China | Banking

# China Minsheng Banking Corporation (1988 HK)

January 17, 2014

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## Costs a'rising

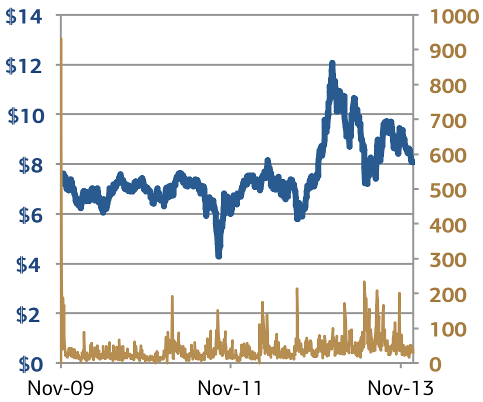
### + 5% demand products?

Minsheng is poised to offer 5% on "money-market cards" redeemable on demand. This indicates just how quickly funding costs for commercial banks are rising. We estimate these cards alone could lower profit by about 3%.

### + Reiterate SELL rating; PT HKD 5.77

We adjust our price target to HKD 5.77 from HKD 4.68 and reiterate our sell rating. Our price target is based on a multiple of book value adjusted for write-downs estimated at RMB 143.8 bln, cost of equity of 13.8%, and normalized ROE of 17%.

**China Minsheng Banking Corporation (1988 HK) one-year share price in HKD (blue) and volume (gold, in mln shares)**




Source: Bloomberg, January 17, 2014

**China Minsheng Banking Corporation (1988 HK)**

| | |
|---|---|
| Price | HKD 8.08 |
| **Rating** | **SELL** |
| **Price Target** | **HKD 5.77** |
| **Difference** | **28.5%** |
| Market Cap | HKD 256.06 bln |
| Simple Moving Avg. | 33.31 mln |
| P/E | 4.32x |

Source: Bloomberg, January 17, 2014

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# The money-market card

**Minsheng is planning to offer 5% to depositors in its "money-market" debit card.**

If Minsheng's most recent product is any indication, funding cost pressure can be expected to accelerate. Minsheng's "money market card" is currently in trial, but will essentially act as a surrogate for demand deposits. It is expected to be priced aggressively and offer 5% annualized returns.[1] To put this in perspective, Minsheng's demand deposits yielded between 0.4% and 0.66% in the second half of 2013.

We believe this is a symptom of Minsheng's need to acquire capital in order to roll over an estimated RMB 108 bln in overvalued assets. Originally, Minsheng found this funding in the interbank market and by printing Bank Acceptance Notes to purchase deposits; in Q2, roughly a quarter of Minsheng's deposit growth was purchased with BANs. But with these avenues closed, Minsheng plans to turn to even more expensive money-market cards.

Money market cards are wealth management products (WMPs) that pool capital into money market funds managed by licensed fund companies. Such products are being widely marketed by the titans of the Chinese Internet, including Baidu, Alibaba, and Tencent. Banks are restricted from managing their own funds, but, like online players, they can market cards on behalf of fund companies. Minsheng's partner funds appear to include Caifutong and Minsheng's very own Minsheng Royal.

Hence, for Minsheng, with its 63.33% owned subsidiary fund company, cards present an opportunity to raise capital and effectively skirt CBRC restrictions on deposit rates.

Buyers of the card have their money invested in the interbank market. This mainly includes short-term loans to banks, negotiated deposits, CDs, and of course Bank Acceptance Notes. Given that Minsheng Royal Asset Management avowedly makes project loans to clients of Minsheng Bank, it is likely that Minsheng Royal Fund will employ money market funds to purchase paper from the its parent. This will help Minsheng Bank further reduce repo exposure and relieve balance sheet pressure caused by burgeoning discounted bills.

[1] http://kuaixun.stcn.com/2013/1113/10908366.shtml

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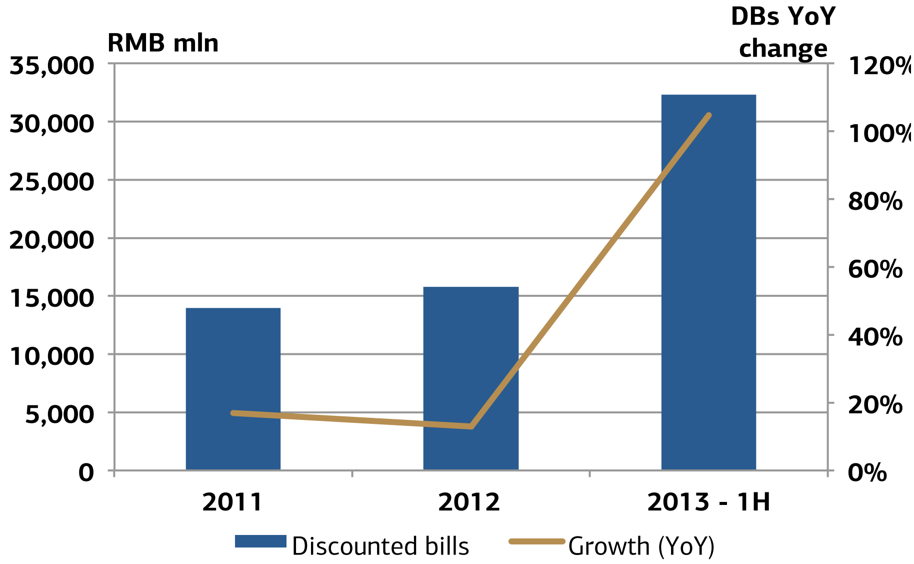
## Chart 1. Minsheng discounted bills




Source: Company filings

In other words, with its own money-market fund, Minsheng will be able to exchange its discounted bills and interbank assets for face value virtually whenever it wants, by selling these assets into the money-market fund.

**Minsheng will be able to move interbank-type assets off balance sheet into money-market funds.**

In essence, this could become WMP 2.0. But instead of moving project loans off balance sheet into asset pools, Minsheng will be able to move interbank assets off balance sheet into money-market funds. The effect will be the same as when a corporate factors its receivables: its cash flow appears higher and leverage appears lower. But the risk is still there: it is merely moved off balance sheet.

Most striking is that funds invested in these cards will be redeemable *on demand*. Given that a Minsheng demand deposit currently yields 0.38%[2] and that a one-month WMP yields 6%,[3] the price point at which the card is being marketed at is aggressive. A money market fund is almost as safe as a deposit, and there is no reason a one-year bank deposit should yield significantly less than money market demand deposits. This means that bank deposit rates are still well below a "fair" rate, and bank-funding costs have a long way to rise before they stabilize.

[2] http://www.bankrate.com.cn/rate/saving/6_1

[3] http://www.cmbc.com.cn/cs/Satellite?c=Page&pagename=cmbc%2FPage%2FTP_IndexLayout&rendermode=preview&cid=1356495500991

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**Adjusting Minsheng's spread for 5% deposit costs results in a 90% profit loss.**

### Table 1. Minsheng actual spread vs. Minsheng spread adjusted for 5% deposit costs

| RMB | Actual | Adjusted | Change |
|---|---|---|---|
| Interest income | 89,018 | 89,018 | 0% |
| Interest expense | -48,454 | -76,212 | 57% |
| Net interest income | 40,564 | 12,806 | 68% |
| Fee and commission income | 17,417 | 17,417 | 0% |
| Fee and commission expense | -1,195 | -1,195 | 0% |
| Net fee and commission income | 16,222 | 16,222 | 0% |
| Net trading gain | 340 | 340 | 0% |
| Net gain arising from disposals of securities and discounted bills | 997 | 997 | 0% |
| Impairment losses on assets | -6,772 | -6,772 | 0% |
| Operating expenses | -20,726 | -20,726 | 0% |
| Other operating income/(expenses) | 369 | 369 | 0% |
| Profit before tax | 30,994 | 3,236 | 90% |

Source: Company filings, J Capital Research

If Minsheng were to reprice its deposits to yield 5%, it would lose 90% of its profits. Of course this is a nightmare scenario; in actuality only a portion of Minsheng's funding costs will be repriced to 5%.

It is impossible to predict the proportion of Minsheng funding requirements that will be met with money market funds with accuracy. But we estimate new, more expensive funding will grow by between RMB 100 bln and RMB 170 bln. We arrived at this estimate by assuming RMB 90 bln as the bare minimum that Minsheng needs in order to grow its credit assets, and estimated deposit growth of RMB 100 bln. As such, we expect it to make up at least 4% of Minsheng's deposits.

Another way to approach our estimate is to assume that Minsheng will seek to use these money market cards to replace the interbank instruments that it gave up after the June liquidity crisis. In this case, money-market cards could rise to as high as ~ RMB 170 bln, or 7.4% of its deposits.

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## Table 2. Cost of money market card (left) vs. funding shortfall as % of deposits (top)

| | | Funding shortfall | | | | |
|---|---|---|---|---|---|---|
| | | 2% | 4% | 6% | 8% | 10% |
| Money market card cost of funds | 3.0% | 0.5% | 0.9% | 1.4% | 1.9% | 2.3% |
| | 3.5% | 0.8% | 1.6% | 2.4% | 3.2% | 4.0% |
| | 4.0% | 1.1% | 2.3% | **3.4%** | 4.5% | 5.6% |
| | 4.5% | 1.5% | 2.9% | 4.4% | 5.8% | 7.3% |
| | 5.0% | 1.8% | 3.6% | 5.4% | 7.2% | 8.9% |

Source: Company filings, J Capital Research

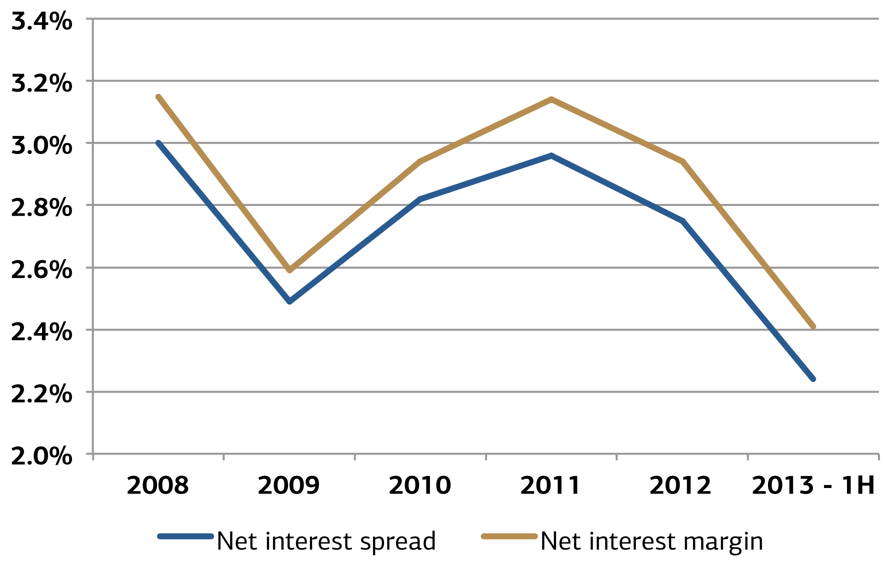
We estimate that substituting high-cost funding from the money-market card alone could decrease Minsheng's profits by about 3.4% in 2014.

### Rising costs all around

Minsheng's money-market card is part of a larger dilemma: costs are rising faster than interest income. In other words, the card indicates desperation for deposits.

**Minsheng has seen spreads fall from 3% to a five-year low of 2.24% over the past five years.**

## Chart 2. Minsheng net interest spread vs. NIM (2008 to 2013)




Source: Company filings

Minsheng's spread has been dropping precipitously since 2011, and is now at an all-time low. This is primarily driven by increasing cost of funds.

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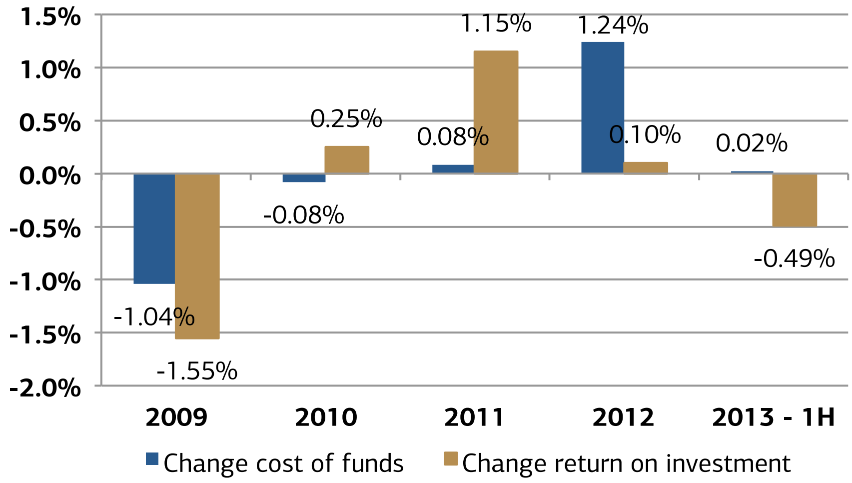
### Chart 3. YoY change in cost of funds vs. change in ROI

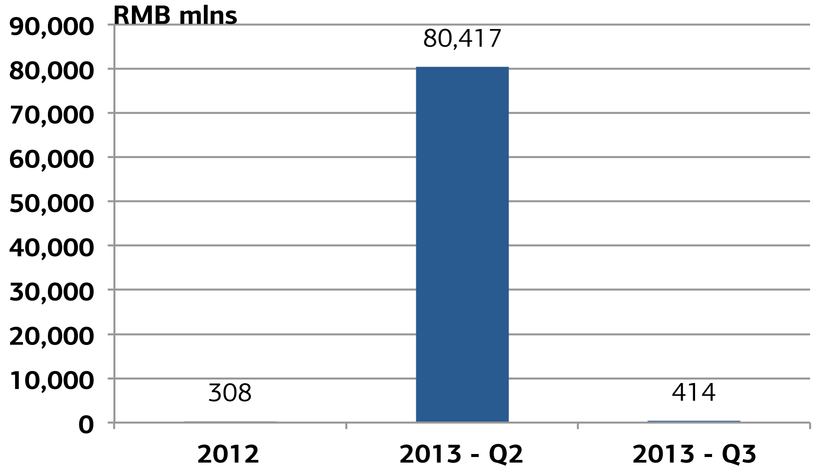



Source: Company filings

Chart 3 shows that in aggregate, and indeed every year with the exception of 2013, return on investment actually *rose*, but was more than offset by increases in funding costs.

Moreover, Minsheng's 2013 reported numbers for cost of funds significantly overstates the health of its funding. That is because, in the midst of the June liquidity crisis, it received massive, exceptional loans directly from the central bank. This means that Minsheng was operating on adrenaline pumped in directly from the PBOC from June 15, when the regulators intervened, until the end of the month. As a result, end-of-period borrowings from central bank surged to unprecedented levels.

### Chart 4. Borrowings from central bank




Source: Company filings

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**Without PBOC intervention, Minsheng's cost of funds would rise to 3.09%.**

Essentially, the June liquidity crisis appeared to have lowered funding costs but really overstated the average balances of extremely cheap sources of funds. If we normalize Minsheng's cost of funding, we find that it is significantly worse without PBOC intervention.

### Table 3. 2013 – H1 Cost of funding: Reported vs. adjusted

| | As reported | Adjusted |
|---|---|---|
| Sources of funding | 3,170,628 | 31,30,254 |
| Interest expense | 48,454 | 48,370 |
| Cost of funding | 3.06% | 3.09% |

Source: Company filings, J Capital Research

The upshot is, Minsheng's normalized cost of funding actually rose fully 50 bps in the first half of 2013.

#### Price competition

To put Minsheng's rising funding costs in context, it helps to understand that Chinese banks have long been beneficiaries of "financial repression," or government policies which keep funding costs for state actors such as banks or insurers below the market rate, giving depositors negative real rates. But depositors will not accept negative real interest rates in perpetuity.

**Banks are being forced to offer WMPs at high yield rates, ironically challenging China's financial repression.**

Now that banks are desperate for deposits to evergreen bad loans, they themselves are finding ways of offering higher rates—in essence, breaking with the deposit cartel—and so financial repression has been breaking down for some time, most notably in the guise of bank WMPs and trust products. The money market card means that WMPs are no longer enough to entice capital. Blue chips like Baidu, Tencent, and Alibaba have begun offering WMPs with yields from 5% to 11%,[4] and so Minsheng has been forced to offer fatter yields to sustain deposits.

#### Lending terms

Areas of lax regulation and low transparency are natural incubators of speculative behavior. It is worth noting that Minsheng Royal is no exception. Minsheng Royal has apparently

[4] http://xw.qq.com/a/finance/20140102001249/FIN2014010200124904

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begun issuing "perpetual entrusted loans" which are exactly like normal loans except that principal never has to be repaid.[5]

### Valuation

We adjust our price target to HKD 5.77 from HKD 4.68 and reiterate our sell rating. Our price target is based on a multiple of book value adjusted for write-downs estimated at RMB 143.8 bln, cost of equity of 13.8%, and normalized ROE of 17%.

[5] http://finance.sina.com.cn/money/fund/20131127/163017454359.shtml

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## Table 4. Balance Sheet

| RMB mln | 2011a | 2012a | 2013e | 2014e | 2015e | 2016e | 2017e | 2018e |
|---|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | | |
| Cash and Deposits with Central Bank | 332,805 | 420,418 | 425,188 | 374,698 | 266,413 | 216,126 | 201,398 | 185,470 |
| Deposits with Other Banks and Financial Institutions | 232,336 | 236,161 | 123,454 | 123,454 | 129,627 | 136,108 | 142,913 | 150,059 |
| Precious Metal | 527 | 3,723 | 3,082 | 3,082 | 3,082 | 3,082 | 3,082 | 3,082 |
| Placements with banks and other financial institutions | 37,745 | 80,082 | 105,476 | 105,476 | 110,750 | 116,287 | 122,102 | 128,207 |
| Trading financial assets | 20,423 | 26,318 | 21,054 | 21,054 | 21,054 | 21,054 | 21,054 | 21,054 |
| Derivative Financial Assets | 587 | 1,234 | 3,766 | 3,766 | 3,766 | 3,766 | 3,766 | 3,766 |
| Financial Assets Purchased Under Agreements to Resell | 141,022 | 732,662 | 615,436 | 615,436 | 646,208 | 678,518 | 712,444 | 748,066 |
| Interests Receivable | 7,210 | 9,638 | 12,021 | 12,021 | 12,021 | 12,021 | 12,021 | 12,021 |
| Corporate loans | 827,158 | 903,270 | 907,149 | 997,864 | 1,047,757 | 1,100,145 | 1,155,152 | 1,212,909 |
| Discounted bills | 13,960 | 15,764 | 38,115 | 65,136 | 87,933 | 118,710 | 124,645 | 130,878 |
| Total corporate loans | 841,118 | 919,034 | 945,264 | 1,062,999 | 1,135,690 | 1,218,854 | 1,279,797 | 1,343,787 |
| MSE | 232,495 | 317,470 | 440,404 | 520,000 | 624,000 | 686,400 | 755,040 | 830,544 |
| Residential Mortgage | 83,337 | 71,518 | 70,893 | 70,893 | 74,438 | 78,160 | 82,068 | 86,171 |
| Credit card receivables | 38,551 | 66,305 | 96,805 | 119,071 | 132,764 | 139,402 | 146,372 | 153,690 |
| Others | 9,720 | 10,283 | 22,759 | 22,759 | 22,759 | 22,759 | 22,759 | 22,759 |
| Total personal loans | 364,103 | 465,576 | 630,862 | 732,723 | 853,961 | 926,721 | 1,006,239 | 1,093,165 |
| Allowance for impairment losses on loans | (26,936) | (33,098) | (41,443) | (47,217) | (52,316) | (56,416) | (60,110) | (64,078) |
| Loans and Advances | 1,178,285 | 1,351,512 | 1,534,683 | 1,748,505 | 1,937,335 | 2,089,159 | 2,225,927 | 2,372,874 |
| Financial Assets Available for Sales | 64,732 | 117,150 | 156,745 | 167,717 | 176,103 | 184,908 | 194,154 | 203,861 |
| Held-to-Maturity Investment | 117,886 | 83,653 | 93,255 | 99,782 | 104,772 | 110,010 | 115,511 | 121,286 |
| Loans and receivables | 8,319 | 15,040 | 45,419 | 90,837 | 136,256 | 170,320 | 187,352 | 206,087 |
| Long-Term Equity Investment | 125 | 125 | 145 | 145 | 145 | 145 | 145 | 145 |
| Fixed Assets | 8,823 | 12,161 | 14,374 | 15,380 | 16,149 | 16,957 | 17,804 | 18,695 |
| Intangible Assets | 4,770 | 4,961 | 5,135 | 5,135 | 5,135 | 5,135 | 5,135 | 5,135 |
| Deferred Income Tax Assets | 6,982 | 8,817 | 10,980 | 11,749 | 12,336 | 12,953 | 13,600 | 14,280 |
| Other Assets | 21,592 | 33,537 | 43,924 | 46,999 | 49,349 | 51,816 | 54,407 | 57,127 |
| Financial lease receivables | 44,895 | 74,809 | 81,711 | 87,431 | 91,802 | 96,392 | 101,212 | 106,273 |
| **Total Assets** | 2,229,064 | 3,212,001 | 3,295,846 | 3,532,667 | 3,722,301 | 3,924,758 | 4,134,027 | 4,357,489 |
| **Liabilities** | | | | | | | | |
| Deposits with Other Banks and FIs | 262,891 | 777,262 | 611,913 | 654,747 | 687,484 | 721,859 | 757,952 | 795,849 |

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| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Borrowing from Central Bank | 160 | 331 | 127 | 136 | 143 | 150 | 158 | 165 |
| Placements from banks and other financial institutions | 16,450 | | - | - | - | - | - | - |
| Derivative Financial Liabilities | 787 | 1,335 | 1,335 | 1,428 | 1,428 | 1,428 | 1,428 | 1,428 |
| Financial Assets Sold Under Agreements to Repurchase | 53,794 | 133,335 | 80,001 | 85,601 | 89,881 | 94,375 | 99,094 | 104,049 |
| Deposit Received | 1,644,738 | 1,926,194 | 2,155,541 | 2,306,429 | 2,421,750 | 2,542,838 | 2,669,979 | 2,803,478 |
| Employee Salary Payable | 5,335 | | 8,404 | 8,404 | 8,404 | 8,404 | 8,404 | 8,404 |
| Tax Payable | 8,414 | 3,263 | 6,439 | 6,439 | 6,439 | 6,439 | 6,439 | 6,439 |
| Interests Payable | 14,894 | | 26,911 | 26,911 | 26,911 | 26,911 | 26,911 | 26,911 |
| Debt securities issued | 31,030 | 74,969 | 91,403 | 91,403 | 91,403 | 91,403 | 91,403 | 91,403 |
| Provisions | 3,061 | 3,173 | 3,156 | 3,377 | 3,377 | 3,377 | 3,377 | 3,377 |
| Other Liabilities | 12,575 | 51,791 | 21,023 | 22,495 | 22,495 | 22,495 | 22,495 | 22,495 |
| Borrowings from banks and other financial instiutions | 40,825 | 71,804 | 86,165 | 92,196 | 96,806 | 101,646 | 106,729 | 112,065 |
| **Total Liabilities** | 2,094,954 | 3,043,457 | 3,092,418 | 3,299,566 | 3,456,522 | 3,621,325 | 3,794,368 | 3,976,064 |
| | | | | | | | | |
| **Total Liabilities and Shareholders' Equity** | 2,229,064 | 3,212,001 | 3,295,846 | 3,532,667 | 3,722,301 | 3,924,758 | 4,134,027 | 4,357,489 |

Source: Company data, J Capital Research estimates

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