

CHINESE BANKS ANNOUNCE NEW DIVIDEND HIKE

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One of the most disappointing performers in [emerging markets](#)—and where many have the most concerns—is state-owned Chinese banks. There remains a lively debate about the trustworthiness of the numbers and whether there will be a surge in [non-performing loans](#) stemming from a massive credit expansion over the last decade. These concerns have caused major Chinese companies to trade at these depressed [valuations](#). Recent earnings announcements coupled with rising payments of cash dividends indicate that the problems many have forecasted have yet to materialize and these stocks may indeed represent significant investment opportunities. **Increase in Net Profits** The largest Chinese banks recently released their year-end earnings reports for 2013, and the reports largely beat expectations from a profitability standpoint. Below we examine the four largest Chinese banks by [market capitalization](#).¹ All four banks reported an increase in net profits of 10% or more compared to the previous year.² • **China Construction Bank** – Net profit was Renminbi (RMB) 215 billion, up over 11% from 2012 • **Industrial and Commercial Bank of China** – Net profit of RMB 263 billion, which represented an increase of over 10% compared to the previous year • **Bank of China** – Achieved an after-tax profit of RMB 164 billion for the year, measuring a year-over-year increase of over 12% • **Agricultural Bank of China** – Reported its financial year 2013 net profit of RMB 166 billion, up 14.5% year-over-year We also analyzed the [return on equity \(ROE\) ratio](#), a common profitability metric of the Chinese banks mentioned above. The four banks averaged an ROE of 20.6%, which was (i) 11.6% higher than that of the developed world banks, (ii) 8.6% higher than the emerging market banks, and (iii) more than twice as profitable as their U.S. bank counterparts. **Valuation Dynamics of**

Indexes	Return on Equity (%)	Indicated Annual Dividend Yield (%)	Dividend Payout Ratio (%)	Estimated P/E Ratio	Annual Dividend Growth
Agricultural Bank of China	20.8	6.53	34.6	4.8x	13%
Bank of China Ltd	17.8	7.10	34.9	4.6x	12%
China Construction Bank	21.3	6.89	34.9	4.7x	12%
Industrial and Commercial Bank of China	22.3	6.84	35.0	4.7x	10%
Average of 4 Chinese Banks	20.6	6.84	34.9	4.7x	12%
Emerging Markets Financials	11.9	3.46	31.1	8.9x	N/A
US Financials	8.7	1.67	24.2	14.0x	N/A
Developed Markets Financials	8.9	3.49	53.4	12.3x	N/A

Source: Bloomberg as of 3/31/2014. Past performance is not indicative of future results. You cannot invest directly in an index.

For

Chinese Financials

definitions of indexes in the chart, please visit our [glossary](#). **Attractive Dividend Yields That Were Just Hiked Double Digits on Average** A key metric in assessing the ongoing profitability of a firm, in our opinion, is its [dividend](#) payout policy. A firm that is able to sustain and grow its dividends can serve to increase shareholder value through higher total returns. The figures in the table indicate what we believe is a significant valuation opportunity. Specifically, its dividend yields were among the top four banks that averaged 6.84%, while yields in developed market banks averaged a paltry 3.49%. One way, of course, to exhibit a high dividend yield is with a declining share price and a constant dividend level, but ideally firms are able to showcase actual dividend growth. All four of the Chinese banks mentioned above have also announced an increase in their annual dividends.—The four banks' dividend growth averaged 12% and ranged from 10% to 13%. **Is This "for Real"?** There is no question that these companies can be mired in complexity and may not always be the most transparent companies on the global stage. By the same token, dividends are tougher to manipulate; the fact that these banks are increasing dividends indicates to us that cash is coming in and that management wants to make a statement that it has the cash flows to pay these dividends. We take this as another sign of confidence by their management teams. The payout ratios are also at very reasonable rates—only 34.9%, not showing signs of stretching their reinvestment and capital building needs. **Increase in Equity Returns** The financial sector in China also happens to be one of the most depressed sectors in the emerging markets space, trading at a P/E multiple of 5.8x³, while [MSCI EM](#)

[Financials Index](#) P/E is 8.9x⁴. Much of this underperformance can be attributed to the markets' preoccupation with the shadow-banking sector in China and what impact that might have on non-performing loans and ultimately bank bailouts. However, we can't help but ask whether markets are too pessimistic given that these companies have grown both their profits and their dividends. This price-versus-valuation divergence presents an interesting investment opportunity in this downtrodden sector of the Chinese markets. ¹"Global Top 100, Companies by Market Capitalization," PWC, 6/13. ²Source: Bloomberg, Company Specific Investor Relations; profitability numbers are from 12/31/2012 to 12/31/2013. ³Source: Bloomberg, MSCI China Financials as of 3/31/2014. ⁴Source: Bloomberg as of 3/31/2014.

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You cannot invest directly in an index.

DEFINITIONS

Emerging market : Characterized by greater market access and less potential for operational risks when compared to frontier markets, which leads to a larger base of potentially eligible investors.

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.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Net profit : A measure of profitability after accounting for all costs.

Market Capitalization : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Return on Equity (ROE) : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Dividend : A portion of corporate profits paid out to shareholders.

MSCI Emerging Markets Financials Index : Designed to measure the combined equity market performance of the Financials sector of emerging market countries.