

Value Hunters: Look to China

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Chinese stocks—measured by the Shanghai Composite—have been off to the races in recent months. Investors are starting to expect more stimulus measures from the central bank and government, and there has been an opening of China's capital markets, encouraging investment sentiment. While prices for many Chinese stocks are moving higher, there remains a segment of the Chinese stocks with very depressed valuations: the largest Chinese banks. Four of the largest banks have [price-to-earnings \(P/E\) ratios](#) below 5.5x. These banks all just recently released their year-end earnings reports for 2014. What might be surprising to some is that the reports came out better than many analysts had expected. These banks reported an average increase in net profits of more than 6.7% in 2014 compared to the prior year. While growth in profits was encouraging, Chinese banks kept dividend payments relatively stable in order to help meet stricter capital adequacy ratios (CAR). China's banking regulators require that the largest banks must have met a Tier 1 capital ratio of 7.9% by the end of 2014 and 9.5% by the end of 2018 to make progress toward complying with Basel III requirements. In order to do so, the Chinese banks have been conservative in growing their dividends and are shoring up capital by issuing preferred shares that can serve as additional Tier 1 capital. Below we detail some highlights from each bank's earnings:

- **China Construction Bank (CCB):** CCB reported 2014 net profit after taxes of RMB 228 billion, higher 6% year-over-year (YOY). Dividend per share (DPS) was left flat at RMB 0.301.
- **Industrial and Commercial Bank of China (ICBC):** Net profit for the year reached RMB 276.3 billion, up 5.1% from the previous year. The bank proposed a dividend payment amounting to RMB 91.02 billion from RMB 91.96 billion last year.
- **Bank of China (BOC):** The bank achieved an after-tax profit of RMB 177 billion for the year, a YOY increase of 8%. It announced plans to pay RMB 0.19 DPS, down from RMB 0.196 last year, in part due to higher capital adequacy ratios.
- **Agricultural Bank of China (ABC):** Net profit after tax increased 8% to RMB 179 billion between 2013 and 2014. The board indicated that cash dividends to common shareholders would be higher by 2.83%, for a total of RMB 59 billion. While these earnings reports came in largely without major conflict, Chinese financials are selling at an aggregate 41% discount to their 10-year [median P/E ratios](#), and these four large Chinese banks are at even greater discounts.

Figure 1: Chinese Financials Trade at Steep Discount

P/E Ratios	10 Yr Median	3/31/2015	Discount
MSCI China Index	12.7x	11.0x	-13.0%
MSCI China Financials	12.5x	7.3x	-41.1%

Figure 2: Attractive Valuations, Higher Return on Equity (ROE) and Higher Income Opportunity

	Market Cap (USD bn)	Indicated Dividend Yield (%)	Estimated P/E Ratio	Dividend Payout Ratio	1-Year Indicated Dividend Growth	3-Year Indicated Dividend Growth	5-Year Indicated Dividend Growth	Return on Equity (%)
Emerging Markets Financials*	2.12	3.9%	9.8x	31.4%	N/A	N/A	N/A	2.5%
Industrial and Commercial Bank of China	276	5.6%	5.4x	32.8%	-1.0%	8.0%	8.9%	19.9%
China Construction Bank	213	5.8%	5.2x	37.7%	0.0%	8.4%	9.0%	19.7%
Bank of China Ltd	199	5.3%	5.3x	35.4%	-3.1%	7.0%	7.2%	16.4%
Agricultural Bank of China	188	5.9%	4.7x	36.9%	2.8%	11.4%	N/A	19.2%
Average of 4 Chinese Banks	219	5.7%	5.2x	35.7%	-0.3%	8.7%	8.4%	18.8%
U.S. Financials*	2.96	1.8%	14.3x	27.4%	N/A	N/A	N/A	8.7%
Wells Fargo & Co	280	2.6%	13.3x	34.1%	16.7%	10.3%	13.9%	12.5%
JPMorgan Chase & Co	226	2.6%	10.3x	26.9%	5.3%	5.4%	8.7%	9.9%
Bank of America Corp	163	1.3%	10.7x	11.1%	300.0%	16.7%	5.7%	5.8%
Citigroup Inc.	157	0.1%	10.0x	0.8%	0.0%	0.0%	N/A	8.4%
Average of 4 U.S. Banks	207	1.6%	11.1x	18.2%	80.5%	8.1%	9.4%	9.1%

*Tm Instead of bn where indicated.

Sources: WisdomTree, Bloomberg, as of 3/31/15. Emerging Markets Financials measured by MSCI EM Financials Index. U.S. Financials measured by S&P 500 Financials Index.

Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of indexes in the charts, visit our [glossary](#). • **Chinese Banks Have an Asset Base That Is 35% Larger:** The total market capitalization of the four major Chinese banks is USD 876 billion, while the four largest U.S. banks amount to USD 826 billion. While their market capitalizations are comparable, total assets of the four major Chinese banks add up to USD 11.05 trillion, while the total assets of the four major U.S. companies sum to USD 8.21 trillion. • **On Average, Chinese Banks Have Return on Equity (ROE) That Is Double That of U.S. Banks:** The largest four banks in China have ROE of 18.8%, roughly twice that of the four largest U.S. banks, which average 9.1%. • **Chinese Banks Have Income-Generating Potential:** The four Chinese banks have on average a 5.7% dividend yield, which is 3.4 times that of the U.S. banks. • **Retained Earnings Building Equity:** Importantly, the dividends are all very well covered by earnings, as the average dividend payout ratio from these banks is only 35.7%, meaning 64.3% is retained earnings that can help build greater equity cushions in case more loans start to turn bad and impact future write-offs. **Capturing These Types of Stocks in Diversified Strategy** For a diversified investment strategy that replicates a value-seeking investment approach exemplified by these four stocks with P/E ratios less than 5.5x, we would encourage investors to take a look at the [WisdomTree Emerging Markets Equity Income Index \(WTEMHY\)](#). As of 3/31/2015 China Construction Bank, Industrial and Commercial Bank of China, Bank of China and Agricultural Bank of China represent 4.63%, 3.68%, 2.97% and 0.84%, respectively, of WTEMHY, for a combined weight of 12.12% in the Index. WTEMHY's methodology employs a process to pick the highest 30% of companies ranked by their dividend yield from a starting universe of 1,200 dividend payers in emerging markets (EM). This selection process—and a further weighting process to magnify higher dividend payers' weights—offers a strict value-oriented approach. As a byproduct of its methodology, the Index has a dividend yield of more than 6%¹. Emerging markets remain one of the more out-of-favor segments of global markets, and this income-oriented approach is one worth consideration. ¹Dividend yield as of 3/31/15.

Important Risks Related to this Article

Diversification does not eliminate the risk of experiencing investment losses. Investments focused in China are increasing the impact of events and developments associated with the region, which can adversely affect performance.