UOB

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Refer to important disclosures at the end of this report

DBS Group Research . Equity

20 Feb 2017

BUY (Upgrade from HOLD)

Last Traded Price (17 Feb 2017): S$21.18 (STI : 3,107.65)
Price Target 12-mth: S$22.70 (7% upside) (Prev S$21.80)

Potential Catalyst: Sustainability of asset quality trends, higher NIM
Where we differ: FY17-18 earnings could be higher than consensus on lower credit costs

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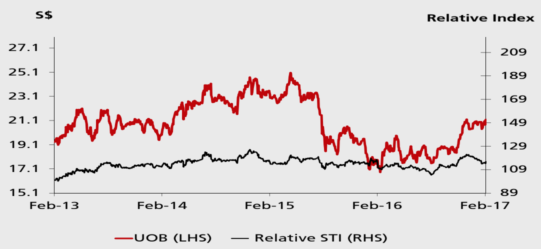
What's New

- **4Q earnings in line, reversal in general provisions**
- **Worst could be over for asset quality**
- **FY17-18F earnings raised by 5-8% on lower credit cost and higher NIM**
- **Upgrade to BUY, TP raised to S$22.70**

Price Relative



Forecasts and Valuation

FY Dec (S$m)	2015A	2016A	2017F	2018F
Pre-prov. Profit	4,451	4,365	4,976	5,282
Net Profit	3,099	2,986	3,516	3,724
Net Pft (Pre Ex.)	3,099	2,986	3,516	3,724
Net Pft Gth (Pre-ex) (%)	(1.3)	(3.6)	17.7	5.9
EPS (S cts)	197	190	223	237
EPS Pre Ex. (S cts)	197	190	223	237
EPS Gth Pre Ex (%)	(1)	(4)	18	6
Diluted EPS (S cts)	193	183	209	215
PE Pre Ex. (X)	10.8	11.2	9.5	9.0
Net DPS (S cts)	90.0	72.1	78.8	81.1
Div Yield (%)	4.3	3.4	3.7	3.8
ROAE Pre Ex. (%)	11.1	10.1	10.9	10.5
ROAE (%)	11.1	10.1	10.9	10.5
ROA (%)	1.0	0.9	1.0	1.0
BV Per Share (S cts)	1,817	1,954	2,154	2,366
P/Book Value (x)	1.2	1.1	1.0	0.9
Earnings Rev (%):			5	8
Consensus EPS (S cts):			191	204
Other Broker Recs:		B: 4	S: 6	H: 3

Source of all data on this page: Company, DBS Bank, Bloomberg Finance L.P.

Positive turns ahead

Worst could be over for UOB, Upgrade to BUY. Of its peers, UOB stood out with asset quality prospects appearing more optimistic. Credit cost should normalise to 32bps in FY17. UOB remains the best buffered in terms of general provision reserves despite reversing a good chunk to offset higher specific provisions in FY16. New NPL formation should ease from here while NPL ratios are expected to hover around the 1.5-1.6% range in FY17. Management stated that its SME exposures have been resilient and are diversified; SME loans are approximately 20% of total loans. Management believes the Fed rate hike impact pass-through would lag SIBOR movements, hence expectations of a later rise in NIM; more apparent in 2H17. Asset quality improvements should be the key catalyst for the stock when compared to its peers. Management's positive stance could provide a share price uplift in the near term.

4Q/FY16 earnings in line. 4Q16 earnings were weaker due to lower trading and investment income. Specific provisions were higher but overall provisions were offset largely by a general provision reversal. Full-year specific provisions came in at S$969m, where 40% of these came from collateral value deterioration from the oil & gas sector. NPL ratio eased to 1.5% while loan loss coverage stood at 118%. Loans grew strongly at 4% q-o-q, 9% y-o-y. NIM was stable q-o-q but dipped y-o-y.

A better 2017. With NIM expected to rise but loan growth moderating to mid-single digits, top-line growth would still be decent. Credit cost should normalise to 32bps; this is the key change in our forecasts as we had expected credit cost to rise to 35bps. Management articulated that provisions have been set aside for most of its exposures. It still has S$2.7bn general provision reserves (general allowance reserve-to-total loans at 1.2%). Cost-to-income ratio could rise to 45-47% as investments in IT and infra continue.

Valuation:

Upgrade to BUY, TP is raised to S$22.70 after our earnings upgrade of 5-8% over FY17-18F on lower credit cost and NIM traction. This implies 1.1x FY17F BV and is derived from the Gordon Growth Model (10.6% ROE, 3% growth, 9.7% cost of equity). Asset quality improvements should be the key catalyst for the stock when compared to its peers.

Key Risks to Our View:

Further risk to asset quality. An extended deterioration in the oil & gas sector, coupled with additional stress from construction sector and SME, could pose downside risk to earnings.

At A Glance

Issued Capital (m shrs)	1,636
Mkt. Cap (Sm/USm)	34,653 / 24,420
Major Shareholders (%)	
Wee Investment Pte Ltd	7.7
Wah Hin & Co. Pte Ltd	5.0
Free Float (%)	87.3
3m Avg. Daily Val (US$m)	38.7
ICB Industry : Financials / Banks	

WHAT'S NEW

Turning optimistic

Highlights:

4Q/FY16 earnings inline. Although a weaker 4Q16, UOB's FY16's earnings stood the strongest albeit saved by general provisions reversal. NIM was stable q-o-q but fell y-o-y. The stability of its NIM for 4Q16 was lifted by yields from securities but offset by lower loan yields. Non-interest income dipped due to lower trading and investment banking income. Associate income was lower due to losses booked for one of the funds it invested in. Expenses were flattish y-o-y but higher q-o-q. NIM was stable q-o-q but fell y-o-y. Loan growth was strong at 4% q-o-q, 9% y-o-y.

Lower provisions for FY16 due to general provision reversal. UOB has the ammunition to reverse general provisions in a bigger way due to its higher-than-peers' general provision reserves-to-total loans. Specific provisions of S$969m booked for FY16 were offset by S$398m general provisions reversal. The general provisions reversal resulted in the general provision reserves-to-total loans declining to 1.2% from 1.4%. The bulk of the specific provisions set aside for the year was due to collateral value mark down, largely related to the oil & gas sector. Of the 70bps specific provisions credit cost in 4Q16, 57bps were for existing NPLs largely for collateral value mark down.

NPL issues look contained. NPL ratio eased to 1.5%. Positively, new NPL formation halved from the previous quarter (S$387m vs S$780m in 3Q16 and S$800m in 2Q16). Upgrades, recoveries and translations were also higher for the quarter. Loan loss coverage stood high at 118% (3Q16: 112%). Absolute NPLs eased slightly q-o-q.

Oil & gas exposures increase. Oil & gas loans were higher on an absolute basis at S$11bn (Upstream: S$5.3bn, traders/downstream: S$5.7bn) or 5% of total loans. This compares to S$9.2bn (Upstream: S$4.0bn, traders/ downstream: S$5.2bn) or 4% of total loans in 3Q16. The bank added exposures to national oil companies (including expansion and asset acquisition transactions) and some increase in volumes for the traders. Concerns, if at all, remain at the upstream exposure.

Capital and dividends were consistent. Capital ratios were stable with CET1 (fully loaded)/Tier-1 and Total CAR at 12.3%, 13.1 and 16.2% respectively. A final DPS of 35 Scts was declared, bringing full-year DPS to 70 Scts (37% payout). Scrip dividend applies for the dividends.

Regional operations holding up in the current uncertain environment. UOB Malaysia showed decent loan growth with NPLs holding up well. There appears to be no weakness in its retail portfolio. Its cost-to-income ratio is at a comfortable 38-39%. UOB Thailand showed strong loan growth of 10% y-o-y albeit from a small base. The focus in Thailand will be on optimising scale and its infra. There should be room to improve efficiency and we should see its cost-to-income ratio (currently 62%) ease over time. Momentum in Thailand is increasing. UOB Indonesia remains in a clean-up mode where provisions remained high. Management is still monitoring its risk exposure there. A new CEO is now at UOB Indonesia to steer the transition. NIM would likely ease in its Indonesian operations. Overall, Indonesia remains a promising market to UOB.

Outlook:

Better NIM outlook but moderated loan growth. NIM should improve from current levels with expectations of rate hikes. Management believes the Fed rate hike impact passthrough would lag SIBOR movements, hence expectations of a later rise in NIM; more apparent in 2H17. As it is, SIBOR is still at 96bps, hardly any movement since the Fed rate hike in December 2016. Our sensitivity analysis implies that for every 25-bp increase in SIBOR/SOR, HK$ and US$ loan rates (collectively), OCBC's NIM could rise by 2bps with an accompanying 1.1% impact to net profit, holding everything else constant. Loan growth is expected to moderate to mid-single digits. We understand that the bulk of the strong loan growth in 2016 was due to property fund refinancing; such trends are unlikely to repeat in 2017. Nevertheless, housing loans are expected to stay relatively strong.

Asset quality issues to ease in 2017. Of its peers, UOB stood out with asset quality prospects sounding more optimistic. New NPL formation should ease from here while NPL ratios are expected to hover around the 1.5-1.6% range in FY17. Management stated that its SME exposures have been resilient and are diversified; SME loans make up approximately 20% of total loans. Management articulated that provisions have been set aside for most of its exposures. UOB remains the best buffered in terms of general provision reserves buffer despite reversing a good chunk to offset higher specific provisions in FY16. It still has S$2.7bn general provision reserves (general allowance reserve-to-total loans at 1.2%). General provisions will continue to be built up as the operating environment improves. Credit cost should normalise to 32bps; this is the key change in our forecasts as we had expected credit cost to rise to 35bps. This resulted in a 3-5% increase in our FY17-18F earnings forecasts.

Valuation and recommendation

Upgrade to BUY, TP lifted to S$22.70. After our FY17-18F earnings revision by 5-8% on lower credit costs and higher

NIM, our TP is correspondingly raised to S$22.70. This implies 1.1x FY17F BV and is derived from the Gordon Growth Model (10.6% ROE, 3% growth, 9.7% cost of equity). Asset quality improvements should be the key catalyst for the stock when compared to its peers. Management's positive stance should bode well with potential share price uplift in the near term.

Quarterly / Interim Income Statement (S$m)

FY Dec	4Q2015	3Q2016	4Q2016	% chg yoy	% chg qoq	FY2015	FY2016	% chg yoy
Net Interest Income	1,277	1,230	1,276	(0.1)	3.7	4,926	4,991	1.3
Non-Interest Income	803	810	752	(6.4)	(7.2)	3,121	3,071	1.6
Operating Income	2,080	2,040	2,028	(2.5)	(0.6)	8,048	8,061	0.2
Operating Expenses	(964)	(918)	(957)	(0.7)	4.2	3,597	3,696	2.8
Pre-Provision Profit	1,116	1,122	1,071	(4.0)	(4.5)	4,451	4,365	(1.9)
Provisions	(190)	(185)	(131)	(31.1)	(29.3)	672	594	(11.6)
Associates	18.0	25.4	(21.0)	nm	nm	90	6	(93.4)
Exceptionals	0.0	0.0	0.0	-	-	0.0	0.0	-
Pretax Profit	944	962	919	(2.6)	(4.4)	3,869	3,777	(2.4)
Taxation	(154)	(169)	(177)	14.9	5.0	649	669	3.1
Minority Interests	(2.0)	(2.6)	(3.0)	(50.0)	15.4	11	12	4.8
Net Profit	788	791	739	(6.2)	(6.5)	3,209	3,096	(3.5)
Growth (%)								
pNet Interest Income Gth	3.4	1.7	3.7			8.1	1.3	
Net Profit Gth	(8.2)	(1.3)	(6.5)			8.3	(3.5)	
Key ratio (%)								
NIM	1.79	1.69	1.69			1.77	1.71	
NPL ratio	1.4	1.6	1.5			1.4	1.5	
Loan-to deposit	84.7	85.0	86.8			84.7	86.8	
Cost-to-income	46.3	45.0	47.2			44.7	45.9	
Total CAR	15.6	16.6	16.2			15.6	16.2	

Source of all data: Company, DBS Bank

CRITICAL DATA POINTS TO WATCH

Earnings Drivers:

Slower loan growth but improved NIM. Expect loan momentum to drift towards low single digits in FY17F. We expect UOB's NIM to rise by 8bps in FY17F and stabilise going into FY18F. Our sensitivity analysis indicates that for every additional 25-bp increase in SIBOR, UOB's NIM will rise by 1bps, holding other variables constant, and this would lead to a further 1.1% uplift to earnings. We note that UOB's S$ loan-to-deposit ratio remains the highest among peers and that itself could even pressure S$ funding cost; S$ deposits forms 48% of UOB's total deposit base.

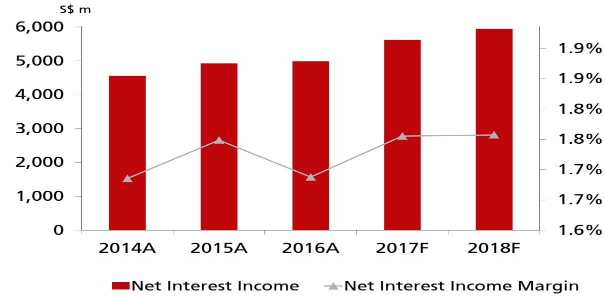
Lacks edge to drive non-interest income. Contrary to peers, UOB does not have a strong franchise when it comes to non-interest income. The bulk of UOB's non-interest income is derived from loan-related activities. While there is increasing traction from wealth management income, it remains small vs peers. Fee income should be consumer-business driven from credit cards and private banking rather than from capital markets.

Costs skewed to business growth. We expect operating expenses to stay high with costs skewed towards business expansion and technology which is required particularly for digital banking and cyber security. Other investments to further enhance regional operations are still ongoing but the increase should not be high. Cost-to-income ratio is expected to inch towards 45-47% in the near term but the target is 40% over the longer term.

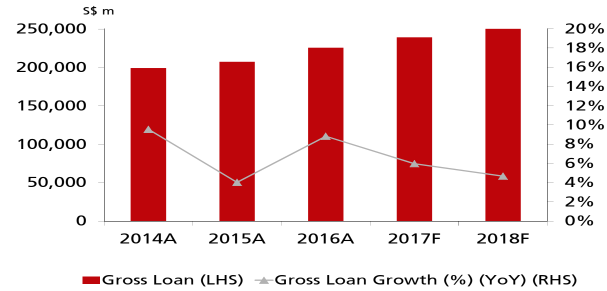
Credit costs remains at the higher end. Compared to peers, UOB's credit costs tend to hover at higher levels largely due to its conservative stance towards setting aside higher general provisions (1.2% of total loans). Management continues to guide for 32-bp credit costs. General provisions will be added back to replace for the reversals it had made in 2016.

Regionalisation remains core to UOB's strategy. UOB's regionalisation agenda remains intact. UOB is relooking at its operations in Indonesia, given the current challenging operating environment. In Malaysia, growth remains cautious but asset quality is at a comfortable position. Its Thai operations remain small, while its Greater China operations are still smaller than peers. UOB has not been aggressively acquiring to add new revenue streams but has chosen to grow organically.

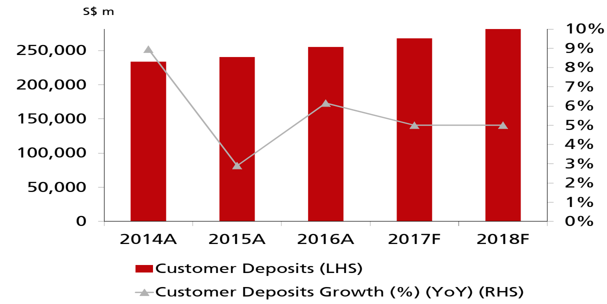
Margin Trends



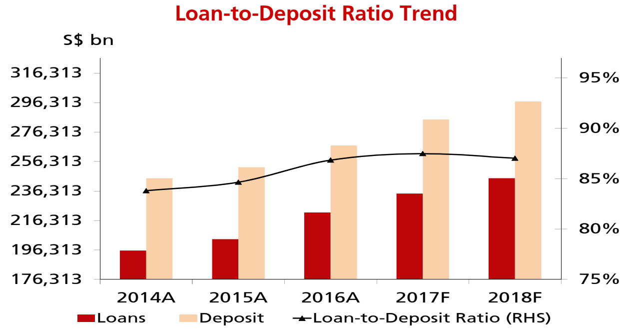
Gross Loan& Growth



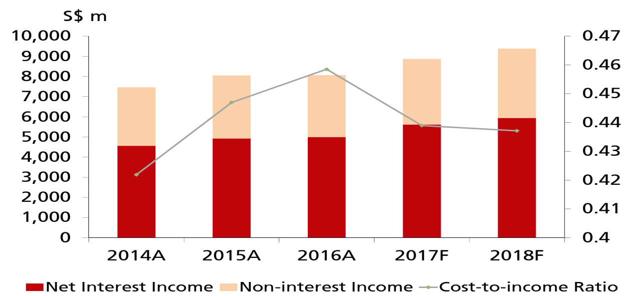
Customer Deposit & Growth



Loan-to-Deposit Ratio Trend



Cost & Income Structure



Source: Company, DBS Bank

Balance Sheet:

All eyes on asset quality. UOB's NPL ratio is higher vs peers, sitting at 1.5%. Exposure to oil & gas comprises 5% of total loans while other commodity segments make up another 3%. Collectively, these account for 8% of total loans. Total loans for commodities and oil & gas amounts to S$18bn, with S$11bn in the oil & gas segment (5% of total loans). These accounts are mostly secured; hence the impact on P/L should be limited. Other commodity segments include metal, mining and agriculture. There is little concern on these.

Strong capital position. Its CET1 comfort zone is 11-12%. We expect absolute DPS (excluding special dividends) to remain stable. UOB has, however, turned on its scrip dividend option to shore up capital in view of stricter capital requirements ahead.

Share Price Drivers:

Of its peers, UOB stood out with asset quality prospects appearing more optimistic. Asset quality improvements should be the key catalyst for the stock when compared to its peers. Management's positive stance should bode well with potential share price uplift in the near term. We believe over time, the bank would need to improve its regionalisation beyond ASEAN to prompt an even stronger re-rating.

Key Risks:

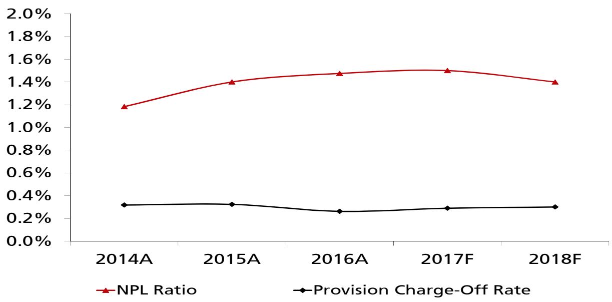
Further deterioration in asset quality. While management articulated that only part of its oil & gas exposure (c.S$14bn) is vulnerable, sustained low oil prices could add pressure to more provisions being set aside and higher NPL ratios to be seen.

High proportion of SME loans. With concerns on a sluggish economy, concerns that SME loans may turn sour may tilt UOB's asset quality position. Although management stated that its SME loan portfolio has been resilient and is diversified, it may still pose downside risks should these loans deteriorate.

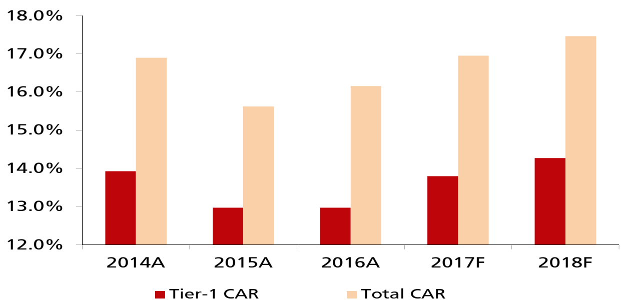
Company Background

UOB provides a wide range of financial services through its global network of branches, offices, subsidiaries and associates: personal financial services, private banking, commercial and corporate banking, investment banking, corporate finance, capital market activities, treasury services, futures broking, asset management, venture capital management, insurance and stockbroking services.

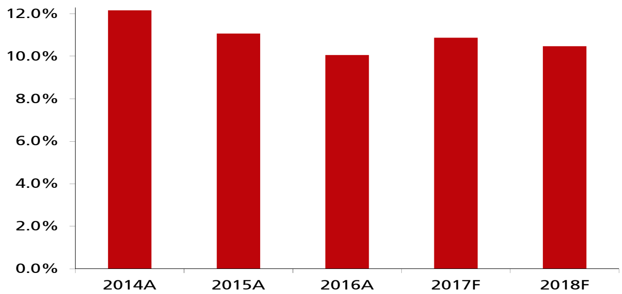
Asset Quality



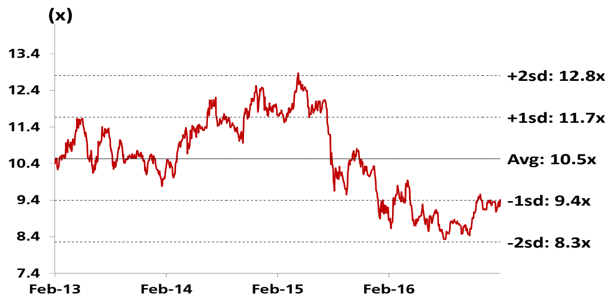
Capitalisation (%)



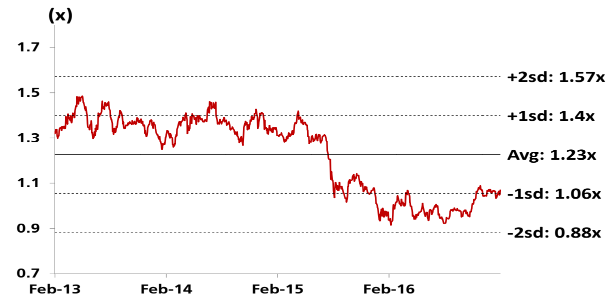
ROE (%)



Forward PE Band (x)



PB Band (x)



Source: Company, DBS Bank

Key Assumptions

FY Dec	2014A	2015A	2016A	2017F	2018F
Gross Loans Growth	9.5	4.0	8.8	6.0	4.7
Customer Deposits Growth	8.9	2.9	6.1	5.0	5.0
Yld. On Earnings Assets	2.7	2.8	2.8	2.9	2.9
Avg Cost Of Funds	1.0	1.1	1.2	1.2	1.2

Income Statement (S$m)

FY Dec	2014A	2015A	2016A	2017F	2018F
Net Interest Income	4,557	4,926	4,991	5,619	5,943
Non-Interest Income	2,900	3,122	3,071	3,250	3,441
Operating Income	7,457	8,048	8,061	8,869	9,384
Operating Expenses	(3,146)	(3,597)	(3,696)	(3,893)	(4,102)
Pre-provision Profit	4,311	4,451	4,365	4,976	5,282
Provisions	(635)	(672)	(593)	(694)	(754)
Associates	149	90.0	6.00	102	108
Exceptionals	0.0	0.0	0.0	0.0	0.0
Pre-tax Profit	3,825	3,869	3,778	4,384	4,637
Taxation	(561)	(649)	(669)	(745)	(788)
Minority Interests	(15.0)	(11.0)	(12.0)	(13.2)	(13.9)
Preference Dividend	(110)	(110)	(110)	(110)	(110)
Net Profit	3,139	3,099	2,986	3,516	3,724
Net Profit bef Except	3,139	3,099	2,987	3,516	3,724
Growth (%)					
Net Interest Income Gth	10.6	8.1	1.3	12.6	5.8
Net Profit Gth	8.3	(1.3)	(3.6)	17.7	5.9
Margins, Costs & Efficiency (%)					
Spread	1.7	1.7	1.7	1.7	1.7
Net Interest Margin	1.7	1.8	1.7	1.8	1.8
Cost-to-Income Ratio	42.2	44.7	45.9	43.9	43.7
Business Mix (%)					
Net Int. Inc / Opg Inc.	61.1	61.2	61.9	63.4	63.3
Non-Int. Inc / Opg inc.	38.9	38.8	38.1	36.6	36.7
Fee Inc / Opg Income	23.5	23.4	24.0	23.2	23.4
Oth Non-Int Inc/Opg Inc	15.4	15.4	14.1	13.5	13.3
Profitability (%)					
ROAE Pre Ex.	12.2	11.1	10.1	10.9	10.5
ROAE	12.2	11.1	10.1	10.9	10.5
ROA Pre Ex.	1.1	1.0	0.9	1.0	1.0
ROA	1.1	1.0	0.9	1.0	1.0

Source: Company, DBS Bank

Credit cost to normalize to 32bps without general provisions reversal

Room for NIM to improve with rising interest rates

Quarterly / Interim Income Statement (S$m)

FY Dec	4Q2015	1Q2016	2Q2016	3Q2016	4Q2016
Net Interest Income	1,277	1,275	1,210	1,230	1,276
Non-Interest Income	803	695	814	810	752
Operating Income	2,080	1,970	2,024	2,040	2,028
Operating Expenses	(964)	(895)	(926)	(918)	(957)
Pre-Provision Profit	1,116	1,075	1,098	1,122	1,071
Provisions	(190)	(117)	(161)	(185)	(131)
Associates	18.0	(30.0)	32.0	25.4	(21.0)
Exceptionals	0.0	0.0	0.0	0.0	0.0
Pretax Profit	944	928	969	962	919
Taxation	(154)	(158)	(165)	(169)	(177)
Minority Interests	(2.0)	(3.0)	(3.0)	(2.6)	(3.0)
Net Profit	788	767	801	791	739
Growth (%)					
Net Interest Income Gth	3.4	(0.2)	(5.1)	1.7	3.7
Net Profit Gth	(8.2)	(2.7)	4.4	(1.3)	(6.5)

General provision reversal offset higher specific provisions

Balance Sheet (S$m)

FY Dec	2014A	2015A	2016A	2017F	2018F
Cash/Bank Balance	35,083	32,306	24,322	32,170	33,778
Government Securities	17,898	19,509	17,515	18,391	19,310
Inter Bank Assets	28,692	28,646	40,033	35,180	36,747
Total Net Loans & Advs.	195,903	203,611	221,734	234,536	244,979
Investment	12,178	11,839	14,767	19,701	20,596
Associates	1,189	1,106	1,109	1,211	1,319
Fixed Assets	2,388	2,847	2,990	2,849	2,849
Goodwill	4,149	4,144	4,151	4,151	4,151
Other Assets	9,256	12,003	13,407	18,763	19,598
Total Assets	306,736	316,011	340,028	366,952	383,328
Customer Deposits	233,750	240,524	255,314	268,080	281,484
Inter Bank Deposits	11,226	11,986	11,855	16,732	15,481
Debts/Borrowings	20,953	20,288	26,143	26,143	26,143
Others	11,035	12,290	13,674	19,799	20,667
Minorities	203	155	169	182	196
Shareholders' Funds	29,569	30,768	32,873	36,016	39,357
Total Liab& S/H's Funds	306,736	316,011	340,028	366,952	383,328

Mid-single digit loan growth expected

Source: Company, DBS Bank

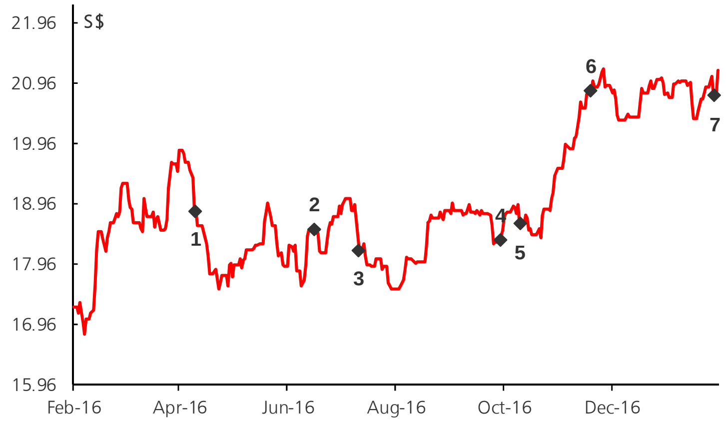
Financial Stability Measures (%)

FY Dec	2014A	2015A	2016A	2017F	2018F
Balance Sheet Structure					
Loan-to-Deposit Ratio	83.8	84.7	86.8	87.5	87.0
Net Loans / Total Assets	63.9	64.4	65.2	63.9	63.9
Investment / Total Assets	4.0	3.7	4.3	5.4	5.4
Cust . Dep./Int. Bear. Liab.	87.9	88.2	87.0	86.2	87.1
Interbank Dep / Int. Bear.	4.2	4.4	4.0	5.4	4.8
Asset Quality					
NPL / Total Gross Loans	1.2	1.4	1.5	1.5	1.4
NPL / Total Assets	0.8	0.9	1.0	1.0	0.9
Loan Loss Reserve Coverage	145.9	129.5	118.0	128.2	152.1
Provision Charge-Off Rate	0.3	0.3	0.3	0.3	0.3
Capital Strength					
Total CAR	16.9	15.6	16.2	17.0	17.5
Tier-1 CAR	13.9	13.0	13.0	13.8	14.3

NPL ratios to stabilise from here

Source: Company, DBS Bank

Target Price & Ratings History



S.No.	Date of Report	Closing Price	12-mth Target Price	Rating
1:	28 Apr 16	18.85	18.80	HOLD
2:	04 Jul 16	18.54	18.80	HOLD
3:	29 Jul 16	18.20	17.70	HOLD
4:	17 Oct 16	18.36	17.70	HOLD
5:	28 Oct 16	18.63	18.10	HOLD
6:	07 Dec 16	20.83	21.80	HOLD
7:	15 Feb 17	20.75	21.80	HOLD

***Note** : Share price and Target price are adjusted for corporate actions.*

Source: DBS Bank
Analyst: Sue Lin LIM

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STRONG BUY (>20% total return over the next 3 months, with identifiable share price catalysts within this time frame)
BUY (>15% total return over the next 12 months for small caps, >10% for large caps)
HOLD (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)
FULLY VALUED (negative total return i.e. > -10% over the next 12 months)
SELL (negative total return of > -20% over the next 3 months, with identifiable catalysts within this time frame)

Share price appreciation + dividends

Completed Date: 20 Feb 2017 08:43:53 (SGT)
Dissemination Date: 20 Feb 2017 10:57:20 (SGT)

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