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Singapore Banking and Finance

Stronger Economy and Higher Dividends Expected

SINGAPORE | BANKING & FINANCE | UPDATE

- We expect Singapore banks to finally see better loans volume and rate dynamics as the economy and capital markets improve.
- Negative EV and record capital ratios will encourage banks to return excess capital to shareholders in the form of dividends.
- We maintain our Reduce rating on UOB and Neutral rating on OCBC. And we upgrade our rating on DBS from Reduce to Accumulate.

And why did we upgrade DBS?
As competition increase, we expect NII to be led by loans volume growth. DBS has the highest Singapore CASA ratio of 91% and the largest overall deposit base of S$342.9bn. This will mean UOB and OCBC will not be able to lend more competitively than DBS. We believe this is the advantage DBS enjoys over its peers, especially against foreign banks like HSBC and BOC as they begin to compete for loans in Singapore.

Loans Growth will be the driver for better NII.
Singapore banks' NII performed better because of stronger loans growth. The actual loans growth rate in 1H17 had exceeded bank managements' guidance of mid-single digit loans growth. The recent improvements to economic outlook across Singapore banks' key markets including Malaysia and Hong Kong will continue to support loans growth and positive loans volume and rate dynamics. However, we expect the pass through of higher interest rates to be crimped by competition especially in the property sector therefore NIMs expansion may be more subdued.

We expect excess capital to be returned to shareholders in the form of higher dividends.
We think that the build-up of excess CET 1 above the regulatory hurdle of 6.5% and the threat of negative economic value as WACC exceeds ROIC may spur the Singapore banks to return some excess capital to shareholders. We opine that the banks may experience lower ROIC because of our view of a more subdued NIMs. Therefore capital that cannot be deployed to improve ROIC above WACC may instead be returned to shareholders.

INVESTMENT ACTIONS

Upgrade to NEUTRAL Singapore Banking Sector – We upgrade the Singapore Banking Sector to Neutral weight from Underweight. Macro conditions have been more positive than we expected. We expect higher interest rates and loan volume to help drive NII higher.

We maintain our Reduce rating on UOB and Neutral rating on OCBC. And we upgrade our rating on DBS from Reduce to Accumulate.

16 October 2017

NEUTRAL (Upgrade)

DBS Group Holdings
Accumulate (Upgrade)

BLOOMBERG CODE	DBS SP
LAST TRADED PRICE	SGD 20.06
FORECAST DIV	SGD 0.66
TARGET PRICE	SGD 21.45
TOTAL RETURN	10.22%

Oversea-Chinese Banking Corp
Neutral(Maintain)

BLOOMBERG CODE	OCBC SP
LAST TRADED PRICE	SGD 10.95
FORECAST DIV	SGD 0.36
TARGET PRICE	SGD 10.81
TOTAL RETURN	2.01%

United Overseas Bank Limited
Reduce (Maintain)

BLOOMBERG CODE	UOB SP
LAST DONE PRICE	SGD 23.05
FORECAST DIV	SGD 0.70
TARGET PRICE	SGD 20.18
TOTAL RETURN	-9.40%

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List of Abbreviations
WM – Wealth Management
NII – Net Interest Income
NIM – Net Interest Margin
LDR – Loan to Deposit Ratio
NPL – Non-performing Loans
PPOP – Pre-Provision Operating Profit
WACC – Weighted Average Cost of Capital
ROIC – Return on Invested Capital
FHR – Fixed Deposit Home Loan Rate
EV – Economic Value

MCI (P) 075/10/2016
Ref. No.: SG2017_0209

Loans growth is better than consensus but NIM and allowances are generally in line.

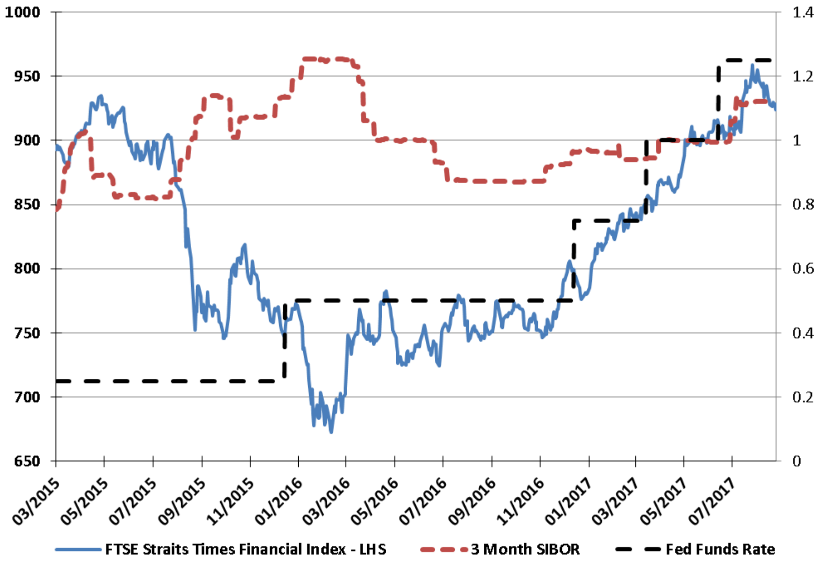
	1H17 results			FY17e guidance			FY17e Consensus			Commentary
	DBS	OCBC	UOB	DBS	OCBC	UOB	DBS	OCBC*	UOB*	
Loans growth (YoY)	6.6%	11.4%	7.3%	Mid-Single Digit %	Mid-Single Digit %	Mid-Single Digit %	3.6%	5.1%	3.8%	Actual growth has outperformed guidance and consensus
NIM	1.74%	1.65%	1.74%	c.1.8%	c.1.65%	c.1.7%	1.78%	1.69%	1.73%	Actual NIM is lagging as loans growth outpaces interest rate growth
Allowances	1H17 S$854mn, forming 82.6% of guidance	-	32bps	FY17e total allowance c.S$1.03bn (ex Swiber c.S$400mn)	-	32bps	S$1.32bn	S$725mn	S$724mn (32bps)	Allowances could increase more than expected as oil and gas sector continues to grapple with low cash flow
NPL	Stable since 4Q16			Expect NPLs to stabilise.			NPA ratio higher 14% YoY			Elevated Net NPL formation offset by write-offs may continue to weigh down on coverage ratio

Source: Bloomberg, PSR estimates

*Correction to previous labelling error where OCBC was placed in the 3rd column and UOB was placed in the 2nd column

How did Singapore banks' share price move in comparison with interest rates?

Contrary to market expectations that a rising SIBOR is always beneficial for Singapore banks, we have seen increasing SIBOR result in a steep fall in share prices. Therefore we highlight that the conditions in which SIBOR moves are more important than the direction of movement.



Source: Bloomberg, PSR estimates

How was the progress for the Singapore banks so far?

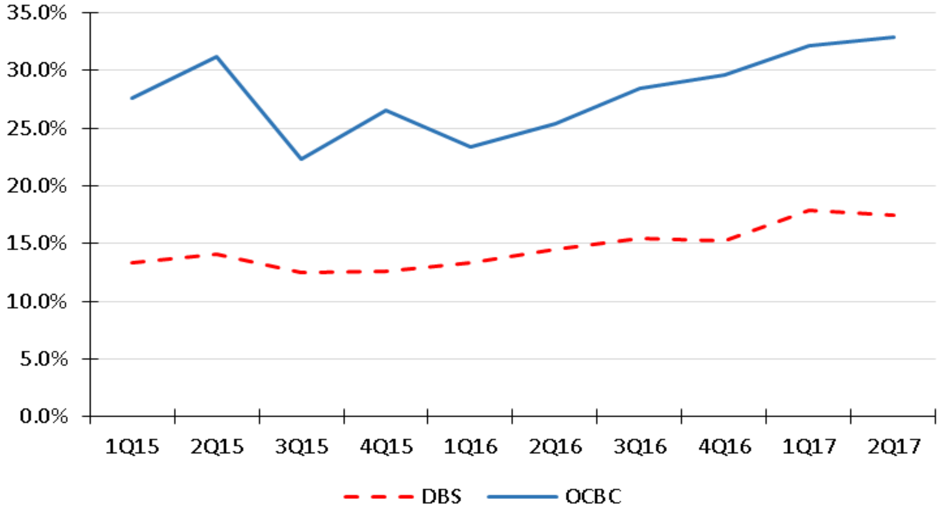
a) Strong growth in DBS and OCBC WM; UOB is lagging behind.

OCBC's stronger WM contributions came from the completion of Barclays WM business acquisition in 4Q16 and the broader mix of WM products and services from its bancassurance arm and the Lion Global franchise. Owing to improving investor sentiments or risk appetite from the start of 2017, expect OCBC WM to continue performing well on the back of growing AUM and product synergies (See Fig. 2). OCBC has announced the acquisition of NAB's private wealth business in Singapore and Hong Kong which is expected to be completed at the end of 2017 subject to regulatory approval.

DBS' WM growth came from the upper affluent clientele through the Treasures, Treasure Private Client and Private Bank platforms (See Fig. 3). We believe that DBS' niche in the upper affluent market segment provides it with long term consistent growth.

UOB is lagging behind in WM compared to peers. UOB AUM from Privilege Banking, Privilege Reserve and Private Bank is only S$99bn. This is significantly lower than DBS AUM from Treasures, Treasures Private Client and Private Bank is S$175bn.

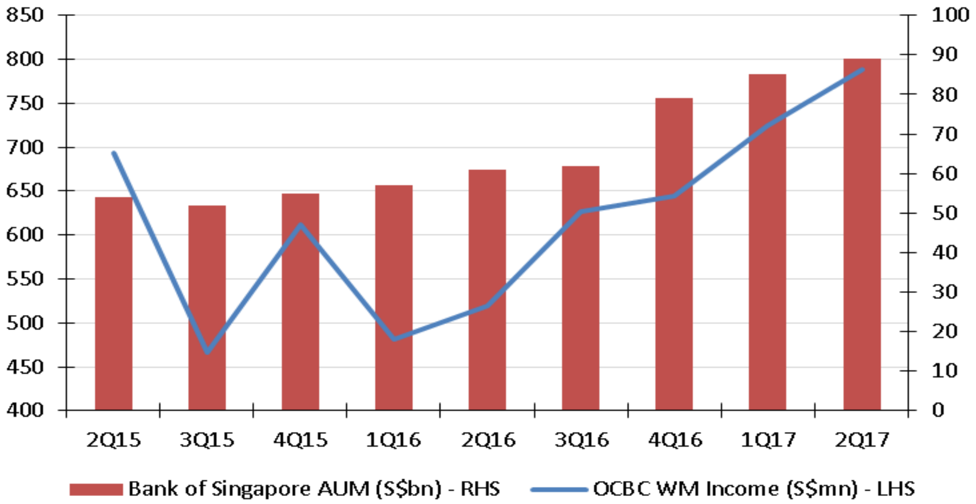
Figure 1: DBS' and OCBC's WM income share of total income has been increasing in the past quarters*



Source: Company, PSR estimates

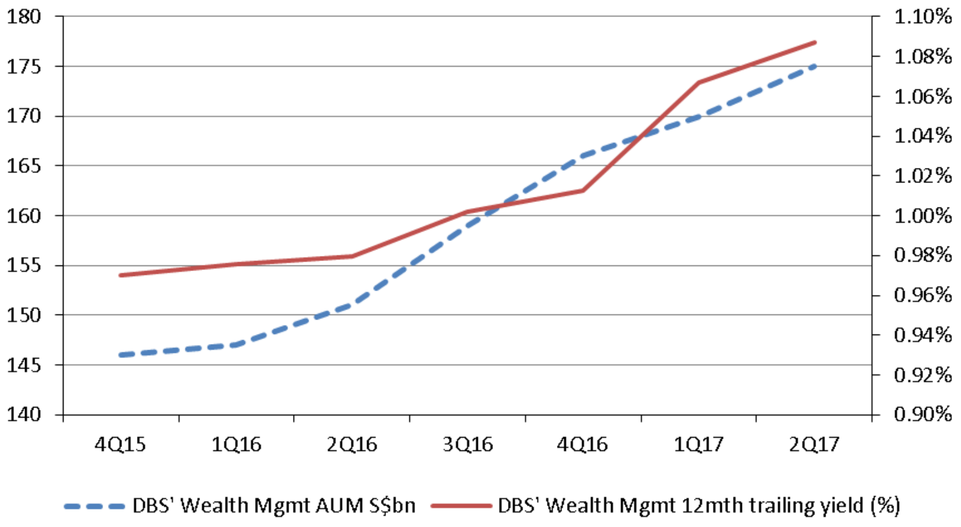
*UOB does not separately disclose their WM income in full detail

Figure 2: OCBC's AUM growth and broad WM product mix has driven quarterly WM income higher.



Source: Company, PSR estimates

Figure 3: DBS' WM income supported by strong AUM growth in its Treasures, Treasures Private Client and Private Banking platforms and improving yields on these AUM.



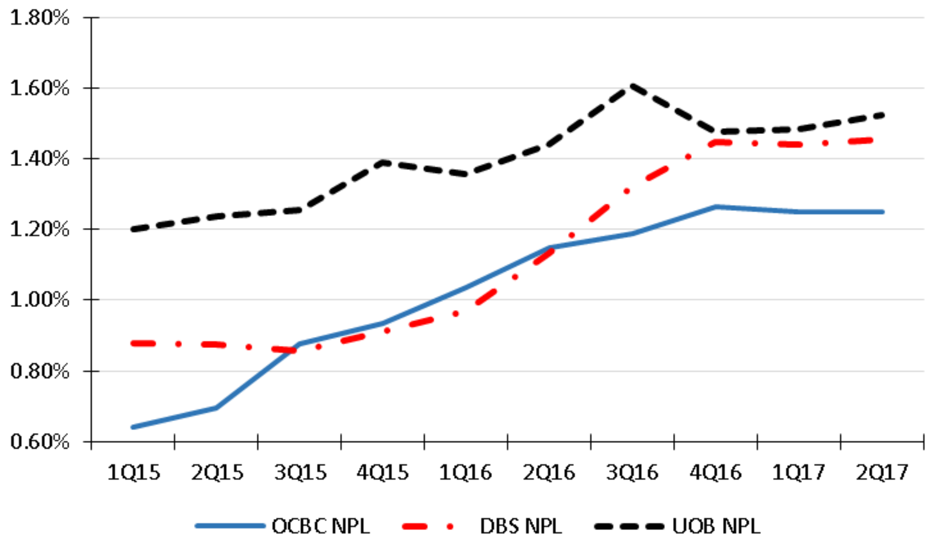
Source: Company, PSR estimates

b) Quarterly provision expense may become more volatile as coverage ratios remain at historically low levels.

Offshore oil and gas vessel owners have been grappling with weak cash flow for about 2 years. Charter rates and charter tenures remain low. Therefore there are risks of elevated net NPL* from the sector. Write offs could become lumpier too as the prospects for recovery remains poor. Given the low coverage ratios, Singapore banks have less buffer to smoothen out the provision expense but will have to respond with the appropriate amount of provisioning expense in any given quarter if NPL formation becomes elevated.

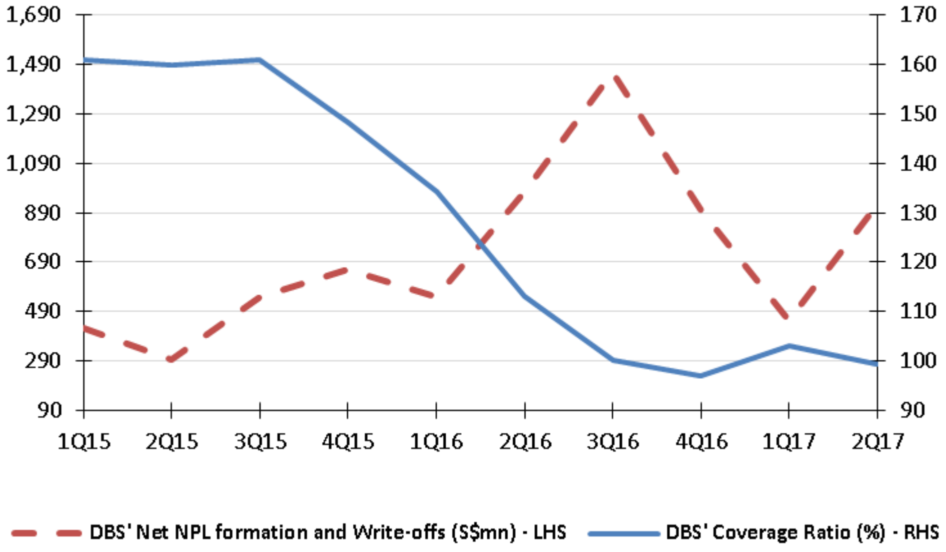
* Net NPL formation is New NPL less upgrades, recoveries and translations.

Figure 4: The Singapore Banks' NPL ratio appears to have stabilised since 4Q16 as risks of lumpy NPL formation is behind us. But NPLs can remain elevated as the offshore Oil and Gas sector is not seeing a recovery soon.



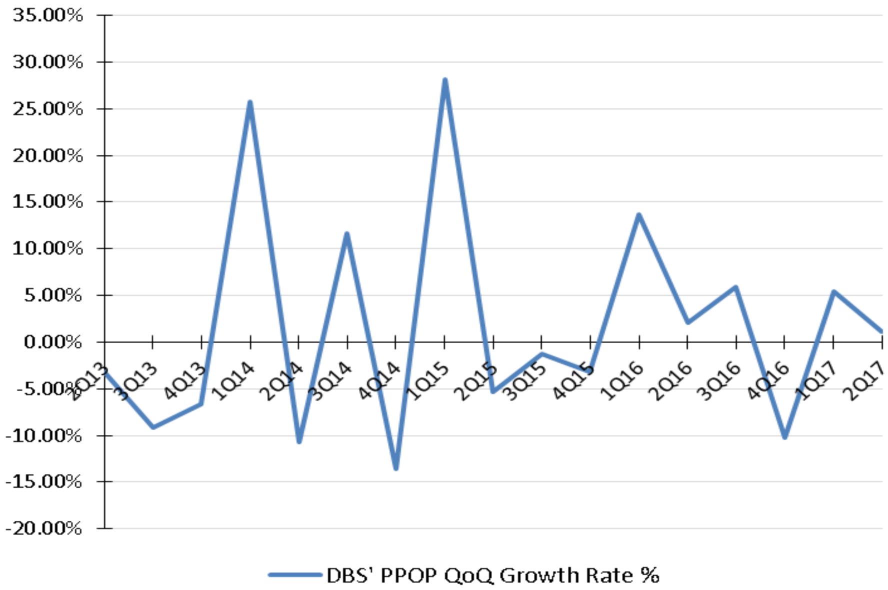
Source: Company, PSR estimates

Figure 5: DBS' coverage ratio holds steady at 100% as the profits from the sale of PwC building was used to pad up general provisions in 1Q17.



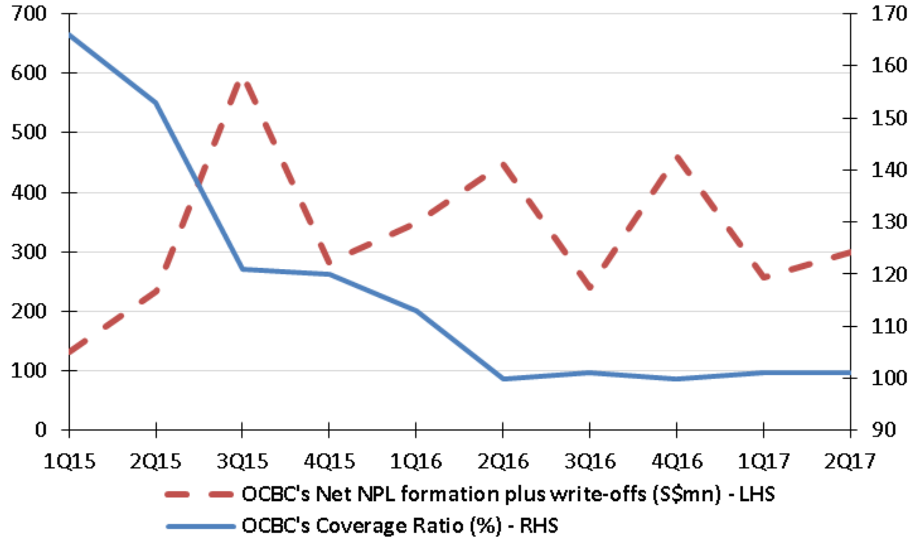
Source: Company, PSR estimates

Figure 6: DBS's recent quarterly PPOP growth rates have been insufficient to offset the elevated net NPL plus write offs. But we expect better performance in 2H17 for DBS.



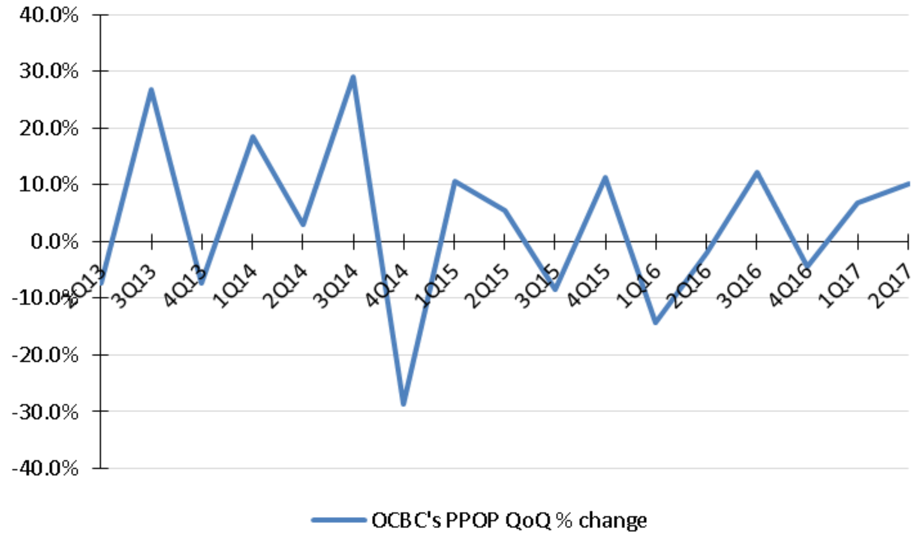
Source: Company, PSR estimates

Figure 7: Multiple episodes of elevated net NPL formation plus write-offs in previous quarters have kept OCBC's coverage ratio trending at the 100% mark.



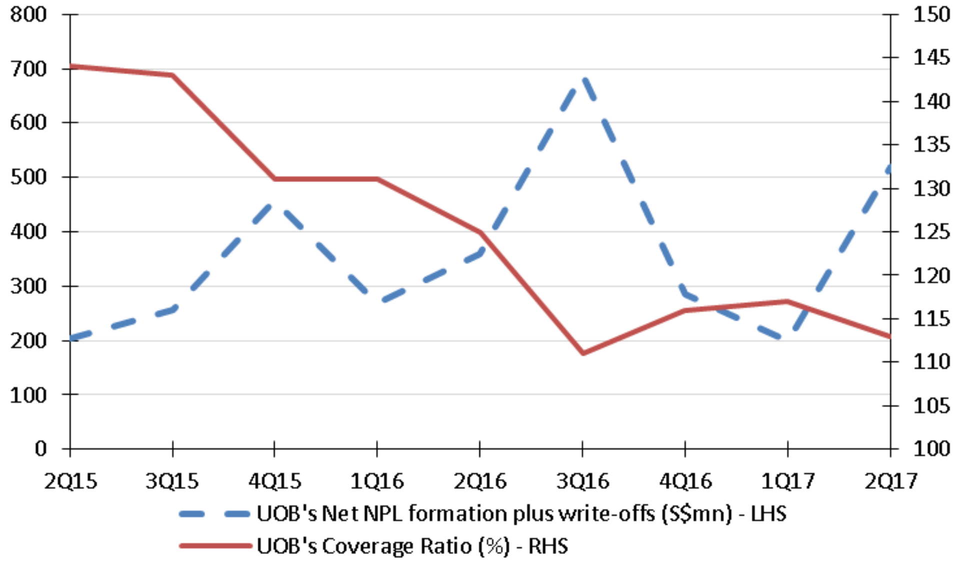
Source: Company, PSR estimates

Figure 8: OCBC's recent range bound quarterly PPOP growth rate appears to be insufficient to offset the recent the net NPL plus write offs and rebuild its coverage ratio.



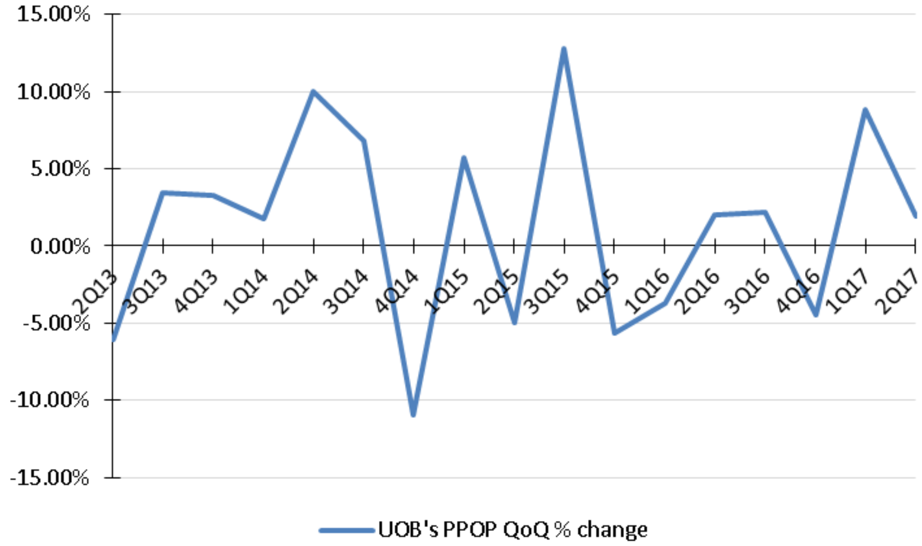
Source: Company, PSR estimates

Figure 9: UOB's coverage ratio had declined the least owing to lower exposure to the upstream oil and gas sector.



Source: Company, PSR estimates

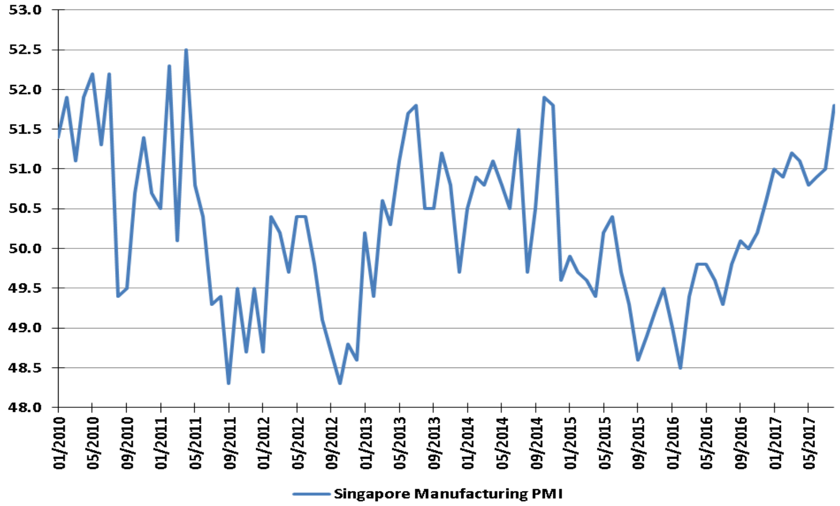
Figure 10: UOB's quarterly PPOP growth



Source: Company, PSR estimates

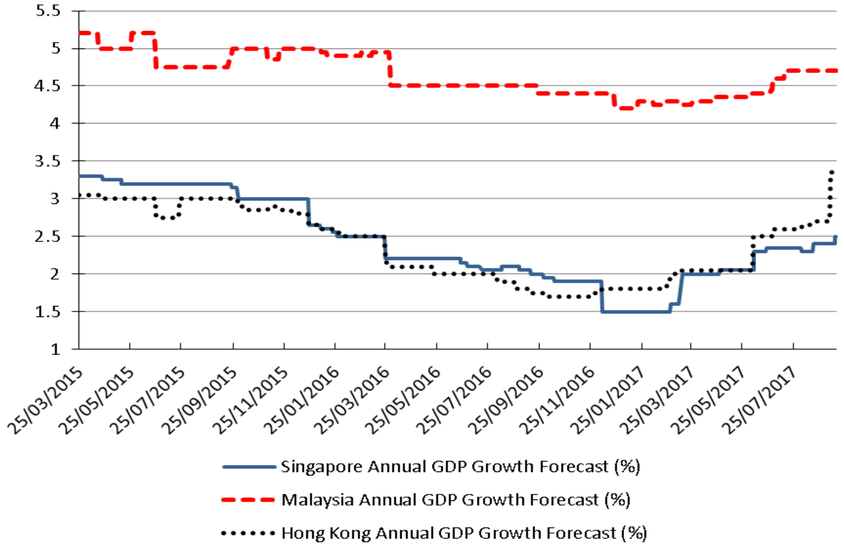
c) Singapore GDP growth forecast and PMI have improved. A better economy will support loans growth, asset quality and positive loan volume and rate dynamics.

Figure 11: Singapore manufacturing PMI is on expansion since late 2016.



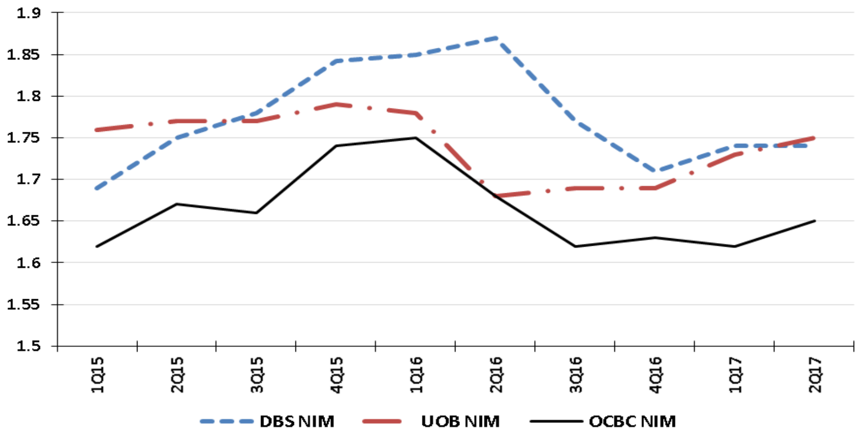
Source: CEIC

Figure 12: Broad based recovery as Singapore banks' key markets have seen upticks in their annual GDP growth forecast.



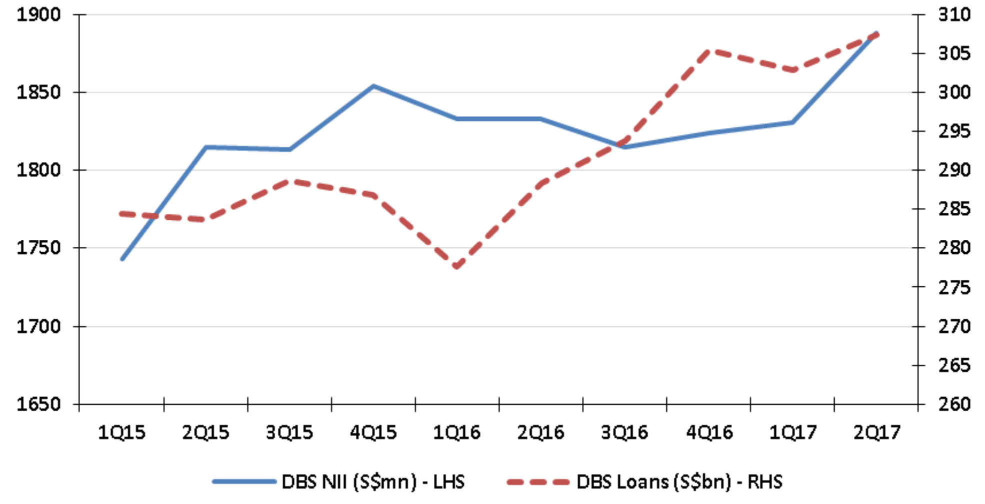
Source: Bloomberg

Figure 13: Expect NIM expansion to be subdued as loans growth will be the main driver for NII.



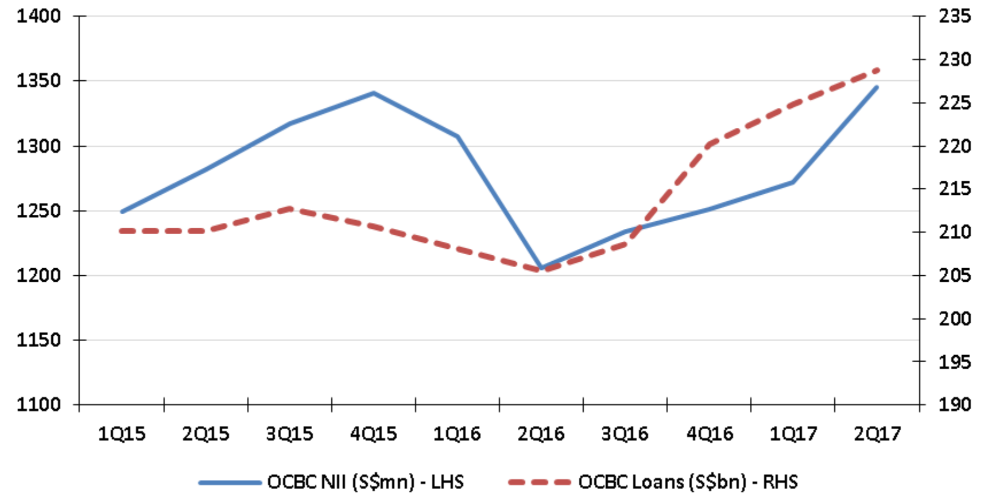
Source: Company, PSR estimates

Figure 14: DBS' loans growth has been the main driver for NII after 3Q16



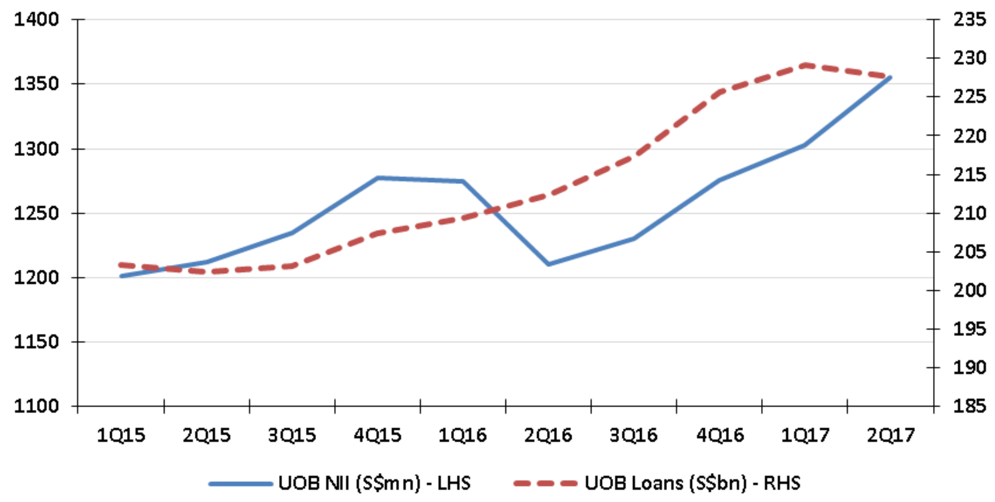
Source: Company, PSR estimates

Figure 15: c.40% of OCBC's Singapore based loans priced in SIBOR. Thus making it more sensitive to SIBOR rates. Recall SIBOR rose quickly from 3Q15 to 1Q16 then declined in 2H16.



Source: Company, PSR estimates

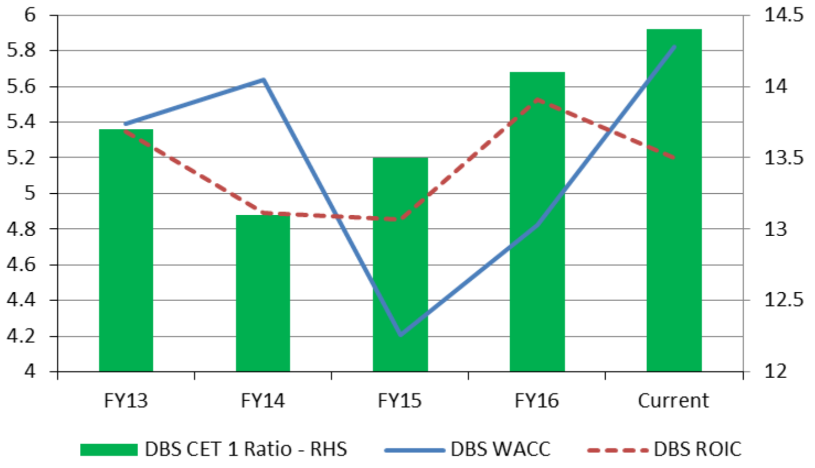
Figure 16: UOB's loans has shown some sensitivity to SIBOR but NII has been largely driven by loans growth.



Source: Company, PSR estimates

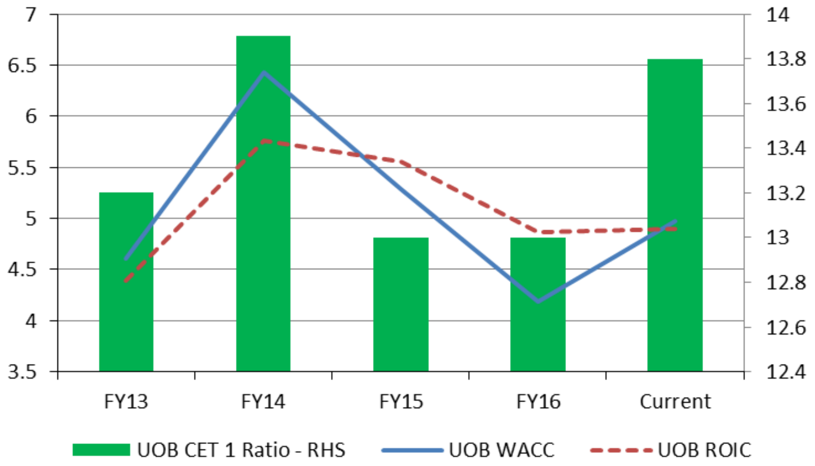
d) Negative Economic Value may encourage banks to return excess capital to shareholders.

Figure 17: DBS' WACC vs ROIC



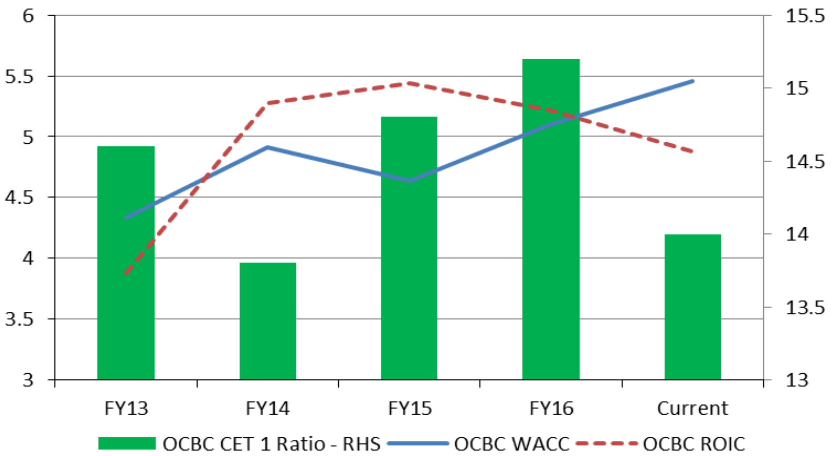
Source: Company, PSR estimates, Bloomberg

Figure 18: UOB's WACC vs ROIC



Source: Company, PSR estimates, Bloomberg

Figure 19: OCBC's WACC vs ROIC



Source: Company, PSR estimates, Bloomberg

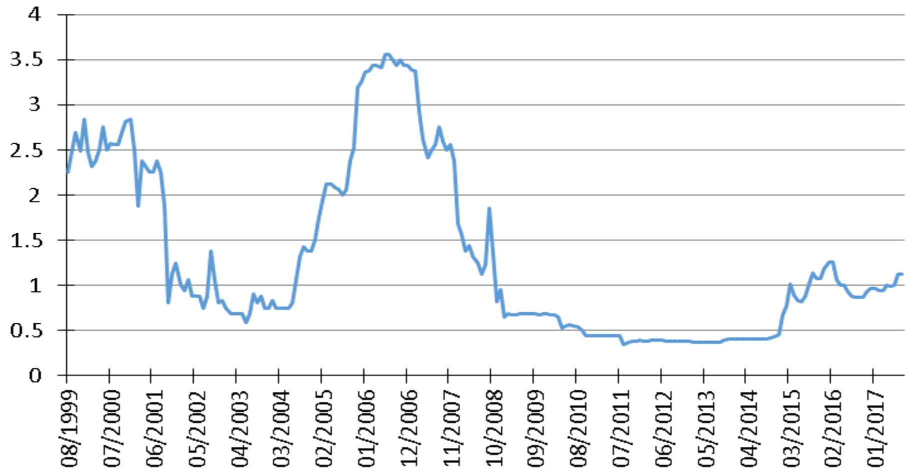
e) Singapore home loans have become more competitive and are more detached from SIBOR even as rates are rising.

Loan packages unpegged to benchmark interest rates were offered even as interest rates were at low point. DBS had introduced the FHR package in 2014 (See Figure 20) followed by OCBC and UOB. The FHR uses the banks' deposit rates which are stable but it also means that the banks will not benefit as much from a faster rising SIBOR. Currently, DBS no longer offers SIBOR-pegged loans and the application take up rate for the FHR package is 90%. OCBC and UOB continue to offer SIBOR-pegged loans.

Recently even as SIBOR is rising, banks dangled fixed rate packages to capture market share. DBS offers a 3-year fixed package at 1.68% which was the only one in the market for some time. Then in the first week of September; UOB, HSBC and BOC introduced similar packages. DBS' management had mentioned in 1Q17 results briefing that their competitors will have difficulty matching the 1.68% 3-year fixed package. OCBC had not followed with similar packages.

We estimate that the **Singapore housing loans makeup to about 15% to 20% of the Singapore banks' loan books therefore as the Singapore housing market shifts away from SIBOR to FHR and fixed rate packages, this portion of the portfolio will become less sensitive to rising SIBOR**. Owing to the competitive pressures (See Fig 20) and desire to build higher quality loan assets, we expect NII to be driven more by loans growth and less by higher interest rates.

Figure 20: 3-month SIBOR historical chart



Source: Bloomberg

Figure 21: Headline home loan rate packages are becoming more competitive even as interest rates are rising

	BOC	UOB	OCBC	DBS	MayBank
Before Dec 2016	2-year fixed rate at 1.4%	2-year fixed rate at 1.8%	2-year fixed rate at 2.38%	3-year fixed rate at 1.88%. Removed the 5-year fixed rate at 1.99%.	Removed the 2-year 1.6% fixed rate in Nov 2016
Sept 2017	2-year fixed rate at year 1: 1.48%, year 2: 1.58%	2-year fixed rate at 1.48%	2-year fixed rate at 2.38%	3-year fixed rate at 1.68%	2-year fixed rate at year 1: 1.48%, year 2: 1.58%

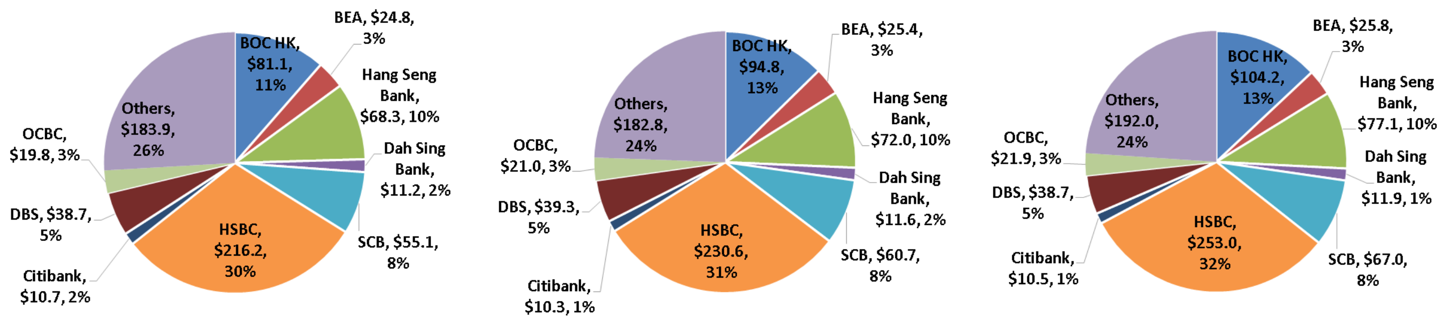
Source: Straits Times, Moneysmart.sg

Our estimates for domestic loans market share in Singapore, Malaysia and Hong Kong.

In Hong Kong, DBS and OCBC experienced compressed NIM as low HIBOR impacted their HIBOR pegged loans. In addition, we think the competitive pressures could have slowed down QoQ loans growth for DBS and OCBC, as HSBC and BOC grew their loans at a faster pace in 1H17. We believe that HSBC poses strong competition not just in Hong Kong but also in the Pearl River Delta region where it is ramping up its presence aggressively.

Figure 22: Hong Kong Domestic Loans by Market Share from 2015 to 1H2017 (USD'bn)

2015 | **2016** | **1H2017**

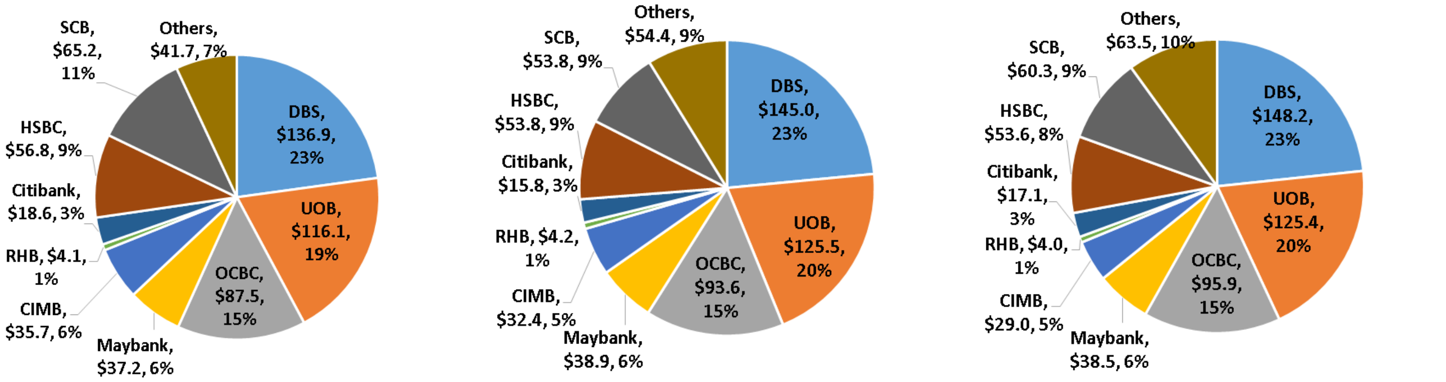


Source: HKMA, Company Reports, PSR estimates | *Source: HKMA, Company Reports, PSR estimates* | *Source: HKMA, Company Reports, PSR estimates*

In Singapore, we do not expect Singapore banks' NIM to have a strong pick up as NII will be driven by loans growth rather than increase in interest rates. We believe that DBS and OCBC can continue to grow their market share of loans because of the acquisition of ANZ wealth business in five Asian markets by DBS; Barclays and NAB wealth businesses in Asia by OCBC. DBS and OCBC strong wealth management franchise will help improve scale and yield of their loans business.

Figure 23: Singapore Domestic Loans by Market Share from 2015 to 1H2017 (SGD'bn)

2015 | **2016** | **1H17**

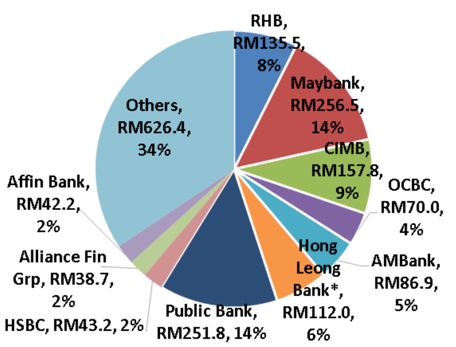


Source: MAS, Company Reports, PSR estimates | *Source: MAS, Company Reports, PSR estimates* | *Source: MAS, Company Reports, PSR estimates*

In Malaysia, potential mergers of the top Malaysian banks had failed to go through (CIMB and RHB in 2015; RHB and AmBank in 2017). Therefore without a couple of major players that has strong market plurality like in Singapore and Hong Kong, the Malaysian market remains fragmented and we expect competition to be more volatile.

Figure 24: Malaysia Domestic Loans by Market Share from 2015 to 1H2017 (MYR'bn)

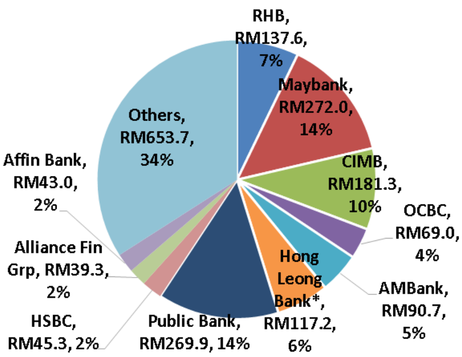
2015



Source: BNM, Company Reports, PSR estimates

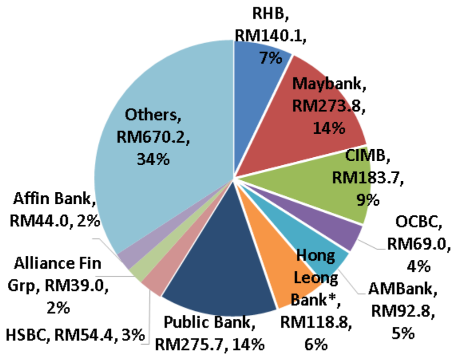
**Estimates using geographical breakdown information from FYE June 2015 and 2016 annual report.*

2016



Source: BNM, Company Reports, PSR estimates

1H2017



Source: BNM, Company Reports, PSR estimates

Peer comparison across key markets of Singapore, Hong Kong and Malaysia

Ticker	Name	Div Yield (%)	ROA (%)	ROE (%)	P/E (x)	P/B (x)	NIM (%)	Non-Performing Assets to Total Loans (%)	Total Loans to Total Deposits (%)	Total Loans 1Y Growth (%)
Singapore										
DBS SP Equity	DBS	3.04	0.95	10.10	12	1.1	1.74	1.6	89.7	6.6
OCBC SP Equity	OCBC	3.26	1.21	11.90	12	1.2	1.67	1.3	86.5	11.3
UOB SP Equity	UOB	2.95	0.99	10.30	13	1.2	1.78	1.6	87.6	7.3
Simple Average		**3.08**	**1.05**	**10.77**	**12**	**1.2**	**1.73**	**1.5**	**87.9**	**8.4**
Malaysia										
MAY MK Equity	MayBank	5.52	1.02	11.17	13	1.4	1.88	2.5	99.2	6.4
PBK MK Equity	Public Bank	2.86	1.38	15.60	15	2.2	2.06	0.5	94.1	5.3
CIMB MK Equity	CIMB	2.96	0.86	9.30	14	1.3	2.58	3.2	93.0	8.2
HLBK MK Equity	Hong Leong Bank	2.91	1.11	9.79	15	1.4	1.79	1.0	80.6	3.8
RHBBANK MK Equity	RHB Bank	2.38	0.77	8.09	12	0.9	1.72	2.3	94.4	3.2
AMM MK Equity	AM Bank	4.10	1.00	8.36	10	0.8	1.45	1.9	99.8	6.6
AFG MK Equity	Alliance Financial Grp	4.27	0.94	10.24	11	1.1	1.71	1.1	88.3	1.3
AHB MK Equity	Affin Holdings	3.56	0.81	6.56	9	0.6	1.67	2.0	89.9	1.9
Simple Average		**3.57**	**0.99**	**9.89**	**12**	**1.2**	**1.86**	**1.8**	**92.4**	**4.6**
Hong Kong										
2356 HK Equity	Dah Sing Banking Grp	2.28	1.17	10.23	10	1.0	2.04	1.3	74.0	3.3
2388 HK Equity	BOC Hong Kong	3.02	1.20	12.87	15	1.7	1.65	0.2	69.0	11.9
11 HK Equity	Hang Seng Bank	3.51	1.33	13.23	19	2.5	1.84	0.5	73.5	9.6
23 HK Equity	Bank of East Asia	2.70	1.02	8.91	31	1.1	1.73	1.6	82.1	3.7
Simple Average		**2.88**	**1.18**	**11.31**	**19**	**1.6**	**1.82**	**0.9**	**74.6**	**7.1**
London										
HSBA LN Equity	HSBC	5.48	0.12	1.35	87	1.0	1.17	1.7	70.7	3.4
STAN LN Equity	Standard Chartered	0.00	0.07	0.20	316	0.6	1.63	3.6	69.4	0.9

Source: Bloomberg, PSR estimates

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