JPM-pp1

CITIC Securities - H (6030 HK)

Neutral

Price: HK$17.04

24 Aug 2015

Price Target: HK$36.00

PT End Date: 31 Dec 2015

1H15 results: Key takeaways from analyst briefing

CITIC Securities reported 1H15 net profit of Rmb12.5bn, up 206% YoY. As the result had been preannounced (please see our note), the focus was mainly on post-balance-sheet activities, particularly related to recent market volatility. Our key takeaways from the analyst briefing held this evening include: (1) margin loans' collateral-to-loan ratio was 250%; (2) management has confidence that the recent market volatility will not set back capital market reform, and CITICS's long-term sustainable ROE is expected to be 15%; and (3) CITICS will continue its strategy of business diversification, including overseas expansion and increasing products offered.

- **Brokerage commission contraction compensated for by volume:** We calculate that the commission rate contracted more than 20% in 1H15 vs. 2014; we estimate that commission in 1H15 was below 5bps. Volume expanded significantly; management commented that market share is stable at about 6.3%. The recent transaction by CSFC may be positive to CITICS's brokerage market shares.

- **Margin financing collateral-to-loan ratio above 250%:** CITICS commented that it has tightened risk controls since April 2015. The aggregate amount of margin loans seeing mandatory liquidation was Rmb500mn, and bad debt is Rmb6mn (0.52% of the end-June margin loans balance). Management believes risk is under control. The warning level in liquidations is 180%. Management commented that risk is manageable for other capital intermediary business, such as stock-pledge repo, even if SHCOMP index falls to 3000.

- **Valuation on investments handled by CSFC uncertain:** CITICS contributed Rmb15.6bn to a collective pool of stabilization funds managed by CSFC. The valuation of the investment is still pending a report from CSFC. CITICS didn't borrow any money from CSFC.

- **Overseas business contributed 7-8% of net profits in 1H15:** The overseas revenue contribution was 15% in 1H15 (vs. 20% in 2014). Key drivers for overseas earnings were: (1) fixed income underwriting and sales; (2) expansion in other Asia countries (ex-HK); and (3) increases in equities underwriting, particularly secondary placements.

- **Management expects long-term sustainable ROE of 15%:** Management believes current average daily turnover (ADT) levels (Rmb1.1tn) are not sustainable, but that Rmb600bn is a sustainable level. Even if ADT falls to Rmb400bn, ROE would be ~10%. In the long term, management believes ROE will be sustainable at 15% due to the following developments: (1) the potential increase of institutional clients' participation in the A-share market; (2) Rmb internationalization increasing overseas business opportunities; and (3) the diversification and development of capital market products, such as increasing ABS issuances.

- **Other important issues:** (a) placement price to NSSF is Rmb18 per share, and this will not change despite recent market volatility; and (b) CITICS has issued USD debt to match USD assets, so net exposure is limited.

Table **1: 1H15 results summary**

Rmb in millions	1H14	2H14	1H15	HoH	YoY		FY15 JPMe	Runrate
P&L items								
Revenue		13,995	22,975	37,123	62%	165%	56,442	66%
Total commission and fees income		6,805	12,110	17,321	43%	155%	29,390	59%
Total interest income		3,227	4,624	7,785	68%	141%	12,521	62%
Net investment gain		3,964	6,241	12,017	93%	203%	14,531	83%
Other income		2,335	220	2,177	890%	-7%	277	787%
Total revenue and other income		16,330	23,195	39,301	69%	141%	56,719	69%
Total expenses		(10,531)	(14,201)	(22,776)	60%	116%	(37,527)	61%
Profit before tax		5,824	9,598	16,927	76%	191%	20,208	84%
Income Tax		(1,490)	(2,070)	(4,184)	102%	181%	(5,052)	83%
Net profits		4,334	7,528	12,742	69%	194%	15,156	84%
Minority interest		(258)	(266)	(272)	2%	5%	(670)	41%
Attributable profits		4,076	7,262	12,470	72%	206%	14,486	86%
Key balance sheet items								
Client deposits and clearing funds		49,814	96,841	246,610	155%	395%	198,939	124%
Loan to margin clients		38,734	74,135	116,350	57%	200%	100,985	115%
Include: Margin financing		37,563	72,036	113,061	57%	201%	100,985	112%
Total assets		**339,744**	**479,626**	**775,506**	62%	128%	**638,813**	121%
Total liabilities		**248,305**	**378,495**	**642,755**	70%	159%	**524,514**	123%
Equity attributable to shareholders		**89,731**	**99,099**	**130,292**	31%	45%	**112,266**	116%
Key ratios								

ROAA	2.67%	3.54%	3.97%	43 bps	131 bps	2.59%
ROAE	9.19%	15.38%	21.75%	636 bps	1256 bps	13.71%
Avg. assets/avg. equity (x)	3.44 x	4.34 x	5.47 x	1.13 x	2.03 x	5.29 x
Avg. assets (excl. client$)/avg. equity	2.94 x	3.56 x	3.97 x	0.41 x	1.04 x	3.89 x
Net capital/net assets	57.1%	56.3%	66.7%	1038 bps	958 bps	47.2%
Net assets/total liabilities	48.9%	35.2%	32.8%	-241 bps	-1611 bps	38.4%

Source: Company reports, J.P. Morgan estimates

Table **2: Summary of 2Q15 financials**

Rmb in millions	**2Q14**	**3Q14**	**4Q14**	**1Q15**	**2Q15**	**QoQ**	**YoY**
P&L items							
Net commission and fees income	3,107	4,151	6,783	5,431	9,524	75%	207%
Net brokerage income	1,566	2,210	3,300	3,464	6,524	88%	317%
Net investment banking income	486	867	1,709	746	1,097	47%	126%
Net asset mgmt fee	1,023	1,002	1,457	1,127	1,814	61%	77%
Other	32	72	317	94	89	-5%	180%
Net interest income	55	207	483	477	1,104	132%	1926%
Investment gains	2,002	2,387	4,617	4,283	4,373	2%	118%
Other income	630	98	(63)	(258)	6,177	-2496%	880%
Total revenue and other income	5,794	6,844	11,819	9,933	21,178	113%	266%
Total expenses	(4,083)	(3,634)	(5,450)	(4,735)	(9,461)	100%	132%
Operating income	1,711	3,209	6,369	5,198	11,717	125%	585%
Non operating income	2,215	12	8	1	11	1041%	-100%
Profit before tax	3,926	3,221	6,377	5,199	11,728	126%	199%
Income Tax	(1,020)	(807)	(1,263)	(1,258)	(2,927)	133%	187%
Net profits	2,905	2,414	5,114	3,941	8,801	123%	203%
Minority interest	(140)	(125)	(142)	(124)	(148)	19%	6%
Attributable profits	2,765	2,289	4,972	3,817	8,653	127%	213%
Key balance sheet items							
Client deposits and clearing funds	49,814	63,027	96,841	122,182	246,610	102%	395%
Loan to margin clients	38,734	53,776	74,135	91,371	116,350	27%	200%
Total assets	339,744	375,706	479,626	568,657	775,506	36%	128%
Total liabilities	248,305	281,105	378,495	462,470	642,755	39%	159%
Equity attributable to shareholders	89,731	92,755	99,099	103,991	130,292	25%	45%
Key ratios							
ROAA	3.36%	2.56%	4.65%	2.91%	5.15%	224 bps	179 bps
ROAE	12.43%	10.04%	20.73%	15.04%	29.55%	1451 bps	1712 bps
Avg. assets/ avg. equity (x)	3.70 x	3.92 x	4.46 x	5.16 x	5.74 x	0.58 x	2.04 x
Avg. assets (excl. client$)/avg. equity	3.17 x	3.30 x	3.62 x	4.08 x	4.16 x	0.08 x	1.00 x

Source: Company reports, J.P. Morgan estimates

Details from management comments:

Financial performance

- CiticS's leverage ratio (excluding the impact from client money) increased from 3.7x in 2H14 to 3.9x in 1H15, but the increase is smaller than that of the industry (increased from 3.1x in 2H14 to 3.6x in 1H15).
- CiticS's asset growth has been slowing since April 2015 as management has been concerned about the risk associated with increasing margin loans.
- The asset management business of CiticS grew substantially in 1H15, with AUM increasing from Rmb750bn in 1H14 to Rmb1.1tn in 1H15, of which Rmb400bn is under the category of active management.

Market share

- The market share of CiticS's securities brokerage business is around 6.3%, which is stable vs. prior periods. CSFC's transactions may have positive contributions in July 2015.
- CiticS's underwriting business ranked #1 during the first half of 2015 in China. For M&A business, CiticS ranked #1 in China and ranked #2 globally.
- For the securities brokerage business, CiticS ranked #2 in China, and the average commission rate declined significantly YoY as a result of fierce competition and the increase in transactions with lower commission rates.

Q&A session

Margin financing and securities lending business (MFSL)

- The amount of MFSL will face headwinds short-term. The scale is expected to pick up long-term with increasing participation of institutional investors.
- The outstanding margin loan balance amounted to Rmb78bn, and the collateral-to-loan ratio is 250% on average. The company is stringent on risk management and has set the warning level of collateral-to-loan at 180%.
- The largest daily liquidation amount was Rmb200mn, and the aggregate amount of mandatory liquidation was Rmb500mn during the last market correction period, representing less than 1% of the total MFSL balances. The amount of mandatory liquidation amounted to Rmb100mn recently in comparison to the Rmb78bn outstanding MFSL balance.
- Bad debt on MFSL amounted to Rmb6mn.

Derivatives position

- The outstanding position of Total Return Swap amounted to Rmb26bn in 1H15, representing 60% of CiticS's position on all derivative products. CiticS requires clients to place at least 30% of guarantee deposits with the company, which is highest among peers.
- For total return swap, CiticS only trades with clients with strong financial positions and never liquidates client positions mandatorily, as clients actively control their positions and place additional deposits when necessary.

Leverage

- The amount of leverage in the near team depends on the market position, but CiticS aims to increase its leverage longer-term in an attempt to enhance product diversity in all types of assets, such as mezzanine financing.

Contribution from overseas business

- The overseas segment contributed 15% of revenue (20% in FY14) and 8% of net profits in 1H15 on the back of strong growth of fixed income products sales and surging underwriting business. In particular, CiticS completed the underwriting of treasury bonds for Mongolia and the United Kingdom.
- CiticS has expanded its footprint outside of Hong Kong, and 30% of its IPO underwriting business took place outside of Hong Kong.
- CiticS's equity underwriting business ranked #4 in Asia (ex-China), and its equity transaction business (including placements) ranked the top in Hong Kong.

Impact of Rmb devaluation

- CiticS issued USD debt to match assets denominated in the same currency, and there isn't any currency mismatch arising from such transactions. CiticS has the largest amount of overseas M&A projects in pipeline among all Chinese brokers.
- CiticS doesn't have excessive USD exposure and believes currency risk is limited. Rmb depreciation will impact its QFII business on one hand, and the company believes the depreciation is beneficial to the company; on the other hand, it could result in translation gains for its overseas subsidiaries.

Proprietary trading position

- CiticS contributed Rmb 15.6bn to a segregated account established by the China Securities Corporation Limited (CSFC) for a collective investment together with other 20 securities companies in July 2015. CiticS hasn't received clarifications from regulators as to the accounting treatments of such investments.
- CiticS didn't borrow from the CSFC and hasn't received the valuation report from CSFC in regards to its investment position with the authority.

Comment on recent market correction

- Management believes there are a couple of factors resulting in the recent market correction, including: (1) the relatively high valuation of the A-share market; (2) the negative sentiment and tighter liquidity arising from the Rmb devaluation; and (3) weak investment sentiment globally.

Long-term return-on equity ratio

- CiticS believes it could achieve a sustainable ROE of 15% long-term. The company believes the average daily turnover (ADT) of Rmb400bn can allow Citic to achieve 10% ROE, while management doesn't believe ADT of Rmb1.1tn to be sustainable.

- Management expects CiticS to record Rmb12 in book value per share in 2H15.

Future opportunities

- CiticS expects increasing capital inflow from institutional investors. Management also sees abundant opportunities arising from the increasing participation of institutional invertors, Rmb internationalization and product differentiation in the capital market, such as asset-backed securities.

Share placement to the National Council for Social Security Fund

- The placement price of HK$18 per share has been approved by the Board and won't be changed amid the recent market volatility.

Stock-pledge repo business

- CiticS uses its own capital carry out the stock-pledge repo business. The warning level of collateral-to-loan is 180%.

- CiticS only trades with clients with strong financial positions and believes the credit risk is limited even if the Shanghai Composite Index trades at 3,000 points.

Investment Thesis

1. CITIC Securities is the largest securities firm in China in terms of asset size at end-2014. It provides full-platform services, including brokerage, investment banking, assets management, etc.

2. CITIC Securities ranked #2 in terms equity turnover in the brokerage business. It ranks #1 in both equity underwriting and debt underwriting among brokers in terms of underwriting volume in 2014.

3. CITIC Securities' brokerage business market share is the largest in Hong Kong compared to other Chinese brokers, mainly due to its acquisition of regional brokers, CLSA, which becomes a wholly owned subsidiary of CiticS in 2013.

4. However, CITIC Securities sees constraints on its capital ratio, as its net capital to net assets was 56% at end-2014, close to the warning level of 48%. This becomes a key constraint for Citic Securities to expand its flow base business.

5. Investment income accounted for 35% of CITIC Securities (PRC GAAP), the highest among peers. Thus, CITIC Securities is subject to higher investment risk than peers.

Valuation

Our Dec-15 price target of HK$36 is based on DDM. Key assumptions include: a risk-free rate of 4.0%, equity premium of 8%, cost of capital of 14.8%, long-term growth of 6%, long-term ROE of 29.8% and terminal date of valuation of Dec-17.

Risks to Rating and Price Target

Upside risks include: faster-than-expected fee-based business, such as advisory and underwriting; improving ADT and commission rates for the industry; higher-than-expected contributions from subsidiaries, such as CLSA and China AMC; and relaxation on capital rules, easing pressure on capital. Downside risks include: faster-than-expected capital consumption, leading to rising capital replenishment needs; losses on investment; the inability to exit principal investments due to sluggish capital markets; and deteriorating trends on A-shares.

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Date	Rating	Share Price (HK$)	Price Target (HK $)
31-May-12	N	15.70	16.00
30-Aug-12	N	13.16	14.00
12-Aug-14	N	19.48	21.00
15-Jan-15	N	28.50	32.00
05-May-15	N	32.95	36.00

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