

## Company Focus

15 October 2008 | 10 pages

# Chinatrust FHC (2891.TW)

 Target price change   
 Estimate change 

## Buy: Getting Most Attractive Bank Franchise in Taiwan at Book

- Playing a market bounce** — Stock pullback presents opportunity to accumulate what we see as most attractive banking franchise in Taiwan below historic trough at 1.0x 2008E P/B. Although we have lowered our target price to NT\$21 from NT\$28.50 to reflect a more conservative LT ROE of 12%, we believe much of the negativity is already in the price. Maintain Buy / Low Risk (1L) rating.
- Baking in more conservative numbers** — Given MTM losses taken on Mega thus far and expectations of a tough year ahead, we are cutting our EPS forecasts for 2008-10E. We have conservatively assumed 0% growth in fees for 2009E as a base case. We have also imputed a 23% increase in loan-loss provisions, expecting new NPL influx to rise to 190bps from 174bps, with a rise in non-card delinquency offset by continued improvements in card delinquency.
- Weathering a downturn** — We believe Chinatrust is better positioned to weather a downturn vis-à-vis peers with CAR at 11.8% and tier-1 at 8.6%. With the credit/cash card crisis largely behind it, asset quality continues to improve with NPL ratio at 1.5% and loan-loss reserve coverage at 78%. Its deposit franchise and liquidity position also appear secure with LDR at 85% for NT\$ loans and 69% for foreign currency loans.
- Risks to our view** — Chinatrust's QFII ownership is down from a peak of 60%, but at 50% is still the highest in the space. We could also see higher credit cost from Chinatrust USA, which accounts for 6% of group loans. Although its exposure to commercial real estate and construction is high, management indicated LTV ratios are conservative at 57% and 45%, respectively.

<b>Buy/Low Risk</b>	<b>1L</b>
Price (15 Oct 08)	NT\$12.95
Target price	NT\$21.00
	<i>from NT\$28.50</i>
Expected share price return	62.2%
Expected dividend yield	3.6%
<b>Expected total return</b>	<b>65.7%</b>
Market Cap	NT\$117,828M
	US\$3,639M

### Price Performance (RIC: 2891.TW, BB: 2891 TT)

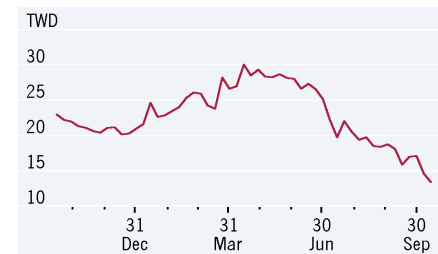


Figure 1. Chinatrust FHC – Statistical Abstract

Year to	Net profit	EPS	EPS Growth	P/E	ABV	P/ABV	DPS	Yield	RoAE
31-Dec	(NT\$ Mils.)	(NT\$)	(%)	(x)	(NT\$)	(x)	(NT\$)	(%)	(%)
2006	-10,192	-1.18	-163	NM	11.47	1.1	0.50	3.9	-10.2
2007	13,346	1.51	227	8.6	12.77	1.0	0.00	0.0	12.9
2008E	10,367	1.14	-24	11.4	13.42	1.0	0.18	1.4	8.7
2009E	10,387	1.14	0	11.3	13.91	0.9	0.46	3.5	8.2
2010E	15,639	1.72	51	7.5	14.34	0.9	0.46	3.5	11.8

Source: Company Reports and CIR estimates

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Fiscal year end 31-Dec	2006	2007	2008E	2009E	2010E
<b>Valuation Ratios</b>					
P/E adjusted (x)	-10.9	6.7	11.4	11.3	7.5
P/E reported (x)	-10.9	6.7	11.4	11.3	7.5
P/BV (x)	1.2	1.0	0.9	0.9	0.9
P/Adjusted BV diluted (x)	1.1	1.0	1.0	0.9	0.9
Dividend yield (%)	3.9	0.0	1.4	3.5	3.5
<b>Per Share Data (NT\$)</b>					
EPS adjusted	-1.18	1.93	1.14	1.14	1.72
EPS reported	-1.18	1.93	1.14	1.14	1.72
BVPS	10.82	12.45	13.66	14.34	14.84
Tangible BVPS	10.82	12.45	13.66	14.34	14.84
Adjusted BVPS diluted	11.47	12.77	13.42	13.91	14.34
DPS	0.50	0.00	0.18	0.46	0.46
<b>Profit &amp; Loss (NT\$M)</b>					
Net interest income	32,898	27,332	26,588	27,499	30,091
Fees and commissions	18,518	21,620	17,280	17,408	19,653
Other operating Income	8,584	1,691	-586	5,471	7,872
<b>Total operating income</b>	<b>60,001</b>	<b>50,643</b>	<b>43,282</b>	<b>50,379</b>	<b>57,617</b>
Total operating expenses	-29,233	-27,179	-25,783	-25,940	-26,567
<b>Oper. profit bef. provisions</b>	<b>30,768</b>	<b>23,464</b>	<b>17,499</b>	<b>24,439</b>	<b>31,050</b>
Bad debt provisions	-50,593	-13,213	-12,536	-15,420	-15,532
Non-operating/exceptionals	3,444	8,970	6,821	3,200	2,880
<b>Pre-tax profit</b>	<b>-16,381</b>	<b>19,220</b>	<b>11,784</b>	<b>12,219</b>	<b>18,399</b>
Tax	6,189	-2,154	-1,416	-1,833	-2,760
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
<b>Attributable profit</b>	<b>-10,192</b>	<b>17,066</b>	<b>10,367</b>	<b>10,387</b>	<b>15,639</b>
Adjusted earnings	-10,192	17,066	10,367	10,387	15,639
<b>Growth Rates (%)</b>					
EPS adjusted	-163.0	262.7	-40.8	0.1	50.6
Oper. profit bef. prov.	-4.4	-23.7	-25.4	39.7	27.1
<b>Balance Sheet (NT\$M)</b>					
<b>Total assets</b>	<b>1,499,892</b>	<b>1,497,163</b>	<b>1,607,684</b>	<b>1,639,878</b>	<b>1,731,872</b>
Avg interest earning assets	1,306,208	1,245,282	1,263,810	1,258,745	1,349,038
Customer loans	822,350	834,622	886,692	906,598	951,052
Gross NPLs	13,744	8,397	13,220	17,102	17,224
<b>Liab. &amp; shar. funds</b>	<b>1,499,892</b>	<b>1,497,163</b>	<b>1,607,684</b>	<b>1,639,878</b>	<b>1,731,872</b>
Total customer deposits	1,153,704	1,101,196	1,153,428	1,160,876	1,195,061
Reserve for loan losses	17,257	10,004	9,085	10,588	10,165
Shareholders' equity	<b>93,387</b>	<b>113,157</b>	<b>124,280</b>	<b>130,520</b>	<b>134,995</b>
<b>Profitability/Solvency Ratios (%)</b>					
ROE adjusted	-10.2	16.5	8.7	8.2	11.8
Net interest margin	2.52	2.19	2.10	2.18	2.23
Cost/income ratio	48.7	53.7	59.6	51.5	46.1
Cash cost/average assets	1.9	1.8	1.7	1.6	1.6
NPLs/customer loans	1.7	1.0	1.5	1.9	1.8
Reserve for loan losses/NPLs	125.6	119.1	68.7	61.9	59.0
Bad debt prov./avg. cust. loans	5.8	1.6	1.5	1.7	1.7
Loans/deposit ratio	71.3	75.8	76.9	78.1	79.6
Tier 1 capital ratio	8.8	8.1	8.6	9.0	8.9
Total capital ratio	11.3	10.6	10.9	11.3	11.0

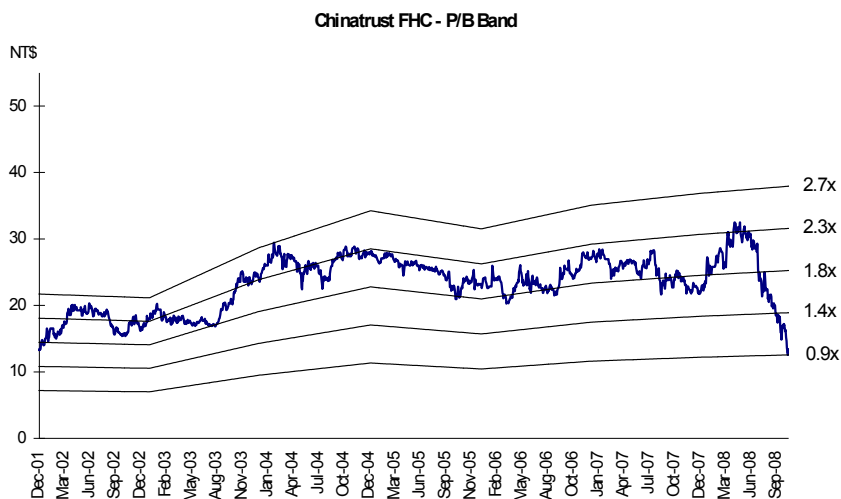
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## Getting the Most Attractive Bank Franchise in Taiwan at Book

We maintain our Buy / Low Risk (1L) rating on Chinatrust shares and expect it will be a beneficiary of a market bounce. Although we could see all stocks benefit at the onset, we anticipate the market will be more selective as the rally matures. With the stock down sharply from year highs, we think this presents an opportunity to accumulate what we consider as the most attractive banking franchise in Taiwan trading below historic trough at 1.0x 2008E P/B.

Figure 2. Chinatrust FHC – P/B Bands

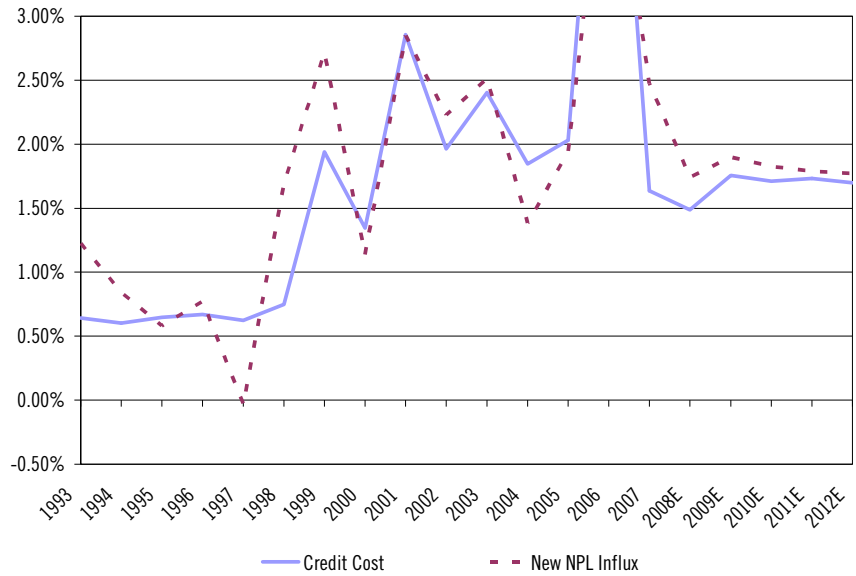


Source: Datastream, Citi Investment Research

We have lowered our 12-month target price to NT\$21 from NT\$28.50, still based on Gordon Growth but reflecting a more conservative LT ROE forecast of 12%, in line with our view of a tougher operating environment into next year. Given MTM losses taken on its stake in Mega FHC (5% classified as trading and 6.2% as available for sale) thus far and expectations of a tough year ahead, we are cutting our EPS forecasts for 2008-10E. We have conservatively assumed 0% growth in fees for 2009E as a base case. Although we could see upside if markets show signs of recovery in 2H09, we think it is better to present a more conservative view in light of present market conditions. We have also imputed a 23% increase in loan-loss provisions, expecting new NPL influx to rise to 190bps from 174bps, with a rise in non-card delinquency offset by continued improvements in card delinquency.

Into an economic downturn, we believe Chinatrust is better positioned to weather it vis-à-vis peers with CAR at 12% and tier 1 at 8.6%. With the credit/cash card crisis largely behind it, asset quality continues to improve with NPL ratio at 1.5% and loan-loss reserve coverage at 78%. Its deposit franchise and liquidity position also appear secure with LDR at 85% for NT\$ loans and 69% for foreign currency loans.

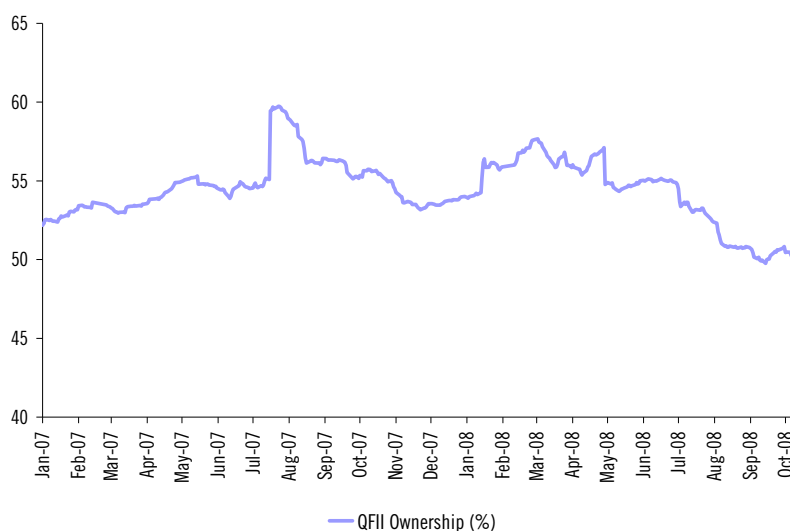
Figure 3. Chinatrust — Credit Costs and New NPL Influx, 1993-2012E (Percent)



Source: Company reports and Citi Investment Research

**Risks to our view?** Chinatrust’s QFII ownership is down from a peak of 60%, but at 50% is still the highest in the space. We could also see higher credit cost from Chinatrust USA, which accounts for 6% of group loans. Although its exposure to commercial real estate and construction is high, management indicated LTV ratios are conservative at 57% and 45%, respectively.

Figure 4. Chinatrust FHC – QFII Ownership (%)



Source: Citi Investment Research

Figure 5. Chinatrust FHC – Estimates Revisions

Year to 31 Dec	Net Profit (NT\$ Mils.)		Diluted EPS (NT\$)			Dividend Per Share (NT\$)	
	Old	New	Old	New	% Chg	Old	New
2008E	15,780	10,367	1.74	1.14	-34.3	0.59	0.18
2009E	18,412	10,387	2.02	1.14	-43.6	0.69	0.46
2010E	22,051	15,639	2.43	1.72	-29.1	0.81	0.46

Source: Citi Investment Research estimates

## Chinatrust FHC

### Company description

Chinatrust is one of Taiwan's leading commercial banks, with well-established positions in corporate lending, treasury, cash management services, capital markets trading and consumer banking particularly credit cards. It has around 123 bank branches servicing 4.7m customers. It also owns the largest ATM network in Taiwan with 4,300 machines.

### Investment strategy

We have a Buy / Low Risk (1L) rating on Chinatrust shares. Given a cautious fundamental outlook, we expect investors will continue to favor quality franchises. Its strength in both corporate and consumer banking should allow it

to continue to post sector-high ROEs. We forecast ROE of 12% on a sustainable basis. The strength of its franchise also implies the stock will benefit from incremental inflows into the sector, on progress on cross-strait or banking reform. We see an attractive buying opportunity with stock valuations below trough, already likely pricing in operating headwinds into 2009.

## **Valuation**

We have lowered our 12-month target price to NT\$21 from NT\$28.50, still based on Gordon Growth but reflecting a more conservative LT ROE forecast of 12%, in line with our view of a tougher operating environment into next year. Target P/B goes to 1.5x from 2x.

Our target price of NT\$21 is based on a P/B of 1.5x 2009E adjusted book. We think 1.5x is fair based on a Gordon Growth valuation approach (ROE-g/COE-g), taking into account normalized ROE of 12%, cost of equity of 9% and long-term growth rate of 3%. Our target also values it at trough valuations over a 5-year history. The stock typically trades at a premium to its peers but we think this is reasonable since we expect foreign inflows will continue to focus on large-cap names with quality franchises. We use P/B as our primary valuation method since this is the tool most investors look at when valuing banks. On a P/E basis, the stock trades at 18x 2008-09E and 12x 2010E EPS at our target price.

## **Risks**

We have a Low Risk rating on the stock, in line with our quantitative risk-rating system that tracks 260-day volatility of shares. Key downside risks include: 1) corporate governance, 2) aggressive business strategy in unsecured consumer and treasury, 3) overpaying for acquisitions, 4) QFII sell-down given high ownership, and 5) deterioration in Koo family's relationship with the government. Any of these risk factors could prevent the shares from reaching our target price.

# Appendix A-1

## Analyst Certification

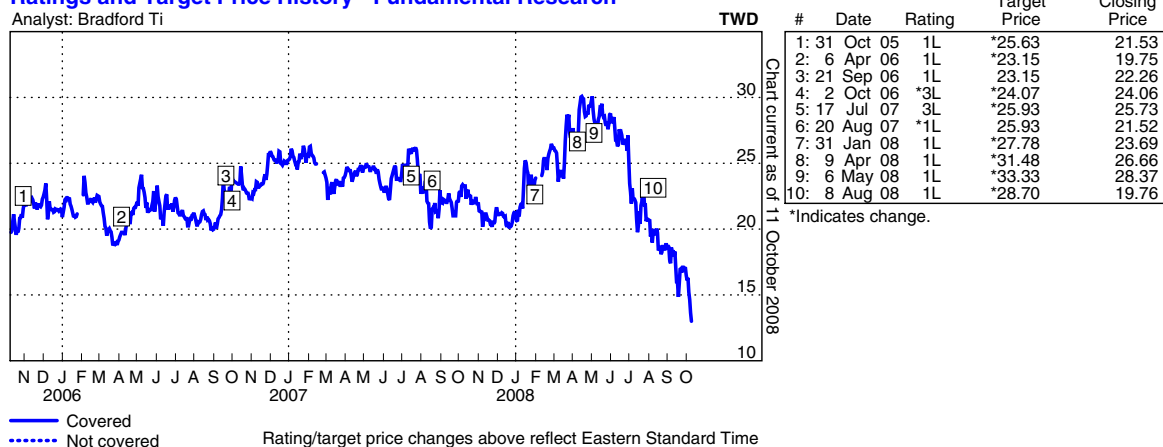
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Analyst: Bradford Ti



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