratio during 2018 China-US trade conflicts.

■ **The following are the consequences under four different scenarios:**

**Extremely bearish scenario:** According to our calculations, the threshold of NPL ratio on bankruptcy in China's banking sector is 20.03%. Therefore, if the NPL ratio reaches 20%, the banking sector will face a systemic crisis.

**Worse case:** The industry loses money, the provision coverage ratio drops 47 ppt from 197% to 150%, and CET-1 drops 1.61 ppt to 9.17%, which still meets the regulatory requirements.

**Base case:** Provision coverage ratio drops 39.47 ppt from 197% to 157.4%, higher than the 150% standard line, in line with the regulator's guidelines for an orderly and reasonable decline in provisioning, with no impact on annual profit and core tier-1 capital.

**Best case:** Provision coverage ratio decreases by 13.09 ppt from 197% to 184%, which is higher than the 150% standard line, in line with the regulator's guidelines for an orderly and reasonable decline in provisioning, with no impact on full-year profit and core tier-1 capital.

Based on the above analysis, we believe that under the current economic conditions, the decline in asset quality is mainly reflected by the increasing NPL ratio and the decrease in provisioning, while profit growth and CET-1 of the banking industry are not materially affected.

■ **What about current valuation levels and how much negative information is reflected?**

In the Hong Kong stock market, the factors which capped banking valuations have escalated from default risks in the property sector to downside risks from the Chinese economy and policy uncertainties. Except CMB and PSBC, other major banks are in the valuation range of 0.25x~0.45x P/B, which is at historical lows. The average valuation level of the Big Four banks is at 0.42x P/B. This valuation implies a 7.8% NPL ratio, much higher than reported NPL ratio of 1.39%. Accordingly, the industry-wide valuation, corresponding to an implied NPL ratio of around 13.5%, far exceeds the pessimistic assumptions in our scenario analysis.

As a result, we believe that market investors have overreacted to negative information about the sector, which is currently oversold and very attractive to long-term investors.

■ **What are the catalysts for the sector re-rating?**

The future recovery of the property sector will not act as a major catalyst for banking sector re-rating, and the significant re-rating needs support from economic recovery.

**Figure 1: Scenario analysis on banks' balance sheet**

Worst case		Base case		Best case	
Assumed NPL ratio	4.04%	Assumed NPL ratio	2.16%	Assumed NPL ratio	1.85%
Assumed NPL balance	6,660	Assumed NPL balance	3,561	Assumed NPL balance	3,050
Required write-off	2,923	Required write-off	0	Required write-off	0
Net profit	(739)	Net profit	Unchanged	Net profit	Unchanged
CET-1 ratio	9.17%	CET-1 ratio	Unchanged	CET-1 ratio	Unchanged
Adjusted allowance to NPL ratio	150%	Adjusted allowance to NPL ratio	157%	Adjusted allowance to NPL ratio	184%

Source: Company data, CMBIGM estimates

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