Hong Leong Bank

Version | Bloomberg: HLBK MK | Reuters: HLBB.KL

DBS Group Research . Equity

30 Aug 2016

BUY

Last Traded Price: RM13.12 (**KLCI :** 1,681.60)
Price Target 12-mth : RM15.00 (14% upside) (Prev RM14.70)
Potential Catalyst: Improved earnings traction
Where we differ: We are more bullish on non-interest income growth as we expect HLB's wealth management contribution to gain traction

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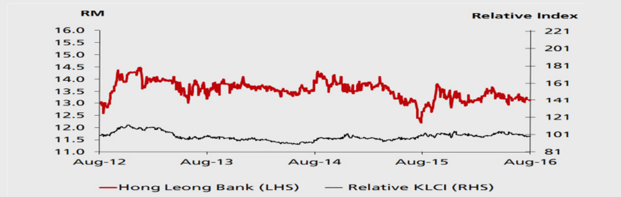
What's New

- **4QFY16 earnings surged on stronger non-interest income and write-backs; ex-MSS, FY16 net profit was largely in line**
- **Ensuring asset quality and liquidity preservation; loan growth expected to be in line with industry**
- **Strategic initiatives focused on digital capabilities**
- **Maintain BUY, TP raised to RM15.00 as we shift our valuation base to CY17**

Price Relative



Forecasts and Valuation

FY Jun (RMm)	2016A	2017F	2018F	2019F
Pre-prov. Profit	2,263	2,511	2,807	3,149
Net Profit	1,903	2,257	2,494	2,769
Net Pft (Pre Ex.)	2,034	2,257	2,494	2,769
Net Pft Gth (Pre-ex) (%)	(6.7)	10.6	10.5	11.1
EPS (sen)	87.8	104	115	128
EPS Pre Ex. (sen)	94.1	104	115	128
EPS Gth Pre Ex (%)	(10)	11	11	11
Diluted EPS (sen)	87.8	104	115	128
PE Pre Ex. (X)	13.9	12.6	11.4	10.3
Net DPS (sen)	41.0	38.4	39.8	42.2
Div Yield (%)	3.1	2.9	3.0	3.2
ROAE Pre Ex. (%)	10.0	10.3	10.7	11.0
ROAE (%)	10.0	10.3	10.7	11.0
ROA (%)	1.0	1.2	1.2	1.3
BV Per Share (sen)	974	1,040	1,115	1,201
P/Book Value (x)	1.3	1.3	1.2	1.1
Earnings Rev (%):		(3)	(4)	NA
Consensus EPS (sen):		103	111	140
Other Broker Recs:		B: 2	S: 10	H: 8

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

Backed by solid fundamentals

Normalised FY17 backed by solid fundamentals; BUY. Hong Leong Bank's (HLB) banking franchise remains undervalued in our view. We believe the market is not attributing sufficient premium to its key attributes of solid asset quality indicators and strong liquidity position. In this current uncertain environment, balancing liquidity versus profitability will be crucial. We expect HLB to grow cautiously in the current operating environment, ensuring asset quality and liquidity preservation while delivering decent earnings growth and ROEs. Bank of Chengdu (BOCD), its 20% associate remains a wildcard.

4Q16 earnings surged on stronger revenues and write-backs; FY16 earnings saw several distortions. As expected, 4QFY16 (FYE June) earnings improved sequentially led by non-interest income with write-backs as a bonus. Expenses were well contained. Topline growth benefited from improved net interest margin (NIM) as asset yields were lifted despite funding cost pressures. Contribution from BOCD was a tad lower q-o-q. On a full year basis, HLB's FY16 numbers were distorted by (1) Mutual Separation Scheme (MSS) costs booked in 2Q16, (2) larger equity base from its rights issue (completed in Dec 2015), and (3) lower contribution from BOCD.

Cautious outlook for FY17F. FY17F targets appear to skew towards a cautious mode with loan growth at 5-6%. Deposits would likely grow at the same pace. HLB aims to keep NIM stable by managing its liability mix. Non-interest income to total income ratio is targeted at above 25%, driven by transactions and customer flows. Cost savings from the MSS will be reinvested to enhance digital capabilities. Digital banking initiatives are expected to drive transaction banking volumes higher over time. Cost-to-income ratio is targeted to be below 46%. Guidance is for credit costs excluding recoveries to normalise at 25-35bps; there are still some recoveries that could be expected but chunky ones are largely done. BOCD is expected stabilise. Post rights and with slower growth expected, ROE is targeted at 10-11%.

Valuation:

HLB is a BUY, with a target price of RM15.00. The higher TP is a result of the shift in our valuation base to CY17 despite some minor tweaks to our forecast to reflect a cautious outlook. Our TP is derived using the Gordon Growth Model and assumes 11% ROE, 9% cost of equity and 4% long- term growth rate; it implies 1.4x CY17 BV.

Key Risks to Our View:

Slower-than-expected materialisation of growth plans. Inability to deliver growth plans for wealth management and excessive NIM compression could limit earnings growth.

At A Glance

Issued Capital (m shrs)	2,052
Mkt. Cap (RMm/US$m)	26,924 / 6,672
Major Shareholders (%)	
Hong Leong Financial Group (%)	64.4
EPF (%)	14.0
Free Float (%)	21.6
3m Avg. Daily Val (US$m)	1.6
ICB Industry : Financials / Banks	

WHAT'S NEW

Core earnings within expectations

Highlights:

4Q16 earnings surged. As expected, 4Q16 net profit improved sequentially. NIM improved as loans were re-priced after a 10bps hike in Base Rate (BR) and Base Lending Rate (BLR) in April 2016. Funding costs however negated some of the increase. Deposit growth of 6% y-o-y was driven by fixed deposits. Retail deposits comprise 55% of total deposits, the highest mix vs peers. Loans grew 2% q-o-q and 6% y-o-y driven by mortgages and SMEs. Hire-purchase loans grew marginally while unsecured loans (credit cards and personal loans) were flattish. Non-interest income rose on higher forex gains; these were largely from customer flows for hedging activities. Cost-to-income for the quarter dipped a little thanks to stronger revenues. The strong pre-provision profits were further exacerbated by writebacks for the quarter but net profit was partially negated by a slightly lower contribution from BOCD.

FY16 distorted by several one-offs. FY16 net profit was 6% lower y-o-y, excluding the RM172m one-off MSS costs, was in line. Topline growth was softer due to NIM pressure y-o-y as funding costs mounted. Non-interest income saw broad base improvements with a surge in fee income from wealth management (bancassurance driven) and credit card fees as well as forex and higher investment income. Excluding the MSS, cost-to-income ratio was 46%. Provisions normalised as recoveries tapered off. Credit cost excluding recoveries was at 22bps. Its associate, BOCD, contributed 14% to pre-tax profit, lower than previous years, as it was dampened mainly by higher provisions and NIM pressure following rate cuts in China. Its NPL ratio hit a high of 2.5% for FY16 while its loan loss coverage ratio was still elevated at 159%.

Asset quality remains sound. Positively, NPL ratios were lower at 0.8% with absolute NPLs only rising by 1% y-o-y. NPL ratios in its core segments were stable: NPL ratios for mortgages were at 0.45%, hire-purchase at 0.79% and SME at 1.42% respectively. Loan loss coverage ratio stood at 120%, albeit lower than a year ago, remains among the highest vs peers. Concerns on commodities and oil & gas sectors should be minimal with only 4% exposure to commodities and less than 1% to the oil & gas sector. HLB's asset quality appears well under control and is unlikely to experience blips.

Capital ratios remained robust. HLB's capital ratios remained robust with CET1 (fully loaded), Tier-1 and Total CAR at 11.7%, 13.1% and 14.7% respectively. Note that the rights issue was completed in Dec 2015. HLB declared a final DPS of 26sen, bringing full year DPS to 41sen, equivalent to a 47% payout ratio.

Outlook:

Cautious mood for FY17F. FY17F targets appear to skew towards a cautious mode with loan growth targeted at 5-6%. Deposits would likely grow at the same pace. HLB aims to keep NIM stable by managing its liability mix. Non-interest income to total income ratio is targeted at above 25% driven by transactions and customer flows. Cost savings from the MSS will be reinvested to enhance digital capabilities. Digital banking initiatives are expected to drive transaction banking volumes higher over time. Cost-to-income ratio is targeted to be below 46%. Credit costs excluding recoveries are guided to normalise at 25-35bps; there are still some recoveries that could be expected but chunky ones are largely done. Post rights and with slower growth expected, ROE is targeted at 10-11%.

Trim earnings by 3-4% across FY17-18F. With more clarity on HLB's targets for FY17, we have adjusted our assumptions accordingly. Both loan and deposit growth assumption now stands at 6% for FY17-18F and 8% for FY19F. This should keep loan-to-deposit ratio at c.80%. Our credit cost assumption for FY17-19F is 9/12/14bps.

BOCD should stabilize but remains a wildcard. After a weak showing in FY16, BOCD is expected to see a peak of its NPL issues by 1QFY17 with NPLs stabilising in the recent quarters. BOCD's earnings have improved compared to trends booked six months ago. With such stable trends in the past two quarters, BOCD should continue to contribute at least 15% of pre-tax profit in FY17F. This, however, remains a wildcard.

Digital banking, a strategic direction forward. HLB's new CEO, Mr Domenic Fuda, identified digital banking as its key strategic initiative to drive the bank forward. It is not a matter of how much digital banking will be able to contribute to the bank's earnings but more of the stance where if nothing is done, the bank will stand to lose traction amid the fintech boom. Over time, digital banking transaction volumes are expected to rise and potential cross selling opportunities would further enhance its capabilities to deliver growth.

Valuation:

Maintain BUY, TP raised to RM15.00. HLB's banking franchise remains undervalued in our view. We believe market is not attributing sufficient premium to its key attributes of solid asset quality indicators and strong liquidity position. We have shifted our valuation base to CY17. Our TP of RM15.00 is based on the Gordon Growth Model and implies 1.4x CY17 BV. Our TP assumes 11% ROE, 9% cost of equity and 4% long- term growth rate.

Quarterly / Interim Income Statement (RMm)

FY Jun	4Q2015	3Q2016	4Q2016	% chg yoy	% chg qoq	FY15	FY16	% chg yoy
Net Interest Income	657	654	663	0.9	1.3	2,741	2,655	(3.1)
Islamic Income	105	114	121	15.6	15.6	420	468	11.4
Non-Interest Income	279	234	295	5.7	26.1	906	1,055	16.5
Operating Income	**1,041**	**1,002**	**1,079**	**3.7**	**7.6**	**4,067**	**4,178**	**2.7**
Operating Expenses	(471)	(472)	(494)	4.9	4.6	(1,769)	(1,914.8)	8.3
Pre-Provision Profit	**570**	**530**	**585**	**2.7**	**10.3**	**2,298**	**2,263**	**(1.5)**
Provisions	(13.7)	(17.7)	54.1	nm	nm	75	(43)	nm
Associates	116	94.2	85.3	(26.6)	(9.4)	418	333	(20.2)
Exceptionals	0.0	0.0	0.0	nm	nm	(45)	(172)	282.2
Pretax Profit	**673**	**607**	**724**	**7.7**	**19.4**	**2,746.**	**2,382**	**(13.3)**
Taxation	(57.7)	(109)	(166)	187.7	52.4	(513)	(478)	(6.8)
Minority Interests	0.0	0.0	0.0	nm	nm	-	-	nm
Net Profit	**615**	**498**	**559**	**(9.2)**	**12.2**	**2,233**	**1,903**	**(14.8)**
Net Profit (ex-one-offs)	**579**	**498**	**559**	**(3.5)**	**12.2**	**2,156**	**2,034**	**(5.6)**
Growth (%)								
Net Interest Income Gth	0.0	(3.5)	1.3			3.0	(3.1)	
Net Profit Gth	18.4	44.7	12.2			6.2	(14.8)	
Key ratio (%)								
NIM	1.94	1.91	1.95			1.94	1.86	
NPL ratio	0.8	0.8	0.8			0.8	0.8	
Loan-to deposit	79.9	80.5	80.4			79.9	80.4	
Cost-to-income	45.3	47.1	45.8			44.6	49.9	
Total CAR	14.3	15.7	14.7			14.3	14.7	

Source of all data: Company, DBS Bank

CRITICAL DATA POINTS TO WATCH

Earnings Drivers:

NIM compression largely unavoidable. Although we expect funding cost pressures, we believe HLB's active treasury functions would strive to keep NIM as stable as possible. CASA, as a low-cost funding source, should help to alleviate NIM compression as well. HLB's CASA-to-total deposits ratio currently stands at 26% of total deposits and it intends to build up this portfolio to 28-30% over the next 3-5 years.

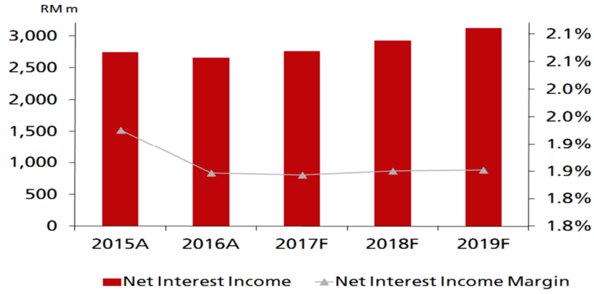
Room to scale up loan growth; loan-to-deposit ratio is still among the lowest. HLB's loan growth is driven by mortgage and SME loans. We are assuming 6% loan growth in our forecasts, while deposit should track loan growth. With a loan-to-deposit ratio still among the lowest in the industry, HLB would have room to further leverage its asset-liability mix to accelerate loan growth and optimise NIM. We expect its loan-to-deposit ratio to hover around 80%.

Wealth management a crucial new driver. Recurring fee income (loan-related and credit card fees) remains HLB's key non-interest income driver. However, it is also building up income from wealth management. HLB has established a regional wealth management and private banking platform in Singapore. Wealth management is expected to be HLB's new growth driver as it gradually gains prominence.

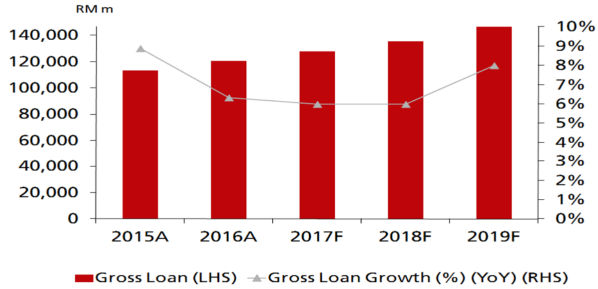
Addressing efficiency issues. From a business-as-usual (BAU) perspective, costs should remain nimble, and cost-to-income ratio should hover below 45%. HLB announced a Mutual Separation Scheme (MSS) on 20 Oct which resulted in an acceptance rate of 12.5%. The MSS cost incurred was RM172m while savings are expected to be RM109m per annum from as early as Jan 16. Cost savings are likely to be used for investments in the bank's digitisation agenda

Bank of Chengdu contribution should stabilize, but remains a wildcard. After a weak showing in FY16, BOCD is expected to see a peak of its NPL issues by 1QFY17 with NPLs stabilising in the recent quarters. Our forecast assumes contribution from BOCD to drop to hover around 15% of pre-tax profit in FY17-19F. This, however, remains a wildcard.

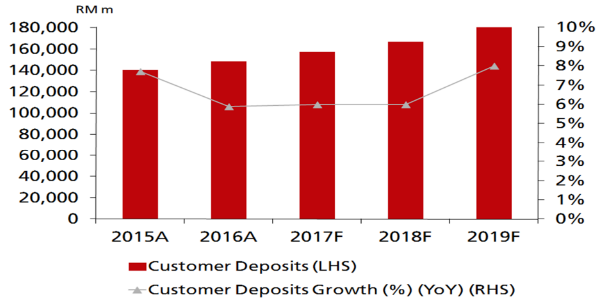
Margin Trends



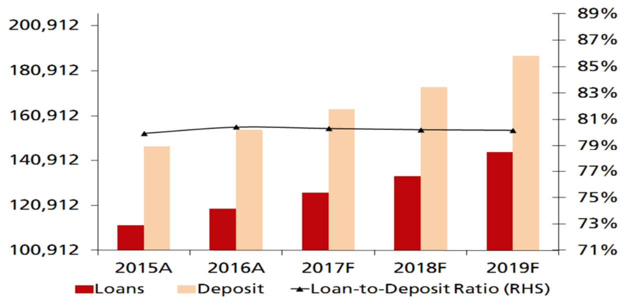
Gross Loan& Growth



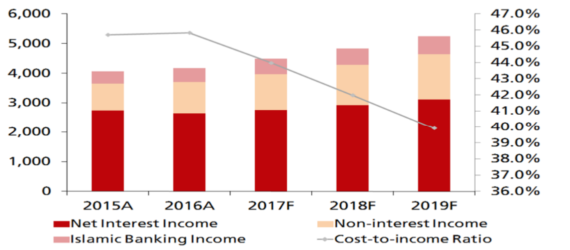
Customer Deposit & Growth



Loan-to-Deposit Ratio Trend



Cost & Income Structure



Source: Company, DBS Bank

Balance Sheet:

Superior asset quality. At <1%, HLB's NPL ratio is second only to Public Bank (PBK). Similar to PBK, HLB also boasts a prudent credit culture. We expect HLB to continue recording resilient asset quality indicators. Normalised credit cost is expected to hover around 25bps, excluding recoveries.

Stronger capital ratios post rights. Post-rights, capital ratios are now stronger, comfortably above the minimum required CET1 of 9.5% (inclusive of conservation and countercyclical buffers) by 2019 as per Basel III requirements. Any capital overhang should be removed with this rights issue. HLB does not have a dividend reinvestment plan in place, but we expect at least 35% payout for FY17F.

Share Price Drivers:

Charting the next course. HLB is currently trading just below -1SD of its 10-year P/BV mean. We believe that the current valuation has unfairly priced this strong banking franchise with solid asset quality and liquidity indicators. In addition, the stock provides a decent dividend yield of 3-4%.

Book value growth has been underappreciated. HLB has been consistently seeing its book value and earnings grow at c.10% p.a., save for the year when it raised capital to acquire EON Capital and the recent rights issue. This however, has not been reflected in its share price performance. Furthermore, we believe HLB's resilient earnings, with wealth management and SME business as key drivers, coupled with strong liquidity indicators and asset quality parameters, should act as a catalyst for the stock.

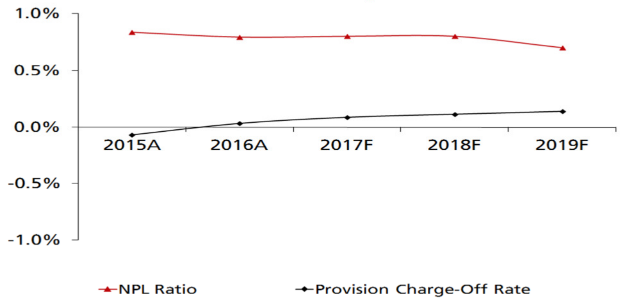
Key Risks:

Slower-than-expected materialisation of plans. Inability to deliver growth plans for wealth management and slowdown in regional operations. While loan-to-deposit ratio is at 80%, which is the lowest among peers, slower-than-expected loan growth and excessive NIM compression could limit earnings growth.

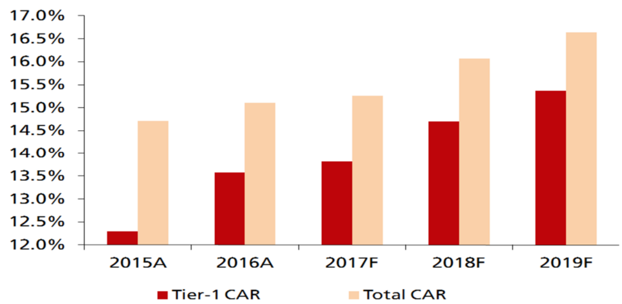
Company Background

Hong Leong Bank Berhad provides commercial banking and related financial services. The company's services include leasing and hire purchase, nominee, Islamic banking, and unit trust management.

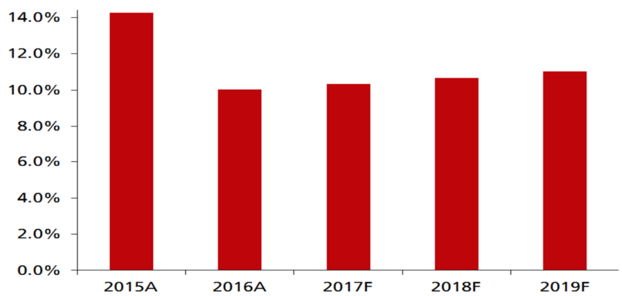
Asset Quality



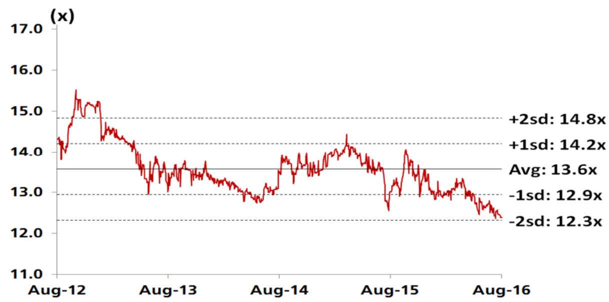
Capitalisation (%)



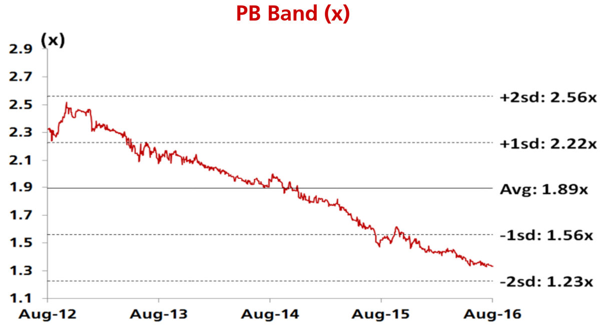
ROE (%)



Forward PE Band (x)



PB Band (x)



Source: Company, DBS Bank

Key Assumptions

FY Jun	2015A	2016A	2017F	2018F	2019F
Gross Loans Growth	8.9	6.3	6.0	6.0	8.0
Customer Deposits Growth	7.7	5.9	6.0	6.0	8.0
Yld. On Earnings Assets	3.7	3.8	3.6	3.6	3.6
Avg Cost Of Funds	2.2	2.2	2.2	2.2	2.2

Income Statement (RMm)

FY Jun	2015A	2016A	2017F	2018F	2019F
Net Interest Income	2,741	2,655	2,756	2,924	3,119
Islamic Income	420	467	514	555	600
Non-Interest Income	906	1,055	1,214	1,359	1,522
Operating Income	**4,067**	**4,178**	**4,484**	**4,839**	**5,242**
Operating Expenses	(1,859)	(1,915)	(1,972)	(2,031)	(2,092)
Pre-provision Profit	**2,208**	**2,263**	**2,511**	**2,807**	**3,149**
Provisions	75.4	(42.8)	(114)	(158)	(207)
Associates	418	333	423	468	519
Exceptionals	45.0	(172)	0.0	0.0	0.0
Pre-tax Profit	**2,746**	**2,382**	**2,821**	**3,117**	**3,462**
Taxation	(513)	(478)	(564)	(623)	(692)
Minority Interests	0.0	0.0	0.0	0.0	0.0
Preference Dividend	0.0	0.0	0.0	0.0	0.0
Net Profit	**2,233**	**1,903**	**2,257**	**2,494**	**2,769**
Net Profit bef Except	2,156	2,034	2,257	2,494	2,769
Growth (%)					
Net Interest Income Gth	3.0	(3.1)	3.8	6.1	6.7
Net Profit Gth	6.2	(14.8)	18.6	10.5	11.1
Margins, Costs & Efficiency (%)					
Spread	1.6	1.5	1.5	1.5	1.5
Net Interest Margin	1.9	1.9	1.9	1.9	1.9
Cost-to-Income Ratio	45.7	45.8	44.0	42.0	39.9
Business Mix (%)					
Net Int. Inc / Opg Inc.	67.4	63.6	61.5	60.4	59.5
Non-Int. Inc / Opg inc.	22.3	25.3	27.1	28.1	29.0
Fee Inc / Opg Income	14.8	14.8	15.8	16.4	17.0
Oth Non-Int Inc/Opg Inc	7.5	10.5	11.2	11.7	12.1
Profitability (%)					
ROAE Pre Ex.	14.3	10.0	10.3	10.7	11.0
ROAE	14.3	10.0	10.3	10.7	11.0
ROA Pre Ex.	1.2	1.1	1.2	1.2	1.3
ROA	1.3	1.0	1.2	1.2	1.3

FY16 earnings dragged by one-off MSS cost

Source: Company, DBS Bank

Quarterly / Interim Income Statement (RMm)

FY Jun	4Q2015	1Q2016	2Q2016	3Q2016	4Q2016
Net Interest Income	657	660	678	654	663
Islamic Income	105	115	118	114	121
Non-Interest Income	279	249	278	234	295
Operating Income	**1,041**	**1,023**	**1,074**	**1,002**	**1,079**
Operating Expenses	(471)	(463)	(486)	(472)	(494)
Pre-Provision Profit	**570**	**561**	**587**	**530**	**585**
Provisions	(13.7)	(21.1)	(58.0)	(17.7)	54.1
Associates	116	85.5	68.5	94.2	85.3
Exceptionals	0.0	0.0	(172)	0.0	0.0
Pretax Profit	**673**	**625**	**426**	**607**	**724**
Taxation	(57.7)	(122)	(81.7)	(109)	(166)
Minority Interests	0.0	0.0	0.0	0.0	0.0
Net Profit	**615**	**503**	**344**	**498**	**559**
Growth (%)					
Net Interest Income Gth	0.0	0.4	2.7	(3.5)	1.3
Net Profit Gth	18.4	(18.2)	(31.6)	44.7	12.2

Earnings led by strong non-interest income and higher writebacks

Balance Sheet (RMm)

FY Jun	2015A	2016A	2017F	2018F	2019F
Cash/Bank Balance	6,230	7,474	8,857	9,732	11,299
Government Securities	3,476	4,296	3,853	4,079	4,396
Inter Bank Assets	3,982	2,057	2,160	2,268	2,382
Total Net Loans & Advs.	112,125	119,457	126,451	133,885	144,513
Investment	42,421	41,712	43,797	45,987	48,287
Associates	3,107	3,323	3,746	4,213	4,733
Fixed Assets	679	1,382	1,410	1,438	1,467
Goodwill	2,149	2,096	2,096	2,096	2,096
Other Assets	9,852	8,030	8,190	8,354	8,521
Total Assets	**184,020**	**189,827**	**200,561**	**212,053**	**227,693**
Customer Deposits	140,276	148,524	157,435	166,881	180,232
Inter Bank Deposits	7,096	6,201	6,511	6,837	7,179
Debts/Borrowings	8,847	4,523	4,523	4,523	4,523
Others	11,010	9,463	9,550	9,640	9,732
Minorities	0.0	0.0	0.0	0.0	0.0
Shareholders' Funds	16,790	21,117	22,541	24,172	26,027
Total Liab& S/H's Funds	**184,020**	**189,828**	**200,561**	**212,053**	**227,693**

Source: Company, DBS Bank

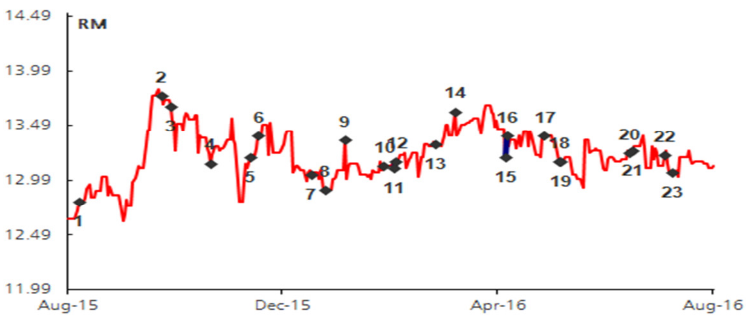
Financial Stability Measures (%)

FY Jun	2015A	2016A	2017F	2018F	2019F
Balance Sheet Structure					
Loan-to-Deposit Ratio	79.9	80.4	80.3	80.2	80.2
Net Loans / Total Assets	60.9	62.9	63.0	63.1	63.5
Investment / Total Assets	23.1	22.0	21.8	21.7	21.2
Cust . Dep./Int. Bear. Liab.	89.8	93.3	93.5	93.6	93.9
Interbank Dep / Int. Bear.	4.5	3.9	3.9	3.8	3.7
Asset Quality					
NPL / Total Gross Loans	0.8	0.8	0.8	0.8	0.7
NPL / Total Assets	0.5	0.5	0.5	0.5	0.4
Loan Loss Reserve Coverage	136.3	119.8	135.8	150.0	179.5
Provision Charge-Off Rate	(0.1)	0.0	0.1	0.1	0.1
Capital Strength					
Total CAR	14.7	15.1	15.3	16.1	16.6
Tier-1 CAR	12.3	13.6	13.8	14.7	15.4

Low loan-to-deposit ratio

Source: Company, DBS Bank

Target Price & Ratings History



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

S.No.	Date of Report	Closing Price	12-mth Target Price	Rating
1:	04 Sep 15	12.80	15.66	BUY
2:	21 Oct 15	13.76	15.66	BUY
3:	26 Oct 15	13.67	15.66	BUY
4:	18 Nov 15	13.14	15.66	BUY
5:	10 Dec 15	13.20	14.80	BUY
6:	15 Dec 15	13.40	14.80	BUY
7:	14 Jan 16	13.04	14.80	BUY
8:	22 Jan 16	12.90	14.80	BUY
9:	02 Feb 16	13.36	14.80	BUY
10:	24 Feb 16	13.12	14.70	BUY
11:	01 Mar 16	13.10	14.70	BUY
12:	02 Mar 16	13.16	14.70	BUY
13:	24 Mar 16	13.32	14.70	BUY
14:	04 Apr 16	13.62	14.70	BUY
15:	03 May 16	13.20	14.70	BUY
16:	04 May 16	13.40	14.70	BUY
17:	25 May 16	13.40	14.70	BUY
18:	02 Jun 16	13.16	14.70	BUY
19:	03 Jun 16	13.16	14.70	BUY
20:	12 Jul 16	13.24	14.70	BUY
21:	14 Jul 16	13.26	14.70	BUY
22:	01 Aug 16	13.22	14.70	BUY
23:	05 Aug 16	13.06	14.70	BUY

Source: DBS Bank

Analyst: Sue Lin LIM
Lynette Cheng

DBS Bank recommendations are based an Absolute Total Return* Rating system, defined as follows:
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: 30 Aug 2016 09:02:23
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