Southeast Asia | Banking
Initiation Report

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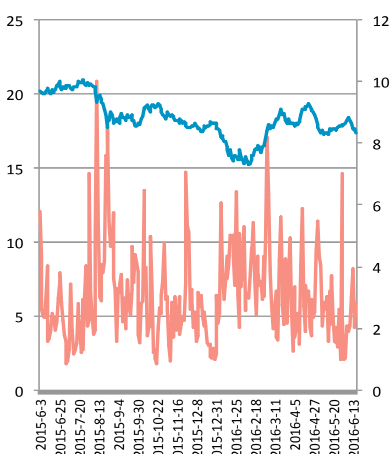
OCBC One-Year Price and Volume



Source: Yahoo! Finance June 16, 2016

Name	**Oversea-Chinese Banking Corporation Limited**
Ticker	O39 SGX
Current Share Price	SGD 8.35
J Capital Target Price	SGD 6.27
Difference	25%
Market Cap	SGD 35.14 bln
P/E (ttm)	9.22
P/B	1.04

Source: Yahoo! Finance share price as of 17th June 2016

Oversea-Chinese Banking Corp. Ltd. (O39 SGX)

Losing Interest

- **Greater China has overtaken Malaysia as OCBC's second-biggest market.** Hong Kong and the Mainland accounted for 27% of the loan book in 2015 and 20% of group profit, but both markets are currently seeing declines in property and trade plus high default risks, and the situation can only get worse.

- **The 9% of OCBC profit deriving from its 20% shareholding in Bank of Ningbo is set to decline.** Meanwhile, we think OCBC is underestimating the risks associated with its 20% shareholding in China's AVIS Trust. These two Mainland holdings together should contribute 1% to what we forecast as a 5% decline in OCBC's earnings this year.

- **Exposure to trading companies and mortgage loans** elsewhere in Southeast Asia makes OCBC uniquely vulnerable to the fallout from Chinese economic decline that is now being felt in key OCBC markets of Malaysia, Hong Kong, Indonesia, and Singapore. We expect interest income to dive this year, from 12% growth in 2015 to negative 3% in 2016.

- **The balance sheet is under stress, as NPLs from Malaysia and Indonesia are set to rise,** given the weakening economies and the slump in property. We forecast OCBC's NPLs from Malaysia and Indonesia to rise to 2.8% and 3.2% respectively in 2016.

- **Comparison with the two other major banks** in Singapore indicates that OCBC has the highest liquidity and foreign-exchange risks.

- **We rate OCBC as a SELL and set a price target of SGD 6.27, 25% down,** based on our DCF model with a WACC of 4.8% and terminal growth rate of 2%.

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Short by Proxy
Summary View

OCBC has found its niche as the community bank for Southeast Asia, lending to SMEs and to property buyers in satellite markets around Singapore. In its asset-management business, OCBC has sought growth from China. These assets now threaten high levels of default.

Nan Yiyi and Anne Stevenson-Yang

We see OCBC as the best short among Singapore's three major banks to express a negative view on Southeast Asian economies exposed to China. OCBC has been aggressive in its expansion into Malaysia, Indonesia, Hong Kong, and China, with Hong Kong-China-Macau ("Greater China") now the second-largest market.

Table 1. Regional Breakdown of OCBC Business

	Loan book breakdown	Total core income	Profit before income tax	Total assets
Singapore	41%	58%	55%	55%
Malaysia	14%	16%	17%	15%
Indonesia	7%	6%	4%	3%
Greater China	26%	16%	20%	18%
Other Asia Pacific	4%	2%	2%	3%
Rest of the World	7%	2%	2%	6%
	100%	100%	100%	100%

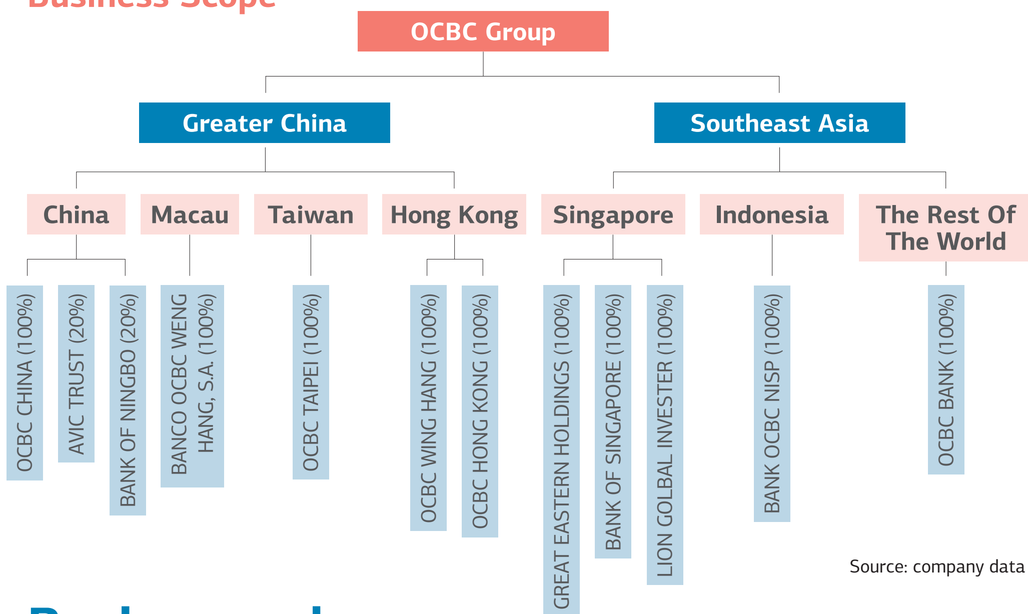
Source: Company filings

OCBC is a well-run bank with strong management. But it lacks the advantages of local competitors DBS Group Holdings (D05 SGX) and United Overseas Bank (UOB, listed as U11 SGX) in having the government backing that provides access to the biggest corporate deposits and investment deals in Singapore. Instead, OCBC has found its niche in becoming the community bank for Southeast Asia, lending to SMEs and to property buyers in satellite markets around Singapore. Meanwhile, in its asset-management business, OCBC has sought growth from Hong Kong and China. These assets now threaten high levels of default.

We believe that OCBC's strategic focus on Hong Kong, China, Malaysia, and Indonesia has opened the bank to risks that the market has not taken into account.

OCBC's principal clients are small enterprises in Singapore, Indonesia, and Malaysia. These pushed up the group's NPL ratio.

Business Scope



Source: company data

Background

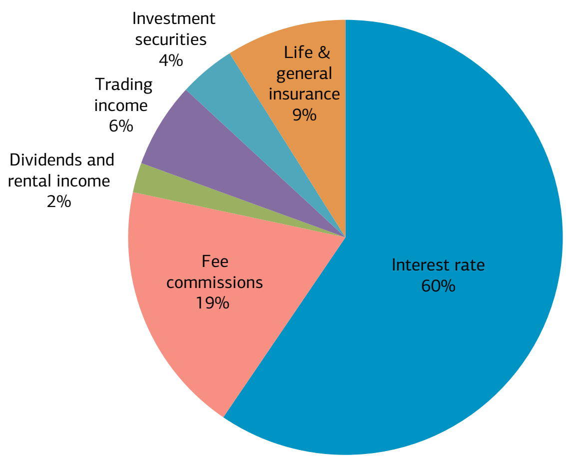
The Oversea-Chinese Banking Corporation Limited is Singapore's second-largest bank and a family-dominated financial services group involved in banking, life assurance, general insurance, asset management, investment holding, futures, and stock broking. It was founded in 1932 through the amalgamation of three banks – Chinese Commercial Bank Limited (1912), Ho Hong Bank (1917) and Oversea-Chinese Bank Limited (1919). The bank operates in five business segments: Global Consumer/Private Banking, Global Corporate/Investment Banking, Global Treasury and Markets, Insurance, and OCBC Wing Hang (0302 HKG), acquired in 2014. It has more than 630 branches in 18 countries and regions. Singapore, Malaysia/Indonesia, and Greater China are the three core markets, contributing 90% of revenue.

The bank listed in Singapore in 2002 on the strength of its superior penetration in Singapore's SME community and its positioning as a community bank in Malaysia. OCBC set its sights on becoming the go-to bank for Southeast Asia, expanding into Indonesia, Vietnam, Myanmar, and Greater China. By 2006, the bank derived 33% of profit from overseas markets, but Malaysia was two-thirds of that number. By 2015, profit deriving from countries outside of both Singapore and Malaysia had risen to 28%.

Weak Links

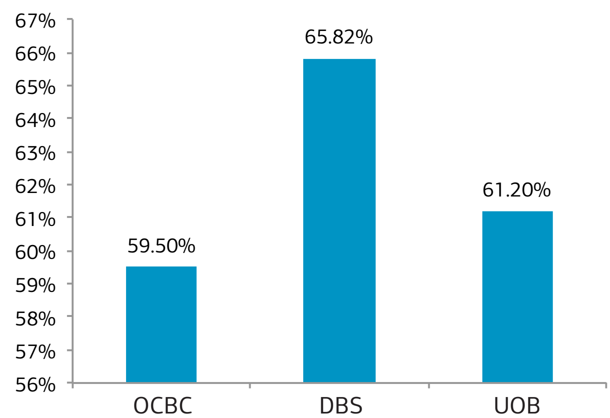
OCBC derives 59.5% of total revenue from interest income, less than its peers, indicating that its loan business is less competitive. This view is supported by the fact that OCBC's interest margin is the lowest of the three Singapore banks. OCBC's principal clients are small enterprises in Singapore, Indonesia, and Malaysia. These pushed up the group's NPL ratio from 0.64% in Q1 2015 to 1.05% in Q1 2016.

Chart 1. Revenue Breakdown 2015



Source: Company data

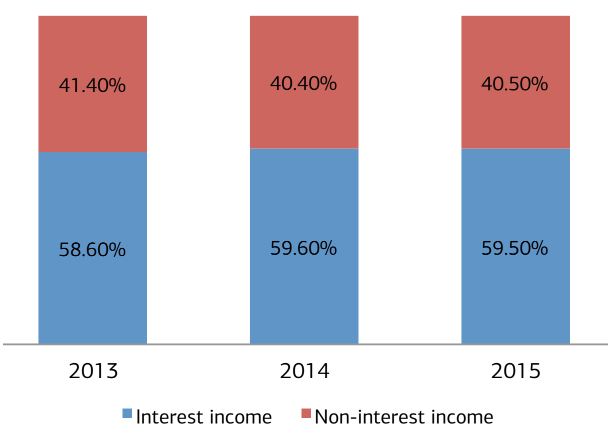
Chart 2. Interest Income Contribution 2015



Source: Company data

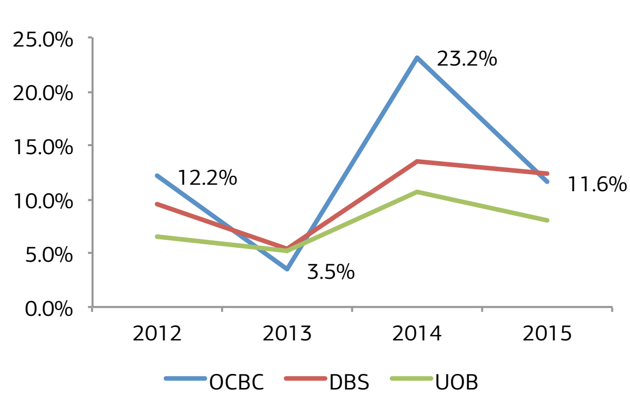
After a sharp run-up, interest income is coming down just as sharply.

Chart 4. Revenue Breakdown (%)



Source: Company data

Chart 5. Interest Income Growth Comparison 2012-15 (%)



Source: Company data

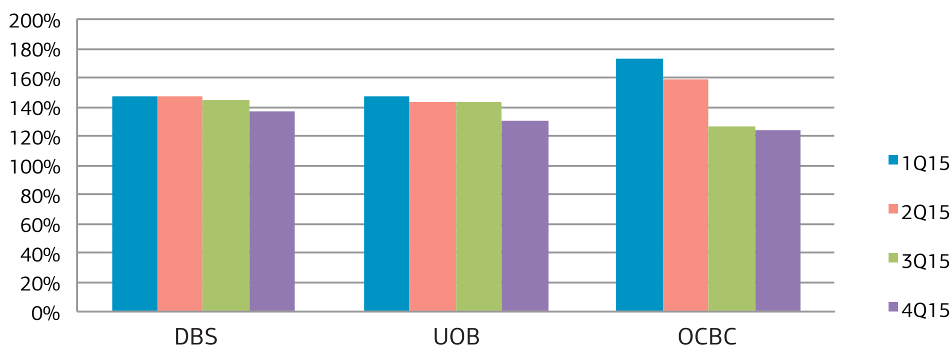
Table 2. Volume and NIM Analysis 2015

SGD million	Volume	NIM factor	Net change
Loans and advances to non-bank customers	609	399	1,008
Placements with and loans to banks	121	-302	-181
Other interest-earning assets	56	-4	52
Total	786	93	879

Source: Company data

OCBC's coverage ratio has declined more sharply than that of its peers.

Chart 6. Coverage Ratio



Source: company data

Table 3. Capital Structure of the Three Banks

OCBC	1Q15	2Q15	3Q15	4Q15
Common Equity Tier 1	10.7%	11.4%	11.6%	12.0%
Tier 1	13.5%	14.2%	14.6%	14.8%
Total	15.5%	16.1%	16.6%	16.8%

DBS	1Q15	2Q15	3Q15	4Q15
Common Equity Tier 1	12.3%	12.3%	11.9%	12.5%
Tier 1	13.4%	13.4%	12.9%	13.5%
Total	15.3%	15.3%	14.8%	15.4%

OCBC	1Q15	2Q15	3Q15	4Q15
Common Equity Tier 1	12.9%	12.6%	12.3%	11.8%
Tier 1	14.3%	14.0%	13.6%	13.0%
Total	17.1%	16.8%	16.4%	15.6%

Source: Company data

The Key Markets: Singapore

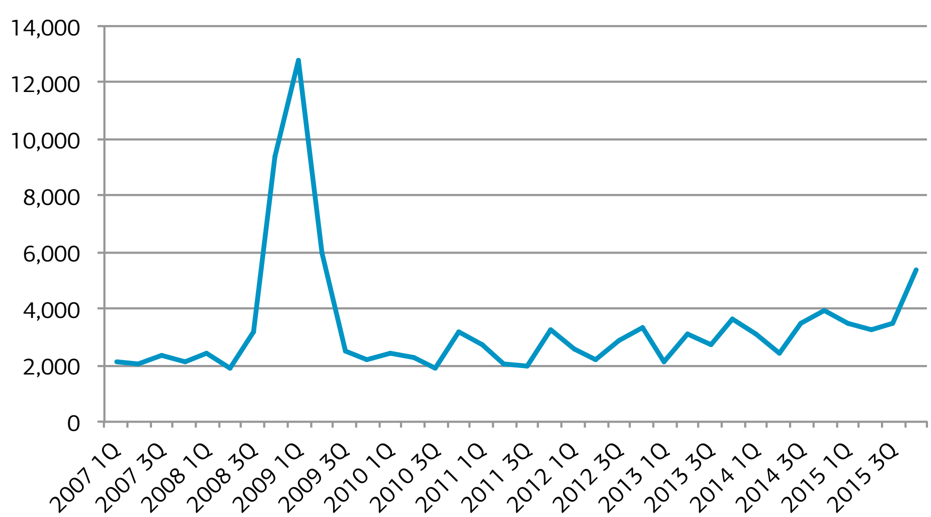
Singapore is more than half of OCBC's profit, but given slower-than-expected growth in the economy, we expect a further loosening of monetary policy. That will result in lower interest rates. The weakening economy will also likely produce more NPLs. Both are bad for OCBC.

To a large but under-appreciated extent, the slowdown in Singapore and Malaysia comes from China and can be viewed as long-term and structural.

To a large but under-appreciated extent, the slowdown comes from China and can be viewed as long-term and structural. In January, Singapore's non-oil domestic exports (NODX) to China slumped 25% YoY, the biggest decline in seven years. Overall exports contracted 9.9% in January, exceeding the market forecast of -7.6% and demonstrating that analysts are not seeing how deep the China decline is and will be. The problem continued through the first quarter, as NODX plunged 15.6% in March, according to International Enterprise Singapore. Exports to China contracted 14% by volume. OCBC's core clientele are exporting SMEs based in Singapore, and so OCBC is likely to be disproportionately impacted by this shrinking demand.

Singapore's domestic economy is similarly glum. Electronics, which make up one-third of manufacturing output, shrank 6.8% last year. Transport engineering, which includes marine and offshore, contracted 13.5% on the back of the global rout in oil prices. The manufacturing sector, which makes up 19% of Singapore's economy, has been in recession for at least a year, with no revival in sight. Manufacturing contracted 5.2% last year, a reversal from 2014's 2.7% expansion. This sector accounted for46% of the total number of people laid off during the quarter.

Chart 7. Quarterly Number of Workers Made Redundant



Source: Singapore Statistics Bureau

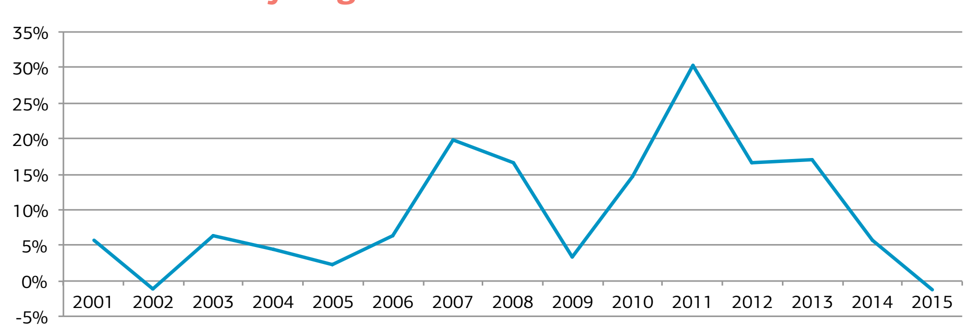
Table 4. GDP Contribution Breakdown and YoY Growth by Industry

Unit: %	2014	2015	2014 Growth	2015 Growth
Goods Producing Industries	**25.5**	**26.4**	**2.97**	**-3.4**
Manufacturing	18.8	19	2.88	-5.17
Construction	5.2	5.2	3.59	2.48
Utilities	1.5	1.4	2.21	1.22
Services Producing Industries	**70.1**	**69.2**	**3.65**	**3.44**
Wholesale and retail trade	16.8	15.6	2.14	6.14
Transportation & Storage	7.4	7.4	2.70	-0.04
Accommodation & Food Services	2.2	2.1	1.70	0.15
Information & Communications	4.2	4.2	6.98	4.21
Finance & Insurance	12.2	12.6	9.10	5.43
Business Services	15.7	15.5	1.59	1.47
Other Services	11.6	11.7	2.65	1.64
Ownership of Dwellings	**4.5**	**4.3**	**3.68**	**5.03**

Source: Singapore Statistics Bureau

Loan growth in Singapore was negative in 2015, -1.2% YoY, for the first time since 2002. OCBC showed the sharpest decline among its peers in interest-income growth, from 23.2% in 2014 to 11.6% in 2015. This indicates a soft market for lending. OCBC is in a weak position to compete for that shrinking pool of loans, as it has a lower interest margin than the other two banks. It will have to sacrifice profit to capture share, or else it will see slower growth in the loan book.

Chart 8. NPLs by Region



Source: Monetary Authority of Singapore

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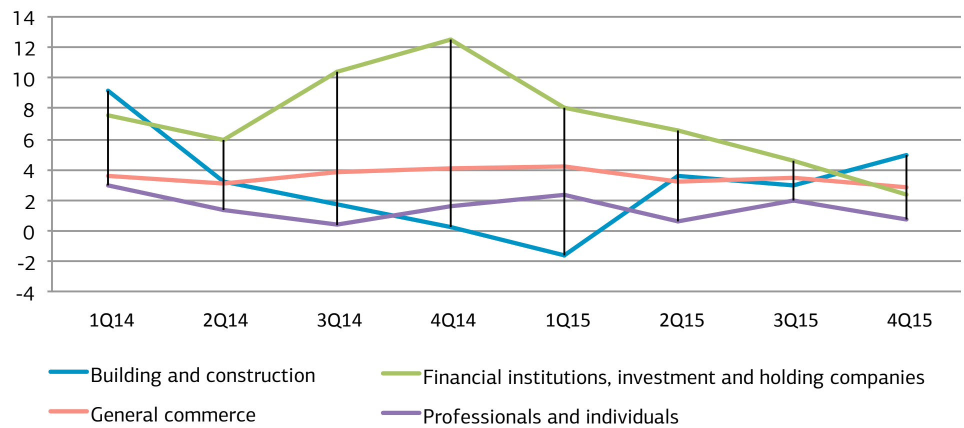
Chart 9. GDP Growth by Sector



Source: Singapore Statistics Bureau

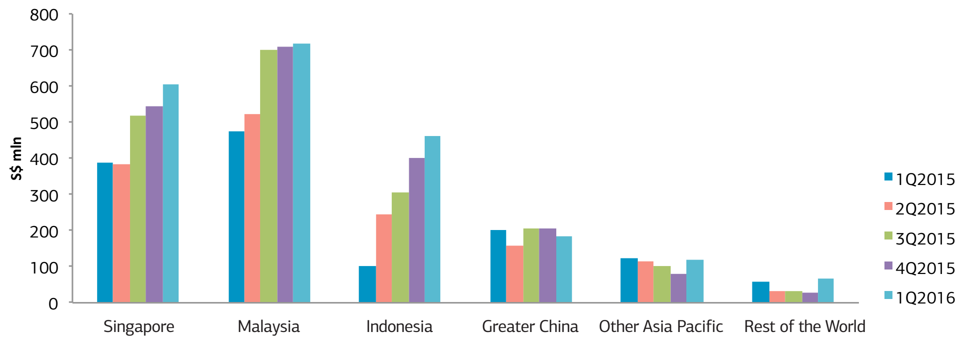
Although OCBC does not disclose the proportion of loans that comes from Singapore property, the bank has 27% of total loans in property, and we assume OCBC roughly has 60% of the housing loans from Singapore, hence around 20% of the total loan book of OCBC should come from Singapore mortgages. As an overseas Chinese bank in a region prone to ethnic preferences, OCBC is also uniquely positioned to serve the carpet-bagging population from China. In 2013, restricted from buying more property at home, Chinese buyers went to Singapore to speculate in property there. This influx sent housing prices in Singapore to record highs, raising concerns from the local government that the market was overheating. When the government put curbs on the market, Singapore saw nine straight quarters of housing price declines, to Q4 2015. Jones Lang LaSalle in Singapore estimated that the market could drop as much as 8% more this year. Rising redundancy in Singapore raises our concern about the ability of borrowers to repay mortgages. We estimate flat growth in Singapore loans this year and negative growth for the next three years, with an increase in the NPL ratio.

Hong Kong and Mainland China

Loan growth in Singapore was negative in 2015, -1.2% YoY, for the first time since 2002.

OCBC has the largest exposure to China among its peers and will likely show more volatility amid China's slowing economy. In 2015, 26% of the loan book was in Greater China, comprising Hong Kong and Mainland China and with Hong Kong representing the majority. Again, property loans in Hong Kong are likely to make up most of OCBC's loans in the territory. As a comparison, 39% of the total loan book of Wing Hang Bank, which OCBC acquired in 2014, is related to the Hong Kong property market, and 62% of those property loans are mortgages to individuals. With property values and sales both sagging in Hong Kong, this portion of lending is vulnerable.

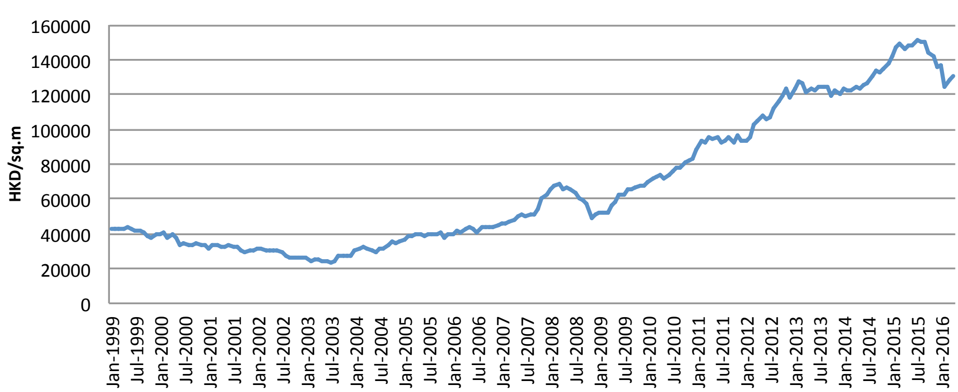
Chart 10: NPLs by Market



Source: Company data

Wing Hang, with over 70% of assets from Hong Kong and the rest from Macau and Mainland China, was responsible for bringing OCBC's profit from Greater China from 12% in 2014 to 20% in 2015. We expect that this will not last: new taxes imposed in 2015 on buyers from outside Hong Kong have cooled the market, where some 40-50% of buyers have been coming from the Mainland. Property prices have now fallen by 17.5% from the July 2015 peak according to news reports, and transaction volumes have hit a 25-year low. Negative equity in homes, where household mortgages exceed a property's market value, has risen by a factor of 15 between 2003 and this year, according to Hong Kong Monetary Authority. Consensus indicates that we may see another 20-30% decline in prices.

Chart 11. Prices for Private Properties in Hong Kong



Source: Hong Kong Rating and Valuation Department

Bank of Ningbo

OCBC's share of results of associates and joint ventures was SGD 353 mln, up from SGD 112 mln a year ago, largely as a result of the full-year consolidation of earnings from the Bank of Ningbo. OCBC first invested in Bank of Ningbo in 2006 and in 2014 increased its holding to 20%, the limit that for a foreign bank's shareholding in a Chinese bank.

Ningbo Bank has the largest exposure[1] in Zhejiang Province, where the local core industries of retailing and light-industrial exports are suffering.

Shaky Chinese Trusts

In 2009, OCBC spent RMB 60 mln to acquire 20% of the Jiangxi Jiangnan Trust, which was renamed AVIS Trust. AVIS Trust defaulted on two trust products in 2014, of RMB 10 mln and RMB 800mln respectively, and delayed payment on another. What is more, AVIS Trust may prove unable to return RMB 23.9 bln in assets to the investors, according to news reports. The majority of AVIS's trust loans are to the property industry, according to press reports. We expect that AVIS Trust will erode OCBC's equity investment returns.

Barclay Wealth

Singapore saw nine straight quarters of housing price declines, to Q4 2015 and could see another 8% this year. Singapore housing loans are about 20% of the total loan book.

OCBC acquired the Asia wealth division of Barclay's for SGD 320mln in April 2016 to target Chinese immigrants to Hong Kong and Singapore. The acquisition will be internally funded by the bank's private-banking subsidiary, Bank of Singapore, and is expected to be earnings-accretive after the first year. The bank expects the deal to be completed toward the end of 2016. Barclays Wealth has AUM of USD 18.3 bln and will increase Bank of Singapore's total AUM by 33.3%, to USD 73.3 bln, up from its previously reported AUM figure of USD 55.0 bln at yearend 2015. This will help OCBC increase its non-interest income, but that depends on the quality of the assets. Some 18% of the assets are in Mainland China, and those investments, we believe, are subject to high risks.

A spillover effect from weakening asset quality in China puts more pressure on OCBC to compete for high-quality assets, suggesting narrowing spreads. We believe that OCBC NPLs in China will increase to 0.7% of gross loans in 2016 from 0.4% in 2015.

Table 5. Geographic Breakdown of Loan Book of 2015

	OCBC	DBS	UOB
Singapore	42%	61.9%	56.0%
Malaysia	14%	0.0%	11.9%
Thailand	0%	0.0%	5.5%
Indonesia	8%	0.0%	5.5%
Greater China	27%	9.4%	12.2%
HongKong	0%	21.2%	0.0%
Other	10%	7.4%	8.9%
Total	100%	100%	100%

Source: Company data

[1] http://wallstreetcn.com/node/219194

Table 6. Return on Assets Comparison

	OCBC	DBS	UOB
Singapore	2.4%	4.1%	2.4%
Malaysia	2.3%	NA	3.1%
Thailand	NA	NA	4.7%
Indonesia	4.5%	NA	4.8%
Greater China	1.9%	1.4%	2.1%
Hong Kong	NA	3.9%	NA
Others	0.7%	0.3%	2.1%

Source: Company data

Table 7. Return on Assets of OCBC

	2014	2015
Singapore	2.2%	2.4%
Malaysia	2.2%	2.3%
Indonesia	4.5%	4.5%
Greater China	1.3%	1.9%
Other Asia Pacific	1.6%	1.4%
Rest of the world	0.8%	0.7%

Source: Company data

On the Mainland, OCBC owns 20% each of the Bank of Ningbo and AVIS Trust, with the two entities contributing 10% of 2015 profit, 9% from Bank of Ningbo and 1% from AVIS trust. Although Bank of Ningbo reports a low NPL rate of 0.92%, the bank focuses on non-interest business such as inter-bank lending. As rates narrow both inside and outside the interbank market, we expect Bank of Ningbo to see a slowdown in profit. AVIS reported a 19% increase in 2015 in assets under management. But Chinese defaults are rising and returns on invested capital declining. We forecast that the two holdings together will contribute around 1%to a 5% decline in 2016 profit.

Loans on the Mainland are likely to be related to trade and to Singapore's direct investment projects there. Chinese exports have been declining and we expect that trend to continue. As for investment, Singapore became China's largest investor in 2013, with direct investment of USD 7.23 bln according to data from International Enterprise Singapore, the government agency that drives Singapore's external economy. Yet this number dived by 19.8% in 2014, to USD 5.8 bln.[2] A large proportion of this USD 72.32 bln invested is in projects jointly undertaken with Chinese provincial and city governments, such as the storied Singapore-Suzhou Industrial Park, and many of the projects are making losses.[3] Although OCBC does not break out its loans to Chinese government entities, the cooperative projects have mostly been financed by local branches of the three big banks in Singapore.[4] OCBC has also financed Chinese State-owned company investments in Malaysia and Indonesia and is seeking deals associated with the "One Belt One Road" policy.

[2] http://www.iesingapore.gov.sg/Media-Centre/News/2015/11/S-pore-is-China-s-largest-investor

[3] http://www.straitstimes.com/singapore/singapore-china-ties-7-things-to-know-about-25-years-of-diplomatic-relations

[4] http://www.straitstimes.com/singapore/singapore-china-ties-7-things-to-know-about-25-years-of-diplomatic-relations

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We believe there are few prospects for a pick-up in property in Hong Kong, and, expanding the volume of Wing Hang Bank's loan business will be challenge. With growing negative equity, delinquency ratio doubled over 14 months, from 0.03% to 0.04%, and we believe it would continue the upward trend.

Malaysia and Indonesia

OCBC has the largest exposure to China among its peers and will likely show more volatility amid China's slowing economy.

Malaysia and Indonesia together represented 21% of OCBC profit before tax in 2015, and they supply much of the bank's growth. But they also supply a disproportionate amount of NPLs. With 13.6% of loans, Malaysia contributed 36% of total NPLs in 2015.Malaysia and Indonesia together accounted for 22% of the total loan book but more than half of the total non-performing loans of the group, even higher than Singapore's, although Singapore contributes half of the loan book. We expect this trend to continue for next couple of years, as 55% of the past-due loans recognized in 2015 were from Indonesia and Malaysia.

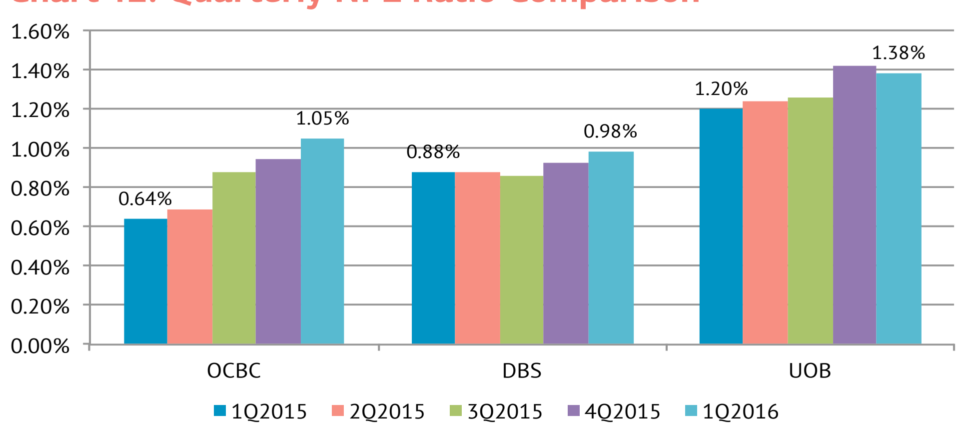
Table 8. NPLs by Region

2015 data	Total loans	NPL Ratio	NPL breakdown	Pass due loans
Singapore	41.6%	0.7%	28%	22.9%
Malaysia	13.6%	2.4%	36%	30.0%
Indonesia	8.2%	2.7%	16%	25.4%
Greater China	26.8%	0.4%	12%	18.1%
Other Asia Pacific	5.1%	1.1%	6%	NA
Rest of the World	4.9%	0.6%	2%	3.6%

Source: company data

We believe the expansion in Malaysia and Indonesia, risky markets with high NPL ratios, will put pressure on OCBC's bottom line.

Chart 12. Quarterly NPL Ratio Comparison



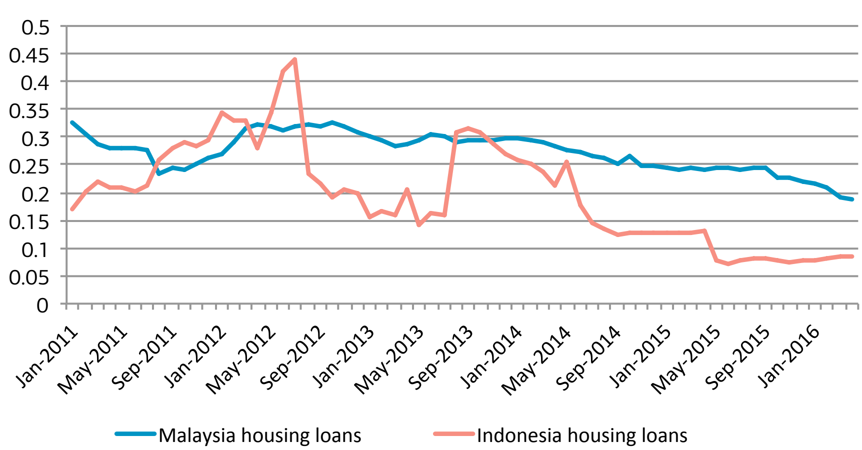
Source: company data

In 2015, OCBC opened four new branches in East Malaysia, bringing the group's total network to 45 branches. Total loan growth rates for Malaysia and Indonesia were 9.4% and 26% in 2015 respectively, much higher than the 1% in Singapore and China. Singapore home loans grew only 1%, while they grew 13% in Malaysia, according to the 2015 annual report. Meanwhile, OCBC's Premier Banking customer base for high net-worth customers grew at 20% for past five years in Malaysia compared with 10% in Singapore. These markets offer a lower yield as the cost of higher growth: Malaysia's pre-tax profit was 3% lower in 2015 than 2014, as higher net-interest and trading income were offset by higher expenses.

Yet these markets are also where the risks are hidden. In 2015, 26% of the bank's capital expenditure went to these two markets, which brought in 21% of the pre-tax profit.

Mortgage loans grew for OCBC in the two countries slower than they did for Malaysia and Indonesia as a whole.

Chart 13. Mortgage Lending Growth Malaysia and Indonesia 2011-16



Source: The Bank of Indonesia; Bank Negara Malaysia

Malaysia sends 19% of its exports to China, which is also among the top five foreign investors in the country. Falling trade from China is hurting SMEs in Malaysia and China who are OCBC customers. The Malaysia business is also focused on Malaysian government projects in China and Chinese SOE acquisitions in Malaysia, so highly geared to the Chinese economy.

Malaysia has been resilient even through the Global Financial Crisis, rapidly recovering to 5.7% GDP growth in 2010.And yet in the first quarter

Table 9. Income and Capex by Region 2015

2015 data	Total income breakdown	Profit before tax breakdown	Capex breakdown
Singapore	59%	55%	64%
Malaysia	16%	17%	18%
Indonesia	6%	4%	8%
Greater China	16%	20%	9%
Other Asia Pacific	2%	2%	1%
Rest of the World	2%	2%	0%
Total	100%	100%	100%

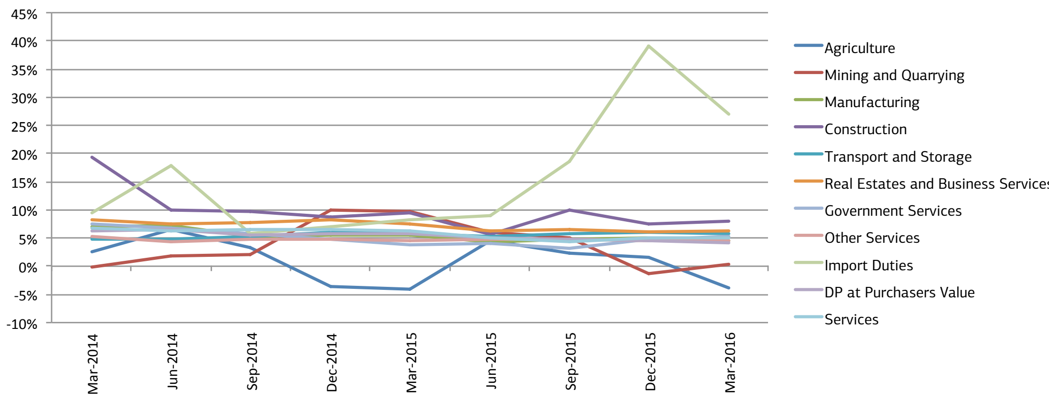
Source: company data

of this year, Malaysia's GDP rose by 4.2%, down from 4.5% in the previous quarter. A private manufacturing purchasing managers' index showed Malaysian factory activity in May contracting for the 14th straight month, recording the sharpest rate of decline in more than three years due to poor market conditions and falling demand. The culprit is both cases is falling demand from China.

Exports of palm oil, a key commodity for Malaysia, are tightly correlated with oil prices. We have a negative view of oil prices and expect palm oil will continue to see weak demand. In April, palm oil exports fell by 1.1% YoY after rising 12.9% a month earlier, when oil prices rose 20%. The weak demand for palm oil will be exacerbated when the government reinstates a 5% VAT. News reports say that traders in Kuala Lumpur are seeing very low demand. That leads us to suspect that Malaysia faces declines in oil prices, which account for around 17% of public revenues. OCBC's business in Malaysia is weighted toward financing for SMEs, which are highly sensitive to these economic cycles.

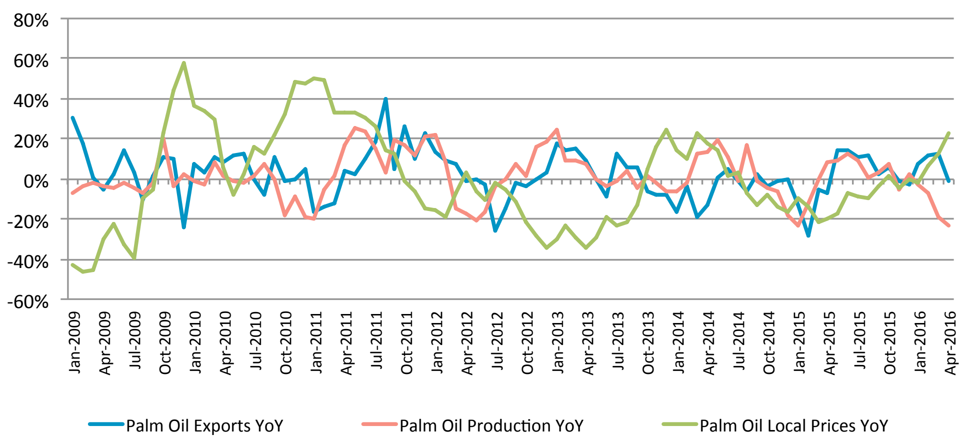
Malaysia still has resilient housing loans. But the growth, at 13% in 2015, is lower than the previous average of 18%. Housing prices in Malaysia have plunged to a 10-year low, and that will weaken the demand for residential loans. These factors together lead us to estimate that NPLs from Malaysia and Indonesia are likely to rise, and we model rates of 2.8% and 3.2% respectively for 2016, up from 2.4% and 2.6% from a year ago.

Chart 14. GDP Growth in Malaysia by Industry



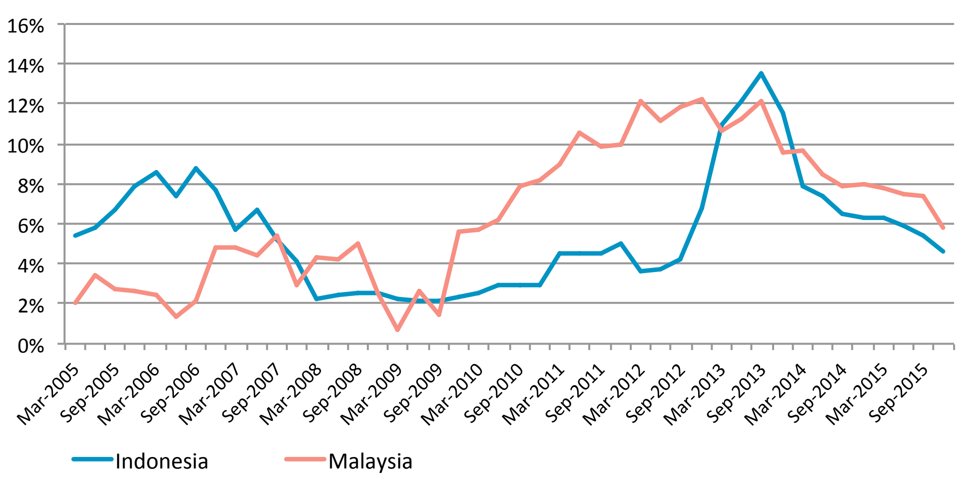
Source: Bank Negara Malaysia

Chart 15. Palm Oil Exports, Production, and Prices



Source: Malaysian Natural Rubber Statistics

Chart 16. Housing Index



Source: The Bank of Indonesia; Bank Negara Malaysia

By Category: Interest Income

In 2015, OCBC interest income grew 11.6% YoY while total loan assets were flat. This is deceptive: our analysis shows that two-thirds of the increment in interest income comes from volume rather than a higher net interest margin. Loan assets refer to the loans outstanding at the end of the period, but there was nevertheless volume growth from higher turnover and more short-term loans.

Mortgages Under Pressure

Housing loans, the biggest part of OCBC's loan book, accounted for 27% of total loan assets in 2015. Year-on-year growth slowed from 29% in 2014 to 3% in 2015, the lowest growth rate since 2009. But of Singapore's three banks, OCBC is the only one still increasing credit to the housing sector, from 25.4% in 2010 to 26.6% in 2015. DBS is down from 25% to 21% and UOB declined from 29.1% to 27.2% over the same period.

Table 10. Loan Book Breakdown of OCBC

	2014	2015
Agriculture, mining and quarrying	4%	4%
Manufacturing	6%	6%
Building and construction	15%	16%
Housing loans	26%	27%
General commerce	14%	12%
Transport, storage and communication	6%	6%
Financial institutions, investment and holding companies	12%	13%
Professionals and individuals	11%	11%
Others	5%	5%
Total	**100%**	**100%**

Source: company data

Faster Growth in NPLs

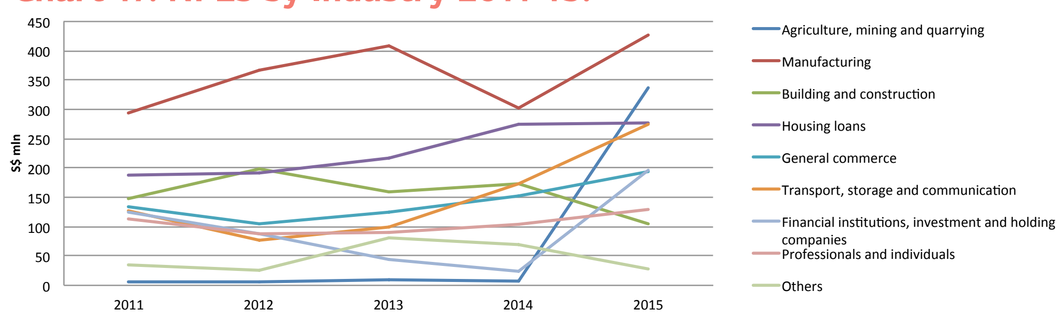
OCBC's NPL ratio is increasing the fastest of its peers, from 0.64% in Q1 2015 to 1.05% in Q1 2016, higher than DBS's 0.98%. As a result of the increase in NPLs, the OCBC coverage ratio declined the most, by 0.49% in 2015.

During 2015, the biggest increase in NPLs came from a few large corporate accounts associated with the depressed oil and gas-services sector. In

2013-2015, NPLs associated with the transport and storage sector nearly tripled. Oil and gas account for 6% of OCBC's loan book.

Other industries showing sharp growth in NPLs include agriculture and mining and finance. In agriculture and mining, NPLs grew from 0.1% to 4.7% of the total between 2014 and 2015. We see little chance of recovery in this pillar of the economy due to weak demand from China. In finance, NPLs grew due to volatility in financial markets and a loss from OCBC's insurance subsidiary, Great Eastern Holdings Limited in Singapore. The finance industry is highly sensitive to the mammoth to the north, where a credit bust, the pricking of the property bubble, or fluctuation in the RMB are all likely.

Chart 17. NPLs by Industry 2011-15.

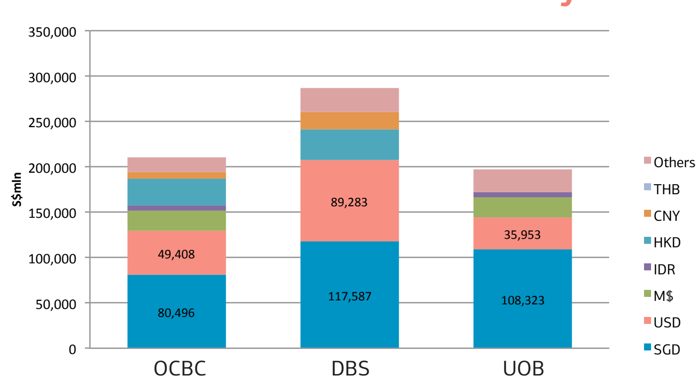


Source: company data

Foreign Exchange Risk

OCBC benefits less than DBS from U.S. dollar appreciation. Since the Hong Kong dollar is pegged to the U.S. dollar, it is affected in the same way. OCBC has only half as many USD loans as DBS and a little more than UOB. A weaker Malaysian Ringgit compared with the Singapore dollar has already conveyed losses to the company.

Chart 18. Loan Book Breakdown by Currency 2015

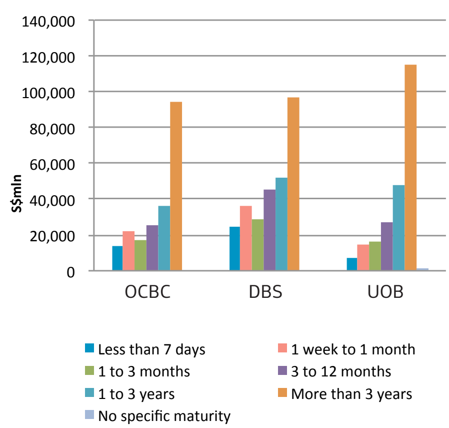


Source: company data

Liquidity Risks

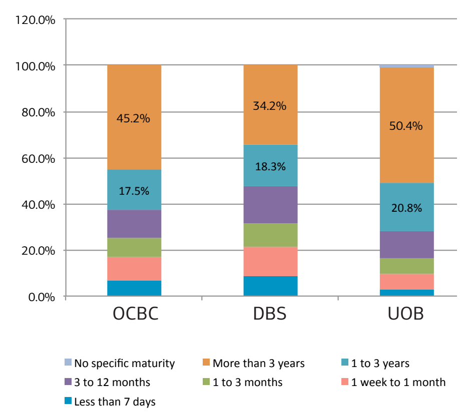
OCBC is less liquid than DBS. During 2015, 45% of its loans had three-year terms compared with 34% for DBS and 50% for UOB. In terms of scale, OCBC is only SGD 3 mln less than DBS in the over three-year category, while DBS has 36% more assets in loans than OCBC does. In short-term loans, OCBC has 25% of its loans in the less-than three-month category, which is 6% less than DBS. In value terms, DBS has double size of short-term loans as OCBC. We believe that fewer short term loans and more long-term loans indicate that OCBC has higher liquidity risks than DBS and will be less resilient than DBS if long-term borrowers slow down repayments.

Chart 19. Loan Breakdown by Value 2015



Source: company data

Chart 20. Loan Breakdown In Percentage Terms 2015



Source: company data

Losses on Insurance

The insurance business contributed 9% of total revenue in 2015 and is the third-largest revenue contributor. But insurance is carried out through a subsidiary, the oldest listed insurer in Singapore and Malaysia, Great Eastern Holdings. This company sells mainly bancassurance products.

In 2015, profit from life assurance of SGD 630 mln declined by 18% from the previous year, primarily due to unrealized mark-to-market losses from Great Eastern Holdings' bond portfolio investments. The drop can be chalked up to the volatility of financial markets, but the bank does not disclose what portion of Great Eastern's investments are in equity, government and corporate bonds, property, and cash as opposed to less risky bond funds.[6]

[6] http://www.investmentmoats.com/budgeting/insurance/insurance-policys-participating-fund-returns-compared/

Valuation

- OCBC has lower asset quality and higher liquidity and foreign exchange risk than DBS but it valued more highly. We think it is overvalued and arrive our price target of SGD 5.72, 33% down, based on our DCF model with a WACC of 5% and terminal growth rate of 2%.

Risks

- Crude price increases and oil demand recovery
- End to Singapore's property curbs
- Flat U.S. interest rates this year
- Timing: Chinese investments would produce high yields this year or next before a decline.
- A Singapore rebound, with higher-than-expected growth of GDP

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