

Singapore Banking Sector

2Q13 Pre-results Updates – Multiple Upgrades

Report type: Update

Sector Overview

The Singapore Banking Sector provides traditional lending and depository functions, as well as other services in the areas of commercial banking, financial advisory, asset management, insurance broking and capital market services.

- The three local banks will be announcing their 2Q13 results in the upcoming weeks
- NIMs are expected to stabilize, while loans growth expected to be healthy
- Fees and commission expected to remain strong but lower q-q from high base. Non interest income likely to remain volatile.
- We upgrade DBS and UOB to “Accumulate”, and OCBC to “Neutral” based on undemanding valuations, strong fundamentals, and high quality growth potential.

What is the news?

The 3 local banks will be announcing their 2Q13 results, with **UOB** on 1 Aug, and **OCBC** on 2 Aug. **DBS** has not released the date of results announcement.

How do we view this?

We expect the banks to post a decent set of results. Net profits are generally expected to be lower q-q from a high base. Net interest margins are expected to bottom, while loans growth are expected to be in line with FY13 guidance but weaker q-q but healthy. We therefore expect q-q higher net interest income. Fees and commission is expected to remain strong, but lower q-q from a high base. A few large one-off transactions were registered by **UOB** and **DBS** in the previous quarter. Non interest income remains a wildcard, but we expect DBS to post a strong set of Non Interest Income (NonII), while OCBC's NonII may face a drag from MTM losses on LT fixed income investments.

Investment Actions?

The banks remain fundamentally strong. NIMs decline, which has been the major drag on earnings, is also expected to bottom out. A gradual increase in Net Interest Income is expected, both from NIMs increase in the medium term per elaborated above, and continued loans growth. Fees and Commission are also expected to grow.

While the economic environment continues to be uncertain, we expect a shift in preference towards high quality growth stocks. This includes the Singapore Banking counters. We therefore upgrade **DBS** and **UOB** to “Accumulate” and **OCBC** to “Neutral” as valuations are undemanding. We present a more detailed analysis of **DBS, UOB and OCBC** in our reports dated 8 Jul 2013. We have a preference for **DBS** over **UOB** and **OCBC** due to the current lower relative valuations, and continued strong growth potential comparable to its local peers.

Singapore Banking Sector

Company	Rating	Price (\$)	TP (\$)	Upside (%)	M.Cap. (US\$m)
DBS Group Holdings Ltd	Accumulate	15.90	17.20	8.2%	30,438
Overseas Chinese Banking Corp	Neutral	9.90	9.75	-1.5%	26,627
United Overseas Bank	Accumulate	20.33	21.35	5.0%	25,097

Source: Bloomberg, PSR

Analyst

Ken Ang

Kenangw.y@phillip.com.sg

Tel : (65) 6531 1793

NIMs to stabilize – Higher Overseas contribution

Banks guided for NIMs to stabilize at current levels – Having experienced significant NIMs decline in FY12, the banks guided in 1Q13 for this to stabilize. Continued pressure from Mortgage loans is expected, while growth of higher yielding overseas loans growth is expected to provide relief to the Mortgage pressure.

Long term interest rates rising in anticipation to eventual increase in Fed rates – With US announcing possible tapering of QE in end CY2013, Fed rates are expected to rise thereafter, possibly in end CY2014. We see an increase in long term interest rates, as markets react in anticipation of Fed rates increasing. This has led to a bear steepening of the yield curve, as seen from the SGD Swap Yield Curve per Fig 1 below.

We expect NIMs to increase gradually in the medium term – We note that most loans are priced based on shorter termed floating rates. The impact of current rising long term rates may therefore not increase Interest income significantly yet, as short term rates remain lower.

Fig 1: LT interest rates (%) rising significantly

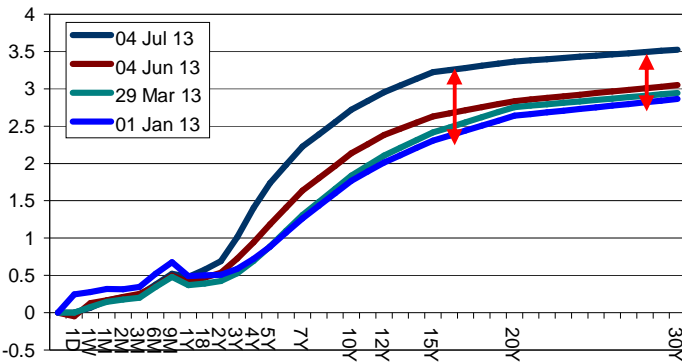
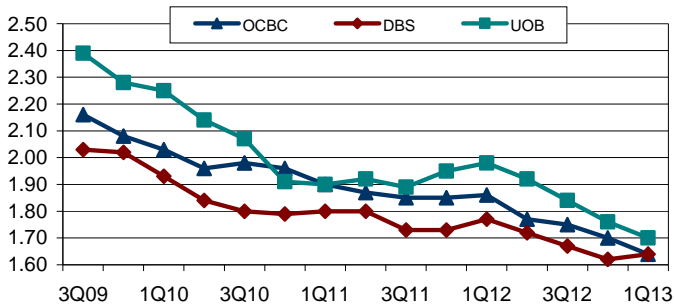


Fig 2: Potentially reversing previous NIMs decline



Source: Bloomberg, Company data, Phillip Securities Research

Expected impact of Interest rates increase mixed but overall gradually higher earnings for all three banks

We expect a few positives and negatives when interest rates rise, and list them here for discussion. In broad, interest income is expected to increase. However, past savings in credit cost, which had enabled the banks to cushion the NIMs decline, is expected to unwind as NPLs increase and higher loan provisions are required. Magnitude of normalizing would depend on the portfolio of loans.

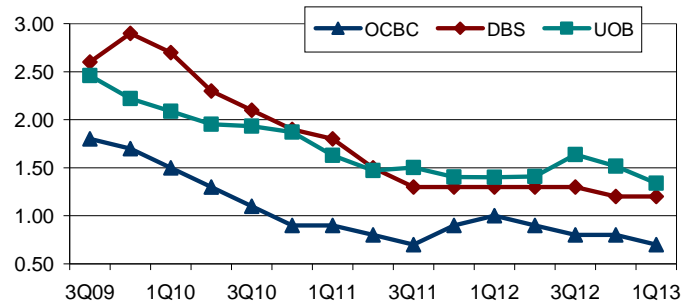
1) (+ve) Gradual increase in Interest Income – Floating rate loans are typically priced by a **Benchmark + Spread**. A typically Benchmark may be 3-months SIBOR. The spread would however vary. While interest rate increase will directly increase the Benchmark, previous downward spread adjustments would however require more time to be adjusted upward. This is especially so for Mortgage loans of the three banks, for which previous lower spreads would remain as they have been locked in for the short term.

2) (+ve) on shift away from Bond issuance towards bank loans for high quality companies – While previous market demand for yields in low interest rate environment led high quality companies to raise capital from bond markets, we expect a shift towards taking bank loans as the difference between bank rates and bond yields decrease. With the wide suite of transaction banking products, customers who take on bank loans may also enjoy rebates or discounts on transaction banking fees and commission. This increases both loans growth and overall Fees and commission.

3) Fixed rates loans will not be adjusted upwards – However, these likely constitute a smaller proportion of total loans, or have short maturities.

4) (-ve) NPLs may rise with higher interest rates – NPL ratios are at extremely low levels, as companies are able to pay off the low interest expenses despite the challenging macro environment. The three banks have also improved overall quality of the loan books. We however continue to expect NPLs to increase when interest rates increase, as some businesses struggle with loan repayments.

Fig 3: NPL ratios currently extremely low

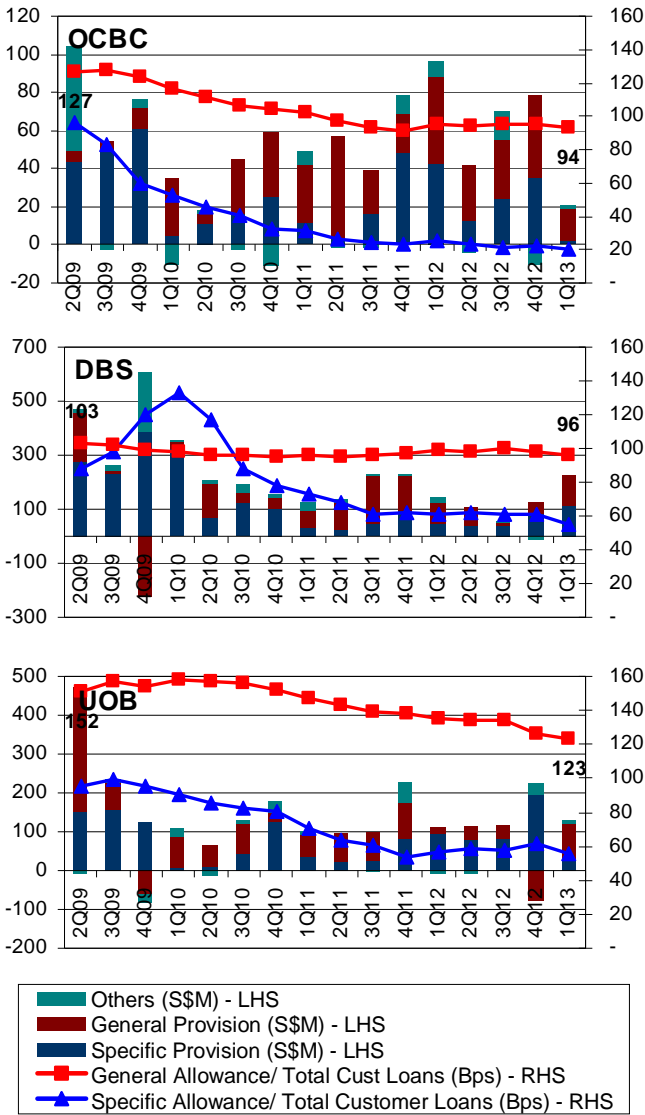


Source: Company data, Phillip Securities Research

5) (-ve) Higher Specific provisions leading to higher credit cost – An increase in NPL is expected to lead to an increase in bad debts, thus increasing credit cost.

6) (-ve) Higher General provisions leading to further credit cost increase – Along with the decrease in NPLs, the banks decreased General provisions (GPs) made as per the Red line in Fig 4. GPs made were lower but adequate in the current low NPL and interest rate environment. However, an expected increase in interest rates and NPLs would lead to **higher GPs over total loans being required**. This will lead to a short-term large increase in credit cost when interest rates and NPL starts to rise.

Fig 4: General provisions declined with lower NPLs



Source: Company data, Phillip Securities Research

We expect gradually higher earnings when interest rates increase – While it is too early to identify the bank that will benefit most due to the impact in numerous areas as per above, we expect overall increase in earnings. Increase in net interest income is expected to be larger than that of credit cost. Interest income is expected to increase gradually, while higher credit cost, specifically GPs in the short term, is expected to reduce the impact of higher interest rates.

Loans growth expected to meet FY13 guidance

While we do not expect a repeat of the high loans growth in 1Q13, we expect the banks to meet their FY13 guidance of high single digit loans.

Key risks to loans growth include a weaker macro environment, specifically China. China's economic outlook has been uncertain. A weaker China may have spillover effects on the ASEAN region, reducing economic growth and demand for loans.

While **DBS** enjoyed strong General Commerce loans growth in 1Q13 as borrowers took advantage of the RMB/USD carry trade, the strengthening of the USD in June may result in the unwinding of this carry trade, thus reducing loans growth.

Fig 5: Q-Q Loans growth to be weaker

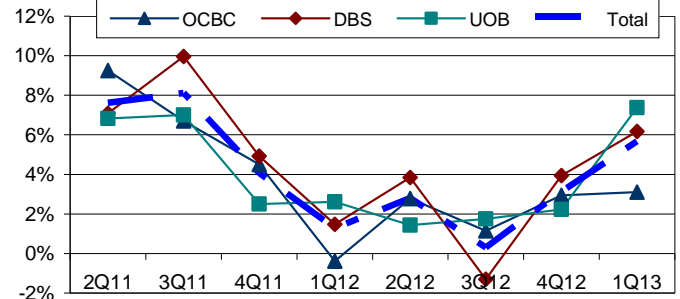
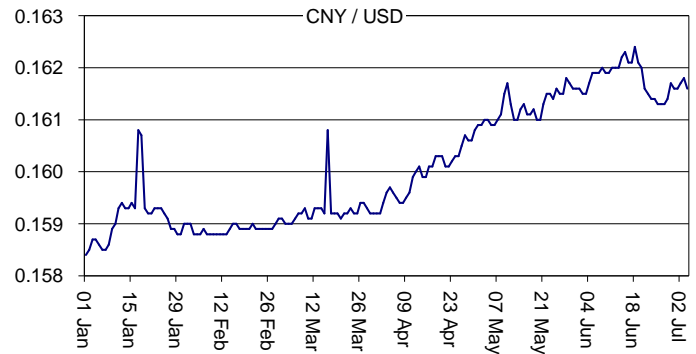


Fig 6: USD strengthening may lead to lower loans growth for DBS as RMB/USD carry trade unwinds



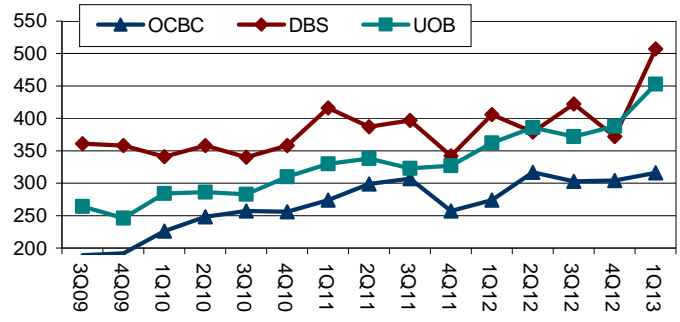
Source: Company data, Oanda, Phillip Securities Research

Fees and Commission – revenue driver in FY2013

Fees and Commission from Wealth management, Trade-related and Loan-related fees are expected to continue growing in FY2013, as the three banks increase their touch points and establish stronger relationships. The wide range of products and expertise will also allow greater cross selling capabilities.

Q-q, Fees and commission for **DBS** and **UOB** may decrease from a high base, which was driven by a few large one-off transactions. We however expect y-y increase as growth of Fees and Commission remains strong.

Fig 7: Fees and Commission to be strong

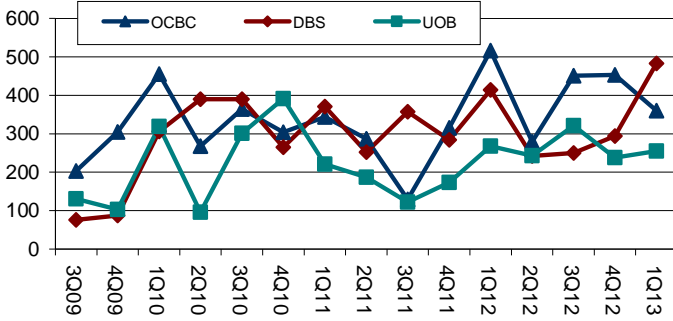


Source: Company data, Phillip Securities Research

Non-interest income a wild card

Non-interest income remains volatile, as can be observed by the fluctuations in Fig 8, and remains rather low quality and market-dependant.

Fig 8: Q-Q Non-interest Income a wildcard

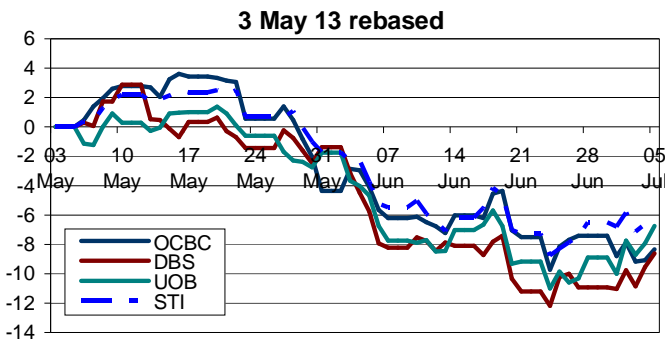


Source: Company data, Phillip Securities Research

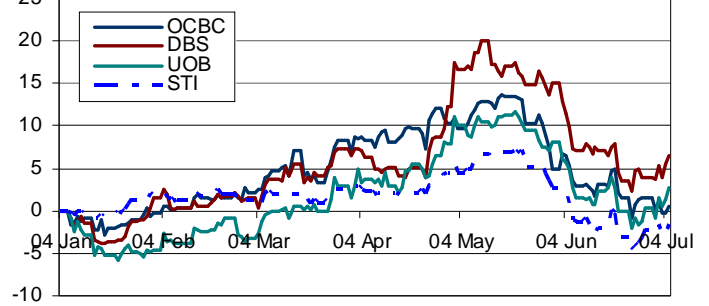
For the individual banks, we think **DBS** is likely to post high non-interest income, although lower q-q from a high base. **DBS** is expected to benefit from Foreign Exchange related activities, such as from the appreciation of RMB relative to USD for the most of 2Q13.

For **OCBC**, we think it likely to post poorer non-interest income due to mark to market losses for investments held by Great Eastern. Insurance companies, such as Great Eastern, is likely to hold long term fixed income investments, so as to match forecasted cash flow payouts for its longer term liabilities. With the sharp increase in long term interest rates per Fig 1 above, we expect mark to market losses on these long term investments. However, **OCBC** may still surprise on trading income. Income may be higher from realizing gains on AFS investments, and other activities.

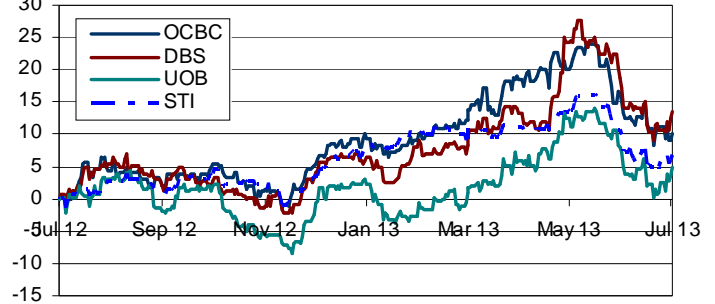
Fig 9: DBS and UOB trades below STI since our downgrade during the last results season



6 months rebased



1 Year rebased



Source: Company data, Phillip Securities Research

Valuations

During the last results season, we downgraded **DBS** and **UOB** to “Neutral” as valuations were high. We maintained our “Reduce” rating on **OCBC**. Share price for the three banks have corrected since, as per Fig 9 above.

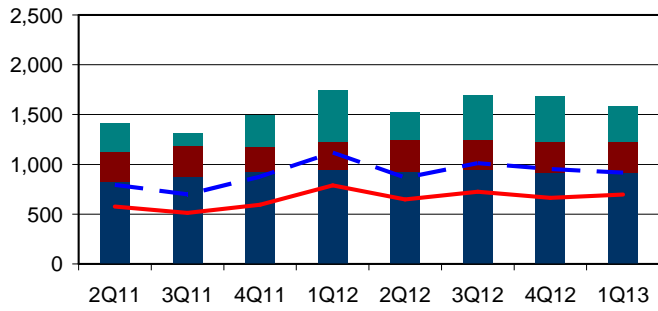
Looking ahead, the banks remain fundamentally strong. NIMs decline, which has been the major drag on earnings, is also expected to bottom out. A gradual increase in Net Interest Income is expected, both from NIMs increase in the medium term per elaborated above, and continued loans growth. Fees and Commission are also expected to grow.

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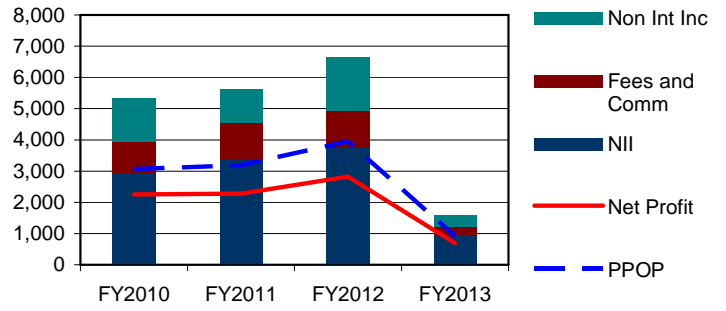
Company	Rating	FYE	Price	TP	Upside (%)	Market Cap. (S\$'mn)	Market Cap. (US\$'mn)	Equity Multiple (X)						Dividend Yield (%)		
								Net Income			Book Value			FY11	FY12	FY13E
Market price as of: 5-Jul-13																
DBS Group Holdings Ltd	Accumulate	Dec	15.90	17.20	8.2%	38,838	30,438	12.8	11.6	11.0	1.4	1.2	1.1	3.5%	3.5%	3.5%
Overseas Chinese Banking Corp	Neutral	Dec	9.90	9.75	-1.5%	33,975	26,627	14.9	12.0	12.6	1.6	1.5	1.4	3.0%	3.3%	3.3%
United Overseas Bank	Accumulate	Dec	20.33	21.35	5.0%	32,023	25,097	13.8	11.4	10.9	1.5	1.4	1.3	3.0%	3.4%	3.4%

Source: Bloomberg, PSR est.

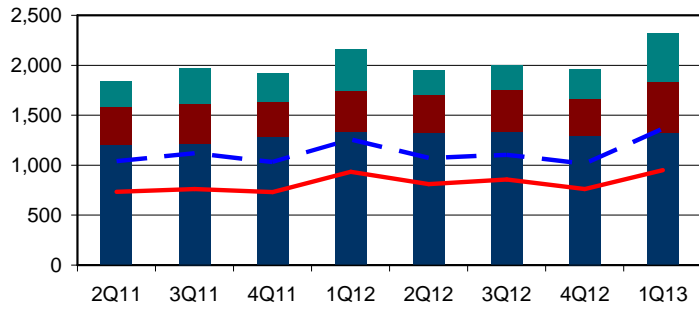
Oversea-Chinese Banking Corp – Insurance “wildcard”



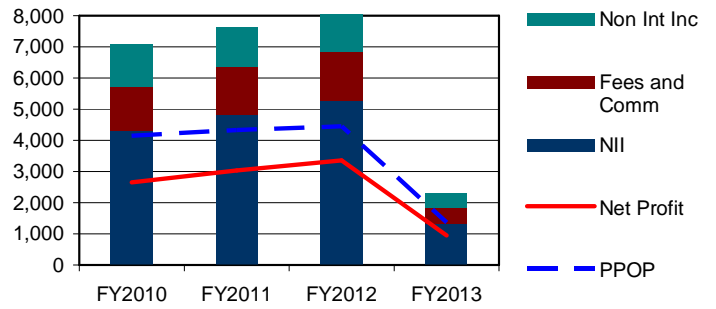
- Growth of Non interest income to be muted in FY2013



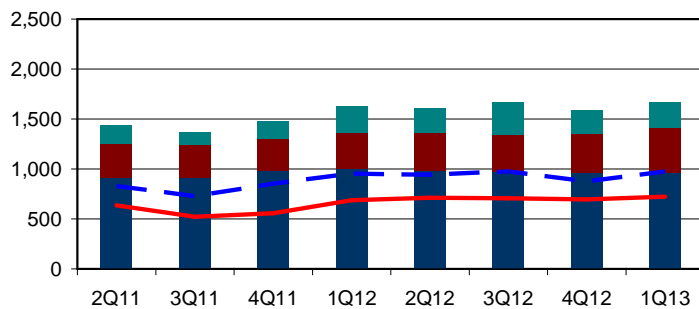
DBS Group Holdings – Relatively consistent growth



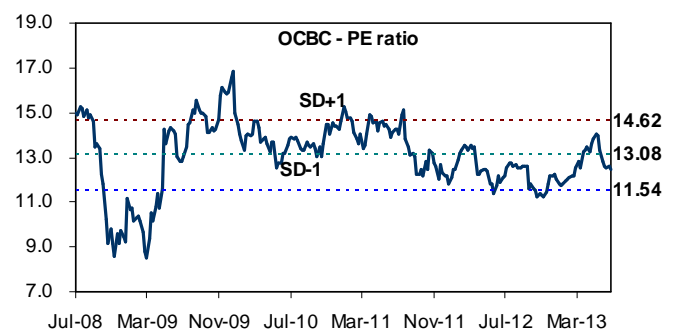
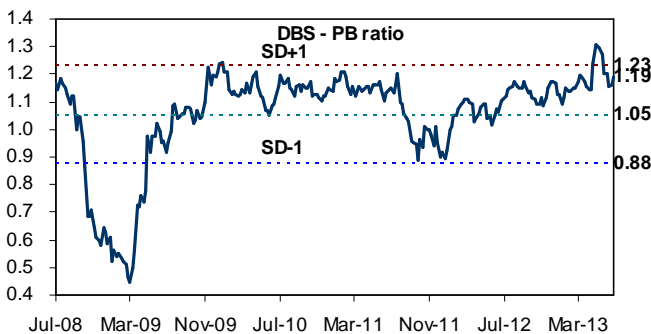
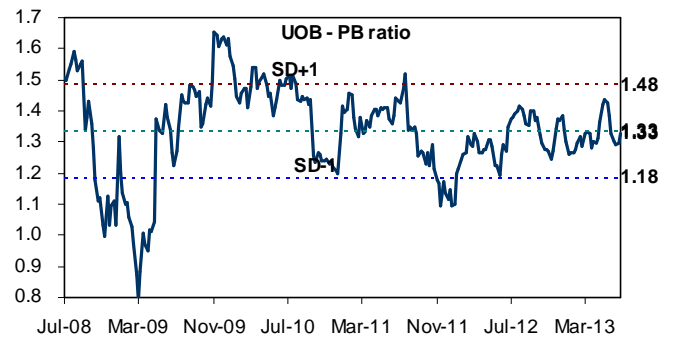
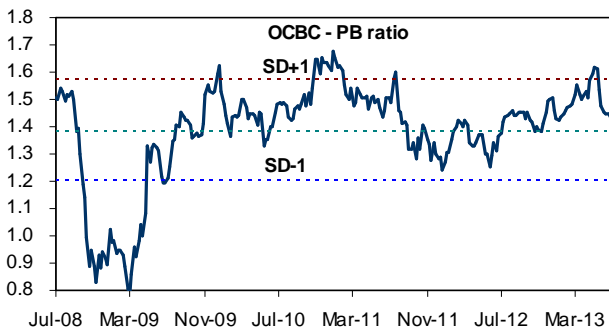
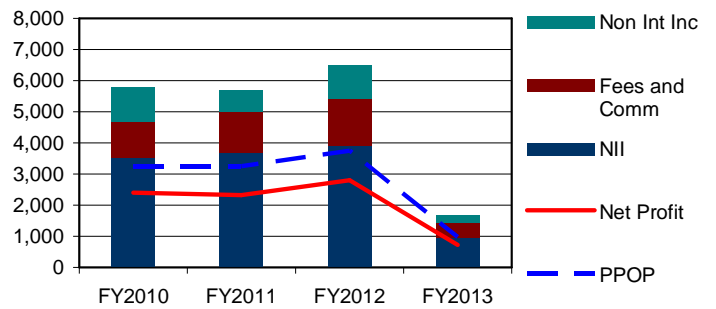
- Strong non-interest income growth expected



United Overseas Bank Ltd – Strong Fees and Commission

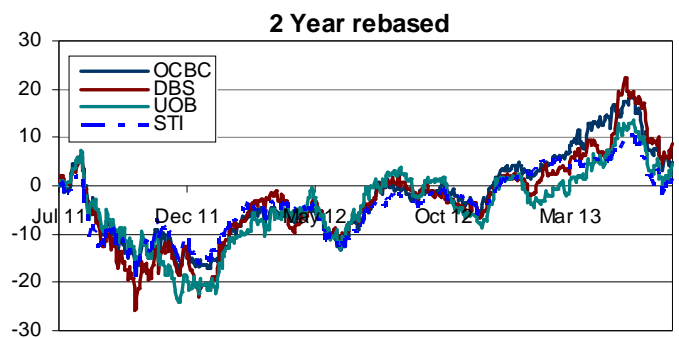
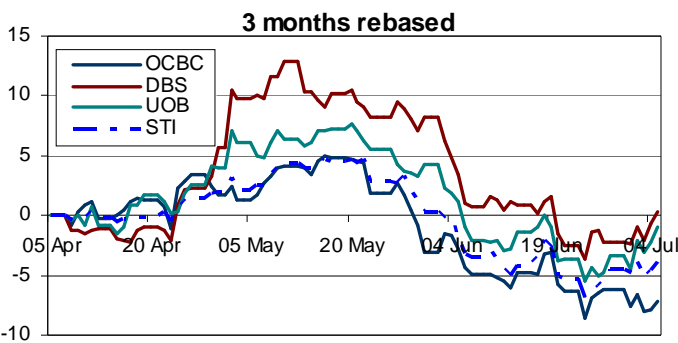
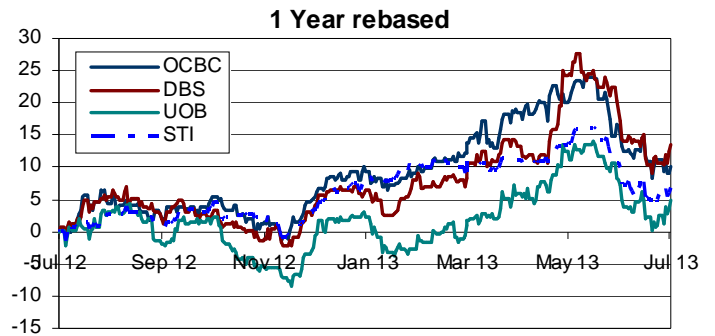
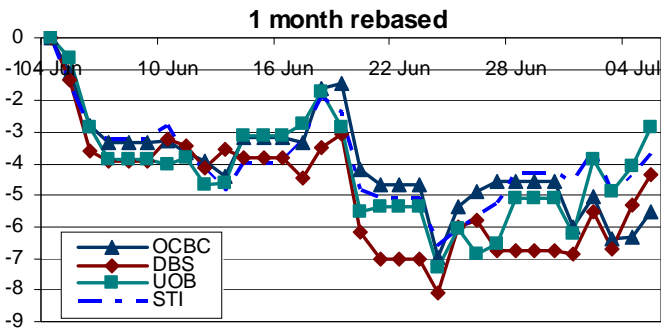
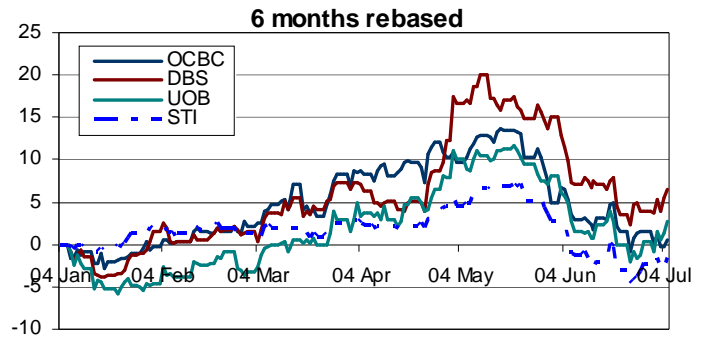
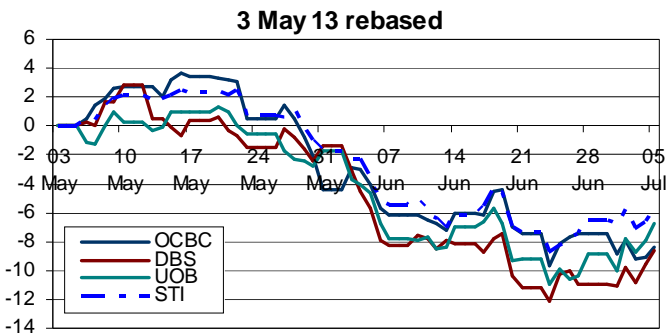
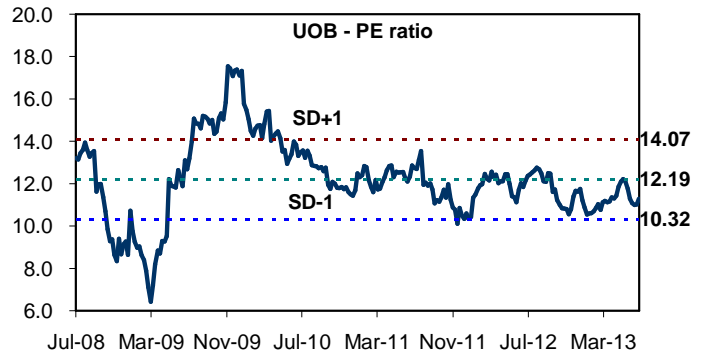
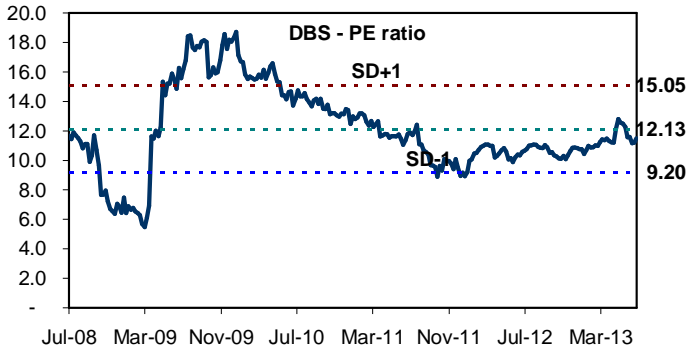


- Fees and Commission guided to grow 15% y-y in FY2013



Source: Company data, Bloomberg, Phillip Securities Research

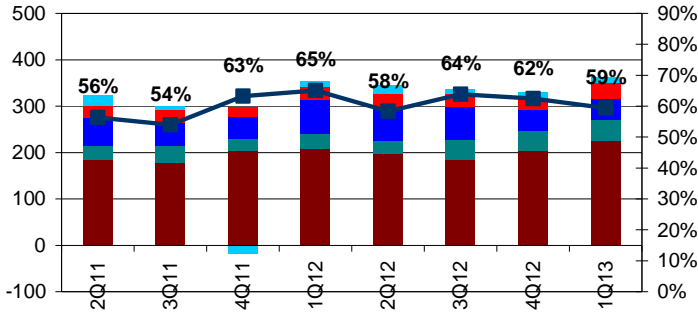
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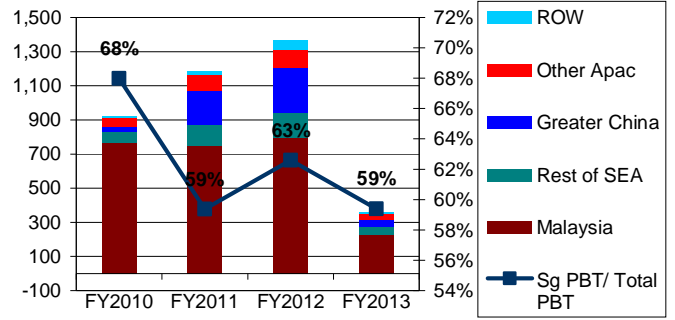
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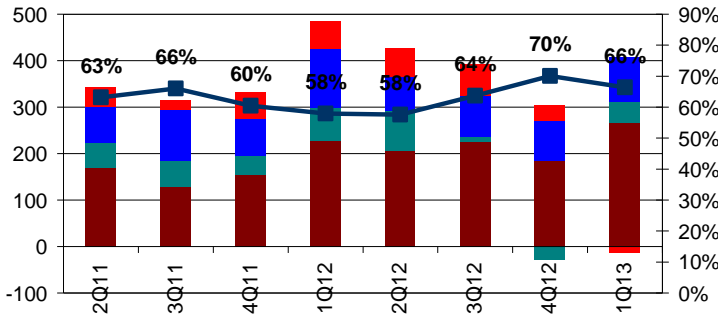
**By Geographical location – Profit before Tax
Overseas-Chinese Banking Corp**



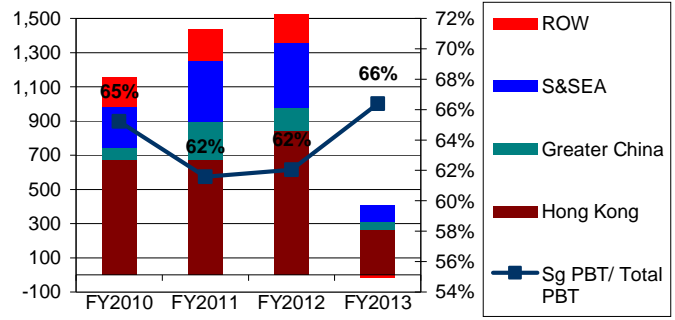
- Contributions from Malaysia improving



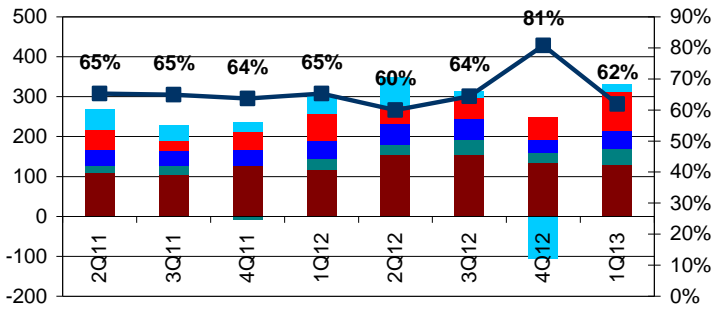
DBS Group Holdings



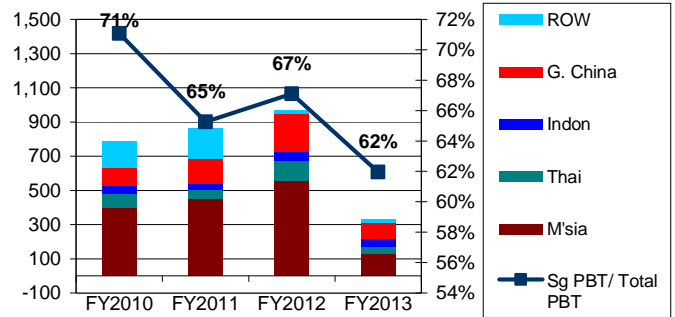
- Volatile but improving contributions from HK



United Overseas Bank Ltd



- Stable contributions from all regional markets



Source: Company data, Bloomberg, Phillip Securities Research

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Contact Information (Singapore Research Team)			
Management			
Chan Wai Chee (CEO, Research - Special Opportunities)	+65 6531 1231	General Enquiries	
Joshua Tan (Head, Research - Equities & Asset Allocation)	+65 6531 1249	Research Assistant	+65 6531 1240
Global Macro, Asset Strategy		Financials, Telecoms	US Equities
Joshua Tan	+65 6531 1249	Ken Ang	+65 6531 1793
Ng Weiwen	+65 6531 1735		
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Roy Chen	+65 6531 1535	Nicholas Ong	+65 6531 5440
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			+65 6531 1249

Contact Information (Regional Member Companies)		
SINGAPORE Phillip Securities Pte Ltd Raffles City Tower 250, North Bridge Road #06-00 Singapore 179101 Tel +65 6533 6001 Fax +65 6535 6631 Website: www.poems.com.sg	MALAYSIA Phillip Capital Management Sdn Bhd B-3-6 Block B Level 3 Megan Avenue II, No. 12, Jalan Yap Kwan Seng, 50450 Kuala Lumpur Tel +603 2162 8841 Fax +603 2166 5099 Website: www.poems.com.my	HONG KONG Phillip Securities (HK) Ltd 11/F United Centre 95 Queensway Hong Kong Tel +852 2277 6600 Fax +852 2868 5307 Websites: www.phillip.com.hk
JAPAN Phillip Securities Japan, Ltd. 4-2 Nihonbashi Kabuto-cho Chuo-ku, Tokyo 103-0026 Tel +81-3 3666 2101 Fax +81-3 3666 6090 Website: www.phillip.co.jp	INDONESIA PT Phillip Securities Indonesia ANZ Tower Level 23B, Jl Jend Sudirman Kav 33A Jakarta 10220 – Indonesia Tel +62-21 5790 0800 Fax +62-21 5790 0809 Website: www.phillip.co.id	CHINA Phillip Financial Advisory (Shanghai)Co. Ltd No 550 Yan An East Road, Ocean Tower Unit 2318, Postal code 200001 Tel +86-21 5169 9200 Fax +86-21 6351 2940 Website: www.phillip.com.cn
THAILAND Phillip Securities (Thailand) Public Co. Ltd 15th Floor, Vorawat Building, 849 Silom Road, Silom, Bangkok, Bangkok 10500 Thailand Tel +66-2 6351700 / 22680999 Fax +66-2 22680921 Website www.phillip.co.th	FRANCE King & Shaxson Capital Limited 3rd Floor, 35 Rue de la Bienfaisance 75008 Paris France Tel +33-1 45633100 Fax +33-1 45636017 Website: www.kingandshaxson.com	UNITED KINGDOM King & Shaxson Capital Limited 6th Floor, Candlewick House, 120 Cannon Street, London, EC4N 6AS Tel +44-20 7426 5950 Fax +44-20 7626 1757 Website: www.kingandshaxson.com
UNITED STATES Phillip Futures Inc 141 W Jackson Blvd Ste 3050 The Chicago Board of Trade Building Chicago, IL 60604 USA Tel +1-312 356 9000 Fax +1-312 356 9005	AUSTRALIA PhillipCapital Level 12, 15 William Street, Melbourne, Victoria 3000, Australia Tel +61-03 9629 8288 Fax +61-03 9629 8882 Website: www.phillipcapital.com.au	SRI LANKA Asha Phillip Securities Limited Level 4, Millennium House, 46/58 Navam Mawatha, Colombo 2, Sri Lanka Tel: (94) 11 2429 100 Fax: (94) 11 2429 199 Website: www.ashaphillip.net/home.htm
INDIA PhillipCapital (India) Private Limited No. 1, C Block, 2nd Floor, Modern Center , Jacob Circle, K. K. Marg, Mahalaxmi Mumbai 400011 Tel: (9122) 2300 2999 Fax: (9122) 6667 9955 Website: www.phillipcapital.in		