A CLOSER LOOK AT CHINESE BANKS

Jeremy Schwartz — Global Chief Investment Officer
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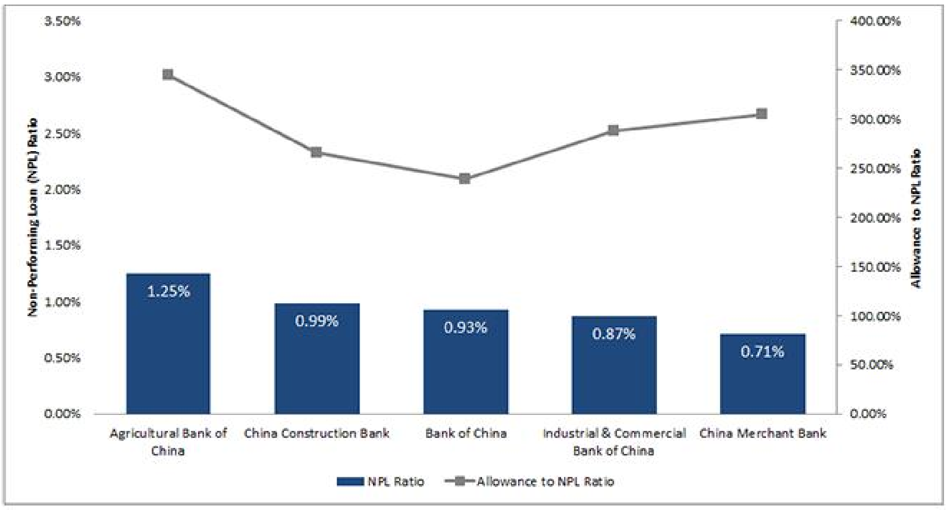
Concerns about a slowdown in Chinese growth and a rise in U.S. Treasury yields have put pressure on emerging market equities this year. One segment in particular receives much attention: the Chinese banks. Chinese banks trade at some of the lowest price-to-earnings multiples and the highest dividend yields in the emerging markets. There is skepticism about the asset quality of Chinese banks and whether their non-performing loans (NPLs) are as low as they officially report. **A Chinese Property Bubble?** Some analysts argue that excessive loan growth in China has resulted in a surplus of properties with artificially inflated values. These analysts have also accused the Chinese government and banks of not accurately reporting these potential bad loans. Certainly slower growth or a "hard landing" in China could put pressure on non-performing loans, but below I will discuss why I believe accusations of outright accounting manipulation have been exaggerated. **Non-performing Loans** The China Banking Regulatory Commission recently announced that by the end of June, the non-performing loan balance of commercial banks was 539.5 billion yuan, with an NPL ratio of 0.96%. The commission also reported that loan loss provisions stood at 1.57 trillion yuan, up 18.97% year-over-year, and the provision coverage ratio was 291.3%[1]. This means that commercial banks have set aside enough reserves to cover approximately three times the amount of current non-performing loans. In the below chart I highlight the individual NPL ratios and the respective allowances for a few of the largest Chinese banks as of their most recent 2013 interim financial reports. **Non-Performing Loan Statistics**



Sources: Bloomberg, WisdomTree (on 09/30/13). Past performance is not indicative of future results.

• **Non-performing Loan Ratio Relatively Low:** Many of the banks above have low non-performing loans relative to the size of their assets—many ratios are close to or below 1.00%. To put this in perspective, the five largest U.S. banks have an average NPL ratio of 1.78%.[2] • **Allowance to Loan Losses Relatively High:** The Chinese banks also typically have a high amount of allowances, in the range of 3% of total loans—which is about 3x their NPL ratios. To put this in perspective, the five largest U.S. banks have an average allowance amount of just 1.65x.[2] Chinese banks thus have a greater cushion in terms of already provisioning for larger loan losses. • **Asset Quality Discussion:** I have discussed this asset quality question with Tracy Yu, a China financial analyst for Deutsche Bank. Her cash flow analysis of the Chinese banks suggests that NPLs are not being underreported. Her analysis showed: o **Cash Increase Matches Profit Increase:** The increase in pre-tax profit of the H-Share-listed Chinese banks from 2007 to 2012 was matched by their net increase in cash. This indicates that the loans performed as expected and the Chinese banking profits were not accomplished through accounting gimmicks. If NPLs were underreported, one would expect net profits to be higher than increases in cash.

o Another piece of evidence Tracy pointed to was the amount of interest income that comes from accruals instead of cash payments: only 46 basis points of assets—which is better than comparable ratios in other emerging markets such as India or Indonesia. o Wealth management products (WMPs) are a source of concern, yet recent disclosure suggests that two- thirds of the WMPs are invested in fairly conservative assets that are liquid. Only one-third of WMPs are invested in riskier, less liquid assets, and these represent only 2.2% of total banking assets. **Chinese Banks Potentially Offer Attractive Valuations** Jiang Jianqing, chairman of the Industrial and Commercial Bank of China (ICBC), commented on the valuations of Chinese banks: "Since last year the market has been extremely suspicious of the Chinese banking sector. They've pressured our [price-to-earnings] and [price-to-book] ratios to low levels. Such good profits, such good returns, such good quality. We think it's a little bit unfair". [4] The chart below displays the most recent reported profitability (1H 2013) increase compared to the same period the year before and other valuation metrics for a few Chinese financials: **Fundamental Metrics**

Company	Net Profit Increase	P/E Ratio	Dividend Yield
Agricultural Bank of China	14.70%	5.9x	5.55%
China Construction Bank	12.70%	5.7x	5.68%
Bank of China	12.40%	5.3x	6.26%
Industrial & Commercial Bank of China	12.40%	5.9x	5.60%
China Merchant Bank	12.39%	5.1x	5.52%

Sources: Bloomberg, WisdomTree (09/30/13). Past performance is not indicative of future results.

Conclusion It is impossible to know what the future will hold, but it is important to consider current valuations. Only very rarely do we find companies with dividend yields that are approximately equal to their price-to-earnings ratios. The market has a fundamental mistrust of the Chinese banking system—yet cash flow analysis suggests the asset quality of Chinese banks is better than many think. The Chinese banks receive much of their funding from strong deposit bases and are unlikely to need to raise more equity capital to fund their operations. I believe these companies' high dividend yields make them attractive for income-oriented emerging market strategies. [1]China Banking Regulatory Commission 2013 Half-year Work Conference on National Banking Supervision & Economic and Financial Situation Analysis Conference [2]Source: Bloomberg, 9/30/2013. [3]Source: Bloomberg, 9/30/2013. [4]Gabriel Wildau and Lawrence White, "Investor Doubts Linger as China's 'Big Four' Banks Top Forecasts," Reuters, 8/30/2013.

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DEFINITIONS

Treasury yield : The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.

Dividend yield : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

Non-performing loan : A loan that is in default or close to being in default. Many loans become non-performing after being in default for 90 days, but this can depend on the contract terms.

Loan loss provisions : money set aside to help cover potential bad loans.

H-Share : A share of a company incorporated in the Chinese mainland that is listed on the Hong Kong Stock Exchange or other foreign exchange.

Basis point : 1/100th of 1 percent.