Research Team

Strategy

China strategy: Banks' exposure to Russia is limited

China

The Bumpy Path to 'Common Prosperity'

Inflation, Deflation or Stagflation?

Investment summary

Market volatility has surged in the wake of Russia's shock invasion of Russia's full-scale invasion of Ukraine in an attempt to depose the government. It has been swiftly followed by increased sanctions on Russia. The latest sanctions and measures were expanded to include restrictions on the Russian Central Bank, and the banning certain Russia banks from the SWIFT system was announced. In this note, we assess HK and Chinese banks' exposures to Russia and the potential impact.

Based on regulators and banks' disclosure, HK and Chinese banks' direct exposure to Russia is relatively small. For **HK banks**, credit exposure to Russia is estimated to be about 0.01% of the industry-wide assets. While China is the biggest trade partner with Russia, **Chinese banks'** exposure to Russia is insignificant. **ICBC (1398 HK)** and **CCB (939 HK)** disclosed they have subsidiaries operating in Russia but their exposure remains small, accounting for less than 0.05% of their total assets/ net assets/ net profits as of 1H21. While the Big-4 Chinese SOE banks have branches in Russia, the contribution is minimal, with Russia branches accounting for 0-4bps of their total assets / net assets / net profits as of end-2020. We believe there is no immediate risk for secondary sanctions on banks operating in Russia or dealing with Russia entities at this stage. Having said that, the situation remains highly fluid, and the market would keep monitoring the development.

In our view, key risk to our constructive view on HK banks, which is a proxy to rising interest rates, would be if there are any changes to Fed rate hike expectations owing to macro uncertainties. We believe share price volatility in HK banks is likely to remain high in the near-term due to rising geopolitical risks. Within HK banks, we prefer **Bank of China HK (2388 HK)**. We believe HK domestic banks and Chinese banks would be defensive plays in light of rising geopolitical tensions. With a stable dividend payout ratio and a relatively high dividend yield, we maintain our view that a near-term trading opportunity for Chinese banks is approaching towards 4Q21 results announcement. Among the Big-4 Chinese banks, we prefer **China Construction Bank (939 HK)** for a relatively stronger capital position. In the medium- to long-term, we prefer those with a more retail-focused strategy and a comprehensive wealth management platform. We prefer **China Merchants Bank (3968 HK)** and **Postal Savings Bank of China (1658 HK)**

Exhibit 1: Focus stocks

Company	Ticker	Current price (l.c.)	Rating	FV(l.c.)	Potential upside	Dividend yield
BOCHK	2388 HK	27.8	Buy	33.6	20.9%	4.4%
China Construction Bank	939 HK	5.9	Buy	7.7	31.4%	7.5%
China Merchants Bank	3968 HK	65.7	Buy	78.0	18.7%	2.8%
Postal Savings Bank of China	1658 HK	6.5	Hold	7.1	9.2%	4.6%

Source: Bloomberg, share price as of 28th January 2022

HK and Chinese banks' exposure to Russia is negligible

The latest sanctions and measures were expanded to include restrictions on the Russian Central Bank, and the banning certain Russia banks from the SWIFT system was announced. For instance, which Russian banks will be targeted has yet to be disclosed, and the impact would vary. At this stage, there are no details on the nature of restrictions imposed on the Russian Central Bank yet.

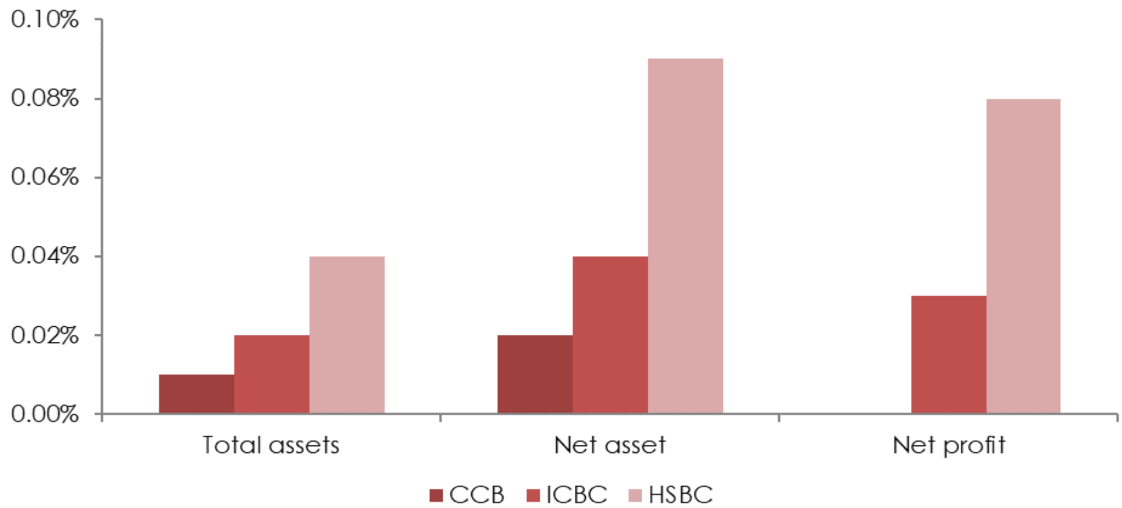
As illustrated in Exhibit 2, HK and Chinese banks' direct exposure to Russia is relatively small, accounting for less than 0.1% their total assets/ net assets/ net profits as of 1H21, and therefore, any potential direct impact should be limited. For **HK banks**, credit exposure (including lending and investments) to Russia is estimated to be about HKD2.6bn, according to HK Monetary Authority, and implies a merely 0.01% of the industry-wide assets.

While China is the biggest trade partner with Russia, **Chinese banks'** exposure to Russia is insignificant. While **ICBC (1398 HK, Buy, Fair value HKD6.0)** and **CCB (939 HK, Buy, Fair value HKD7.7)** disclosed they have subsidiaries operating in Russia, their exposure remains small, accounting for less than 0.05% of their total assets/ net assets/ net profits as of 1H21. These subsidiaries' business scope focuses mainly on facilitating Sino-Russia bilateral trade, providing international settlement and trade finance etc. Large state-owned enterprise (SOE) banks have been reducing financing exposure to Russian commodities owing to credit-risk concerns and should further limit Chinese banks' exposure to Russia.

While the Big-4 Chinese SOE banks have branches in Russia, the contribution is minimal, with Russia branches accounting for 0-4bps of their total assets / net assets / net profits in 2020. For instance, **BOC (3988 HK, Hold, Fair value HKD3.3)** disclosed it has two branches operating in Russia, but these branches offer limited business services, such as, offering forex services to facilitate RMB internationalization etc. Based on BOC's 1H21 disclosure, it generated 3% / 3.4% of its 1H21 total revenue / net profit from 'other country regions', which primarily includes business in the US, Europe, Japan, and Singapore etc. As such, it is estimated that BOC's Russia exposure is likely very negligible.

We believe there is no immediate risk for secondary sanctions on banks operating in Russia or dealing with Russia entities at this stage. Having said that, the situation remains highly fluid, and the market would keep monitoring the development.

Exhibit 2: Selected HK and Chinese banks' exposure to Russia*



Source: company data as of 1H21; *note: % of group total

Economic and interest rate impact

If the scope of sanctions by the US and its allies extends to Russian energy sources, the supply shock on oil, gas and commodities will feed directly into rising input prices, and supply chain disruptions could prompt an upward spiral in consumer and producer prices. BOS economist views this may be an untenable outcome for Europe and US, and therefore we put a low probability of less than 10% on this outcome.

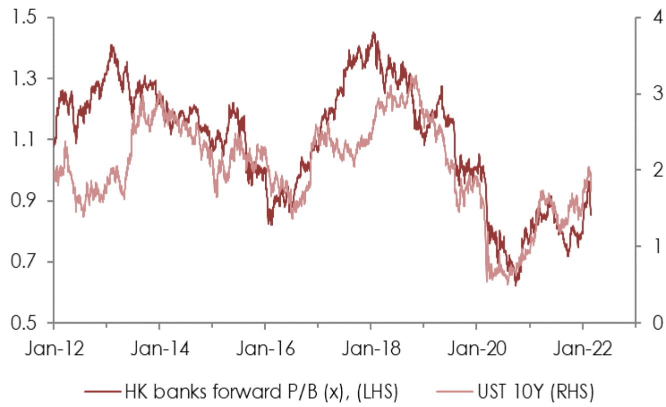
Following the outbreak of war, central banks are likely to act cautiously when raising interest rates to curb inflation. Higher oil prices and further supply chain disruptions could lead to "stagflation" pressure. The 10-year UST has declined from its recent peak of 2.06% to 1.83%, reflecting market concerns on the long-term economic outlook.

Investment implications - HK domestic banks and Chinese banks would be defensive plays

In our view, key risk to our constructive view on HK banks, which is a proxy to rising interest rates, would be if there are any changes to Fed rate hike expectations owing to macro uncertainties. We believe share price volatility in HK banks is likely to remain high in the near-term due to rising geopolitical risks. Having said that, given the direct exposure is negligible and therefore the potential earnings impact, if any, should be limited and manageable, investors could accumulate on weakness if there are no material changes to the broad direction of rate hike cycle.

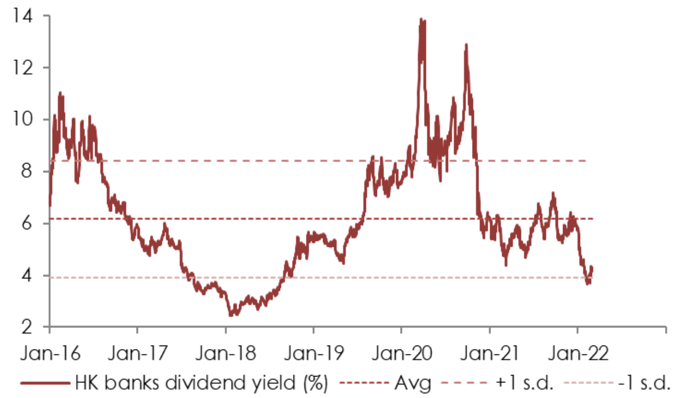
We believe HK domestic banks and Chinese banks would be defensive plays in light of rising geopolitical tensions. Within HK banks, we prefer **BOCHK (2388 HK, Buy, Fair value HKD33.6)**. With a stable dividend payout ratio and a relatively high dividend yield, we maintain our view that a near-term trading opportunity for Chinese banks is approaching towards 4Q21 results announcement. Among the Big-4 Chinese banks, we prefer **CCB (939 HK, Buy, Fair value HKD7.7)** for a relatively stronger capital position. In the medium- to long-term, we prefer those with a more retail-focused strategy and a comprehensive wealth management platform. We prefer **CMB (3968 HK, Buy, Fair value HKD78)** and **PSBC (1658 HK, Hold, Fair value HKD7.1)**.

Exhibit 3: HK banks forward P/B (x) vs. 10-year US Treasury (%)



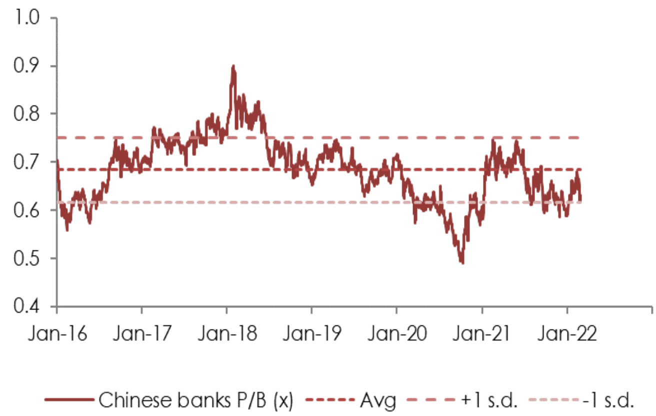
Sources: Bloomberg

Exhibit 4: HK banks forward dividend yield (%)



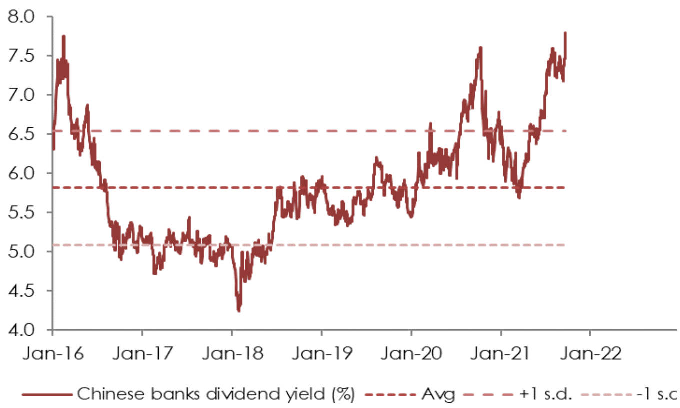
Sources: Bloomberg

Exhibit 5: H-shares Chinese banks forward P/B (x)



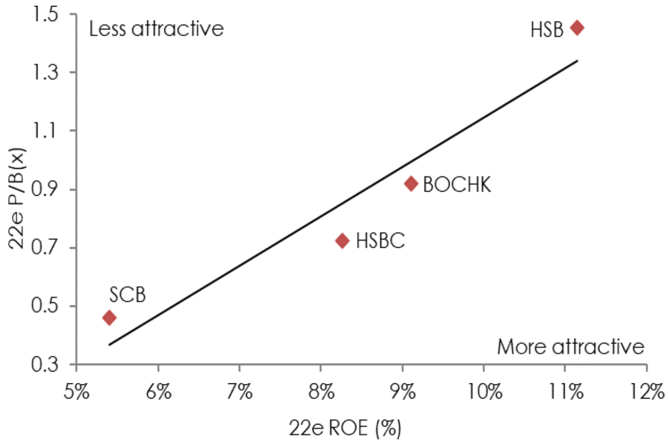
Sources: Bloomberg

Exhibit 6: H-shares Chinese banks forward dividend yield



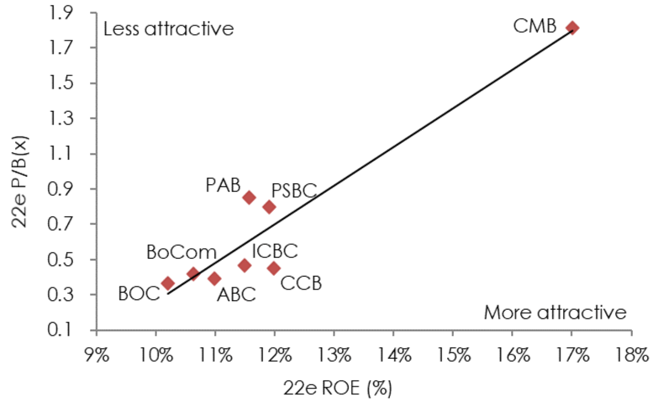
Sources: Bloomberg

Exhibit 7: HK banks ROE vs. P/B



Sources: Bloomberg

Exhibit 8: H-shares Chinese banks ROE vs. P/B



Sources: Bloomberg

Exhibit 9: Valuation Summary

	Price/Earnings		Price/Book		Dividend Yield (%)		ROE (%)	
	2021E	2022E	2021E	2022E	2021E	2022E	2021E	2022E
BOC HONG KONG HOLDINGS LTD (2388 HK)	11.7	10.1	0.9	0.9	4.4	5.0	8.2	9.1
CHINA CONSTRUCTION BANK-H (939 HK)	4.1	3.8	0.5	0.4	7.5	8.0	12.1	12.0
CHINA MERCHANTS BANK-H (3968 HK)	11.7	10.1	1.8	1.6	2.8	3.3	16.5	17.0
POSTAL SAVINGS BANK OF CHI-H (1658 HK)	6.7	5.9	0.8	0.7	4.6	5.2	11.6	11.9

Source: Bloomberg, share price as of 1st March 2022

ANALYST DECLARATION:

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