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CHINESE BANK IPOS AND THEIR INVESTMENT IMPLICATIONS

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Chinese Bank IPOs and Their Investment Implications

Introduction

With the October 2006 initial public offering (IPO) of China's largest bank, The Industrial and Commercial Bank of China (ICBC), five of the top six Chinese banks by asset size are listed, signaling the growing maturity of the country's capital markets. Whereas many of the first Chinese companies listed were small firms, the big banks and many other blue-chip companies have gone public in the past few years. Investors in Chinese equities can now get exposure to the Chinese banks (and financials generally) that was unavailable just a few years ago.

In fact, commercial banks now account for more than one-third of the market capitalization of the Shanghai Stock Exchange and more than 10% of the MSCI China Index and Hong Kong's Hang Seng Index, compared to virtually nil two years ago. Investors may also have increased indirect exposure to China's banks through investment in financial firms that are strategic investors in China's banks. Now is, therefore, a good time to take stock and examine the China bank story and its implications for investors.

Chinese Banks on the International Stage

China's global ambitions and entrance into the World Trade Organization (WTO) in December 2001, which required China to open up its financial sector to foreign competition within five years, necessitated a rethinking of the Chinese banking system. China's leaders concluded that foreign expertise and capital would help the banks reform, modernize, and compete on a global scale. However, access to such expertise and capital required a cleanup of the non-performing loan (NPL) problem, which the Chinese government had begun addressing in the late 1990s by moving large amounts of NPLs out of the largest banks into four newly created asset management companies and shoring up the banks with capital infusions. Accordingly, the government pumped billions more dollars into Chinese banks and wrote off billions of bank assets, thereby reducing the reported NPL ratio of three of the largest banks, ICBC, the Bank of China (BOC), and China Construction Bank (CCB) to 3.8%-5.7% from 2001 levels of 19%-29%.[1]

The next step was to secure strategic foreign investment, which included not only cash but, more importantly, expertise in risk management, new products, and other areas. Big-name foreign strategic investors also provided international credibility (Table A). At the same time, the Chinese government was careful to secure investment on its own terms, capping foreign investment at 25% ownership (20% for any single foreign institution) in almost all banks. Nevertheless, China had little trouble convincing strategic investors that participation via Chinese banks in the country's huge growth story outweighed the lack of management control. Other sticks and carrots no doubt had their intended effect. Foreign financial firms could naturally view investment as a prerequisite for realizing other business opportunities, such as

[1] Diana Farrell, Susan Lund, and Fabrice Morin, "The promise and perils of China's banking system," *The McKinsey Quarterly*, web exclusive, July 2006. Wendy Dobson and Anil Kashyap, "The Contradiction in China's Gradualist Banking Reforms," National Bureau of Economic Research, October 2006, Table 3.

underwriting, in China. Moreover, at least one leading Chinese bank reportedly guaranteed the value of strategic investments—though with a lock-up period as a quid pro quo.

Blessed with the approval of strategic investors—who of course could expect to benefit directly from an IPO—Chinese banks were able to go to the public markets. China Merchant Bank's IPO, the first listing of note, took place in April 2002 and three of the big four commercial banks listed after September 2005.[2] Shares were listed primarily in Hong Kong in order to best attract foreign capital and this had the added benefit of subjecting the banks to higher standards that in theory will improve their transparency and corporate governance.[3]

Chinese bank IPOs have been wildly successful, with investor interest far outstripping available supply. ICBC's $21.9 billion October 2006 dual listing in Hong Kong and Shanghai was the world's largest ever. Indeed, the IPOs of CCB, BOC, and ICBC from October 2005 through October 2006 accounted for one-sixth of the value of IPOs worldwide over this period.

The banks' post-IPO performance has been excellent as well (Table B). Based upon the value of their public float, China's biggest three listed banks now rank in the top eight worldwide based on market capitalization (Table C).

Implications for Investors

The listing of the Chinese banks has significant implications for investors. From a macroeconomic standpoint, the bank IPOs are a key element in the reform of China's capital markets. Under the WTO, China is committing to an unprecedented level of cooperation with and reliance upon foreign markets. A resurgence in the level of NPLs or the occurrence of other events that cause foreign investors to lose confidence will affect not only the listed Chinese banks but also the entire Chinese capital market.

From a microeconomic standpoint, investors in China-based indices now have exposure to Chinese banks that was not present even two years ago. Banks now account for 36.3% of the market value of firms listed on the Shanghai Stock Exchange and make up about 12.6% of the MSCI China Index compared with just 0.4% two years ago (Table D). Hong Kong's Hang Seng Index now has exposure of about 11% to 14% to Chinese banks as well.[4] Investors in U.S. and other financial firms that are strategic investors in China's banks also have indirect exposure to the fortunes of these banks.

[2] The fourth, the Agricultural Bank of China, holds more than half of the country's total NPLs and no timetable has been set for listing.

[3] There was also a year-long moratorium, from mid-2005 through mid-2006, on domestic Chinese IPOs while companies were conducting shareholding reforms pursuant to government direction.

[4] The exact figure depends upon whether the BOC's locally listed Hong Kong bank is included. CCB accounts for 11% of the Hang Seng Index. The Chinese bank exposure in both the Hang Seng and the MSCI China indices should increase once ICBC is added to both indices. Note also that Shanghai market cap numbers exclude the value of Chinese bank shares listed in Hong Kong.

There is little doubt that from the standpoint of securing institutional and retail investment the Chinese government has managed the bank reform process adroitly thus far. Yet, despite the excellent post-IPO performance by Chinese banks, it remains to be seen whether they will prove to be a good investment over the longer term. Balanced against the growth opportunities that these banks see in China's economic and financial market growth story, their huge customer base, and the more than $2 trillion in personal savings held by Chinese in the banks,[5] are many risk factors such as the lack of good credit and risk management skills, the high level of corruption, and the likelihood that the true number of NPLs will turn out to be significantly higher than the currently reported level.[6]

Perhaps most importantly, government control of the banks means that the banks are not fully subject to market forces. Big-bank lending has been disproportionately targeted toward state-owned enterprises, including unprofitable firms,[7] and there is ample evidence of fraud in the system. Given the fixed deposit and lending rates, Chinese banks have a strong incentive to lend as much as possible and the large increases in bank lending this year, which by late summer had already surpassed the government's RMB2.5 trillion (about $310 billion) target for 2006, suggest that moral hazard may be present. Investors should not assume that the Chinese government will rescue the banks again if NPL levels spike up again or bank profitability is otherwise hit through fraud, a slowdown in Chinese economic growth, or even a hard landing. Many commentators have pointed out the inconsistency between banks that in theory function according to free market concepts but in practice are viewed by the Chinese Communist Party as central to its efforts to preserve employment and social stability.

Investors should likewise be cognizant of the fact that valuations for the Chinese banks appear high, both relative to other Chinese firms and relative to other mega banks (Table E). After all, the Chinese banks have not even proven their ability to operate profitably in a competitive market and clearly have a long learning curve ahead. They have also not definitively resolved their NPL problem, in contrast to Japanese mega banks, which took many years to overcome this obstacle but trade at much lower valuations. Clearly, Chinese bank valuations rest wholly on the assumption that the great China growth story will continue.

Public equity investors should also recognize that their interests are not necessarily aligned with those of the strategic investors. The latter have other goals that have helped drive their investment decisions and, in many cases, have already made enormous paper profits on their investments. Moreover, should they sell out once their lock-up periods expire, bank stock values may suffer.

Deng Xiaoping famously argued that the reform process should be a measured one, likening it to crossing the river one stone at a time. Investors in Chinese banks, and indeed in Chinese equities generally, would be well-advised to adopt this metaphor for what is likely to be a risky and uncertain journey.

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[5] People's Bank of China news release (October 2006).

[6] For example, if one takes the estimated RMB1.34 trillion ($170 billion) in "special mention" loans by China's top four listed banks held as of the end of 2005 into account, the NPL numbers look less rosy. Dobson and Kashyap, "The contradiction in China's gradualist banking reforms," pp. 17-18.

[7] See Richard Podpiera, "Progress in China's Banking Sector Reform: Has Bank Behavior Changed?" IMF Working Paper No. 06/71, March 2006. Dobson and Kashyap, "The Contradiction in China's Gradualist Banking Reforms."

Table A

STRATEGIC FOREIGN INVESTORS IN CHINESE BANKS

Strategic Investor	Target
Allianz	Industrial & Commercial Bank of China
American Express	Industrial & Commercial Bank of China
Bank of America	China Construction Bank
Bank of Nova Scotia	Xi'an City Commercial Bank
BNP Paribas	Nanjing City Commercial Bank
Citigroup	Shanghai Pudong Development Bank
Commonwealth Bank of Australia	Jinan City Commercial Bank
Deutsche Bank	Hua Xia Bank
Goldman Sachs	Industrial & Commercial Bank of China
HSBC	Bank of Communications; Bank of Shanghai
ING	Bank of Beijing
Merrill Lynch*	Bank of China
Newbridge Capital	Shenzhen Development Bank
Royal Bank of Scotland	Bank of China
Standard Chartered Bank	Tianjin Bohai Bank
Temasek	China Construction Bank; Minsheng Bank
UBS	Bank of China

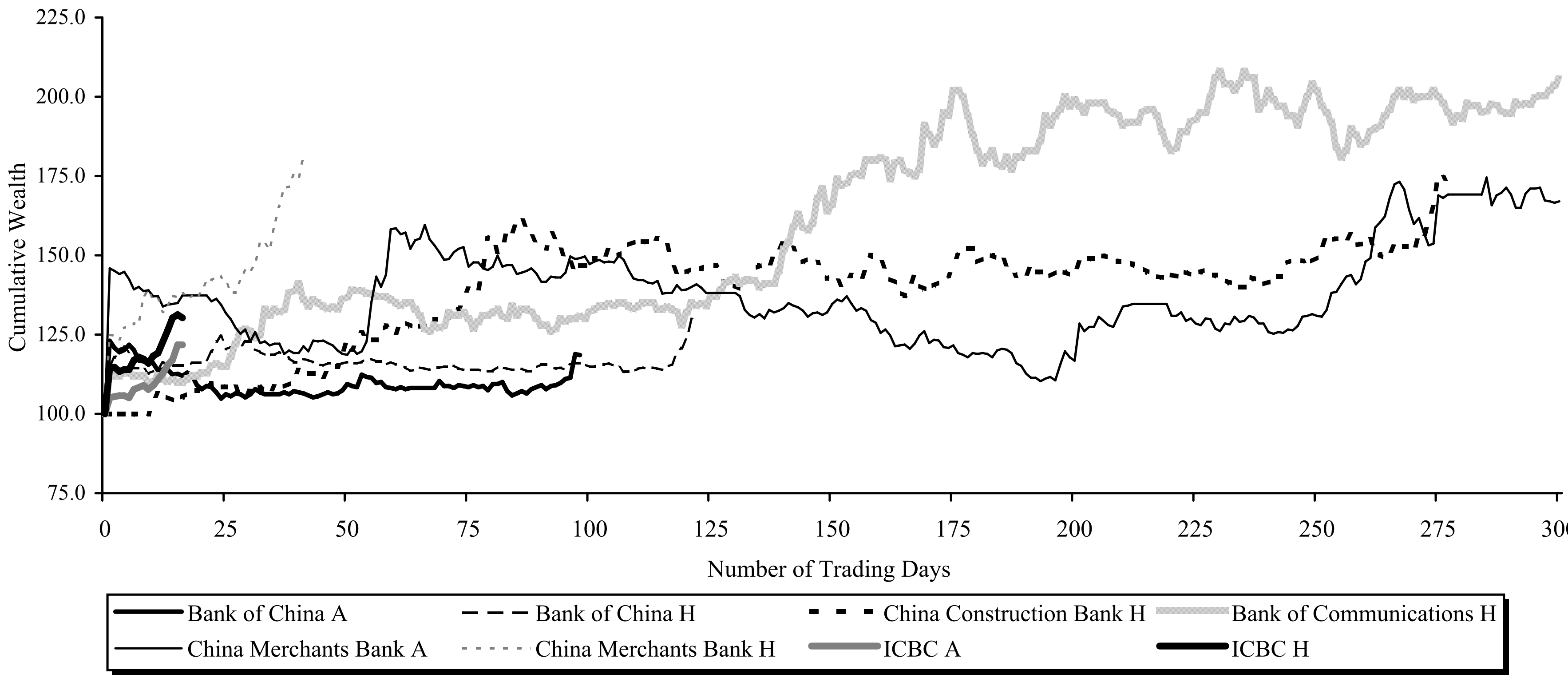
* Prior to the Bank of China IPO Merrill Lynch reportedly sold part of its stake to two U.S. hedge funds.

Source: Various news reports and articles.

Note: Data are not a comprehensive listing.

Table B

CHINESE BANKS POST-IPO PERFORMANCE



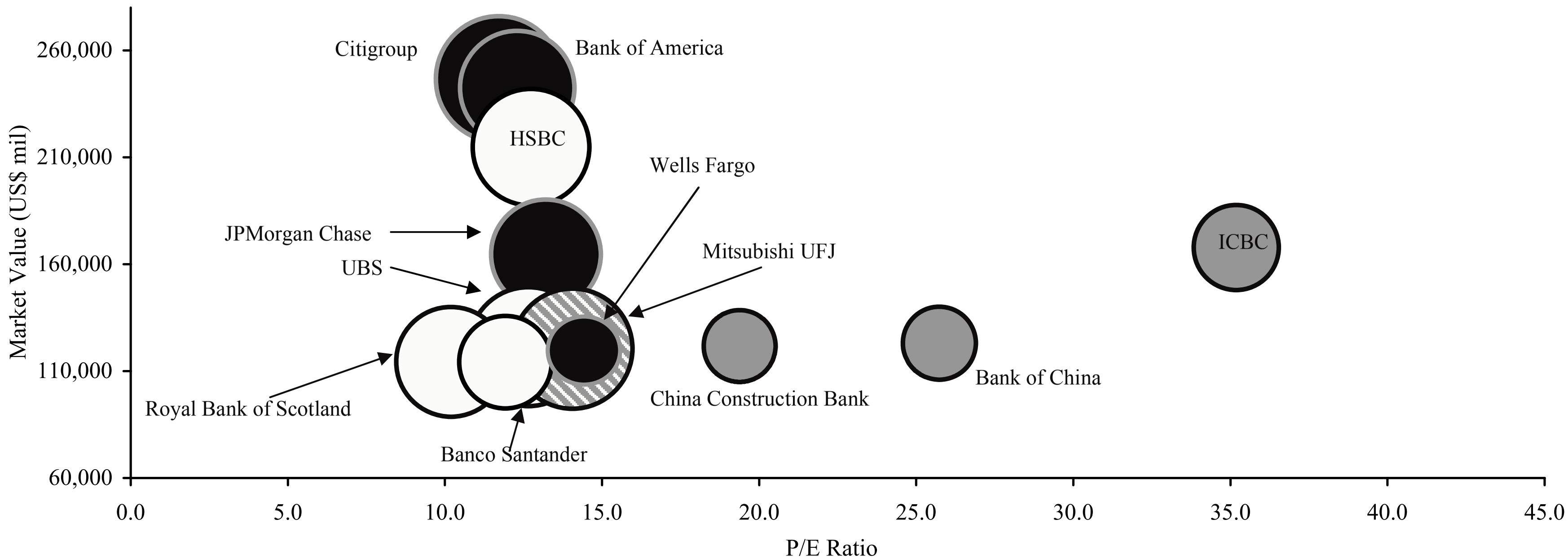
Bank	Bank of China		China Construction Bank	Bank of Communications	China Merchants Bank		Industrial & Comercial Bank of China	
Share Type	A	H	H	H	A	H	A	H
IPO Date	7/5/2006	6/1/2006	10/27/2005	6/23/2005	4/9/2002	9/22/2006	10/27/2006	10/27/2006
Cumulative Return								
Since IPO (%)	19.16	31.86	79.15	188.00	249.13	79.88	25.64	33.22
AACR Since IPO (%)	56.91	77.47	71.86	110.42	31.00	2901.40	1859.97	4107.79

Source: Thomson Datastream.

Notes: Data are in local currency. Data are through November 24, 2006.

Table C

TOP BANKS BY MARKET CAP



Bank	**Country**	**P/E Ratio**	**P/B Ratio**	**Market Value** (US$ Mil)	**Total Assets** (US$ Mil)
Citigroup	U.S.	11.7	2.1	246,469	1,746,586
Bank of America	U.S.	12.3	1.8	242,315	1,449,211
HSBC	U.K.	12.7	1.9	214,717	1,499,302
ICBC	China	35.2	5.2	167,802	800,044
JPMorgan Chase	U.S.	13.2	1.4	164,500	1,338,029
Bank of China	China	25.7	3.7	123,090	585,552
Wells Fargo	U.S.	14.8	2.7	122,395	483,441
China Construction Bank	China	19.4	3.3	121,633	568,213
UBS	Switzerland	12.7	3.3	121,466	1,562,254
Mitsubishi UFJ	Japan	14.1	1.9	120,521	1,585,768
Royal Bank of Scotland	U.K.	10.2	1.6	114,234	1,334,752
Banco Santander	Spain	11.9	2.1	114,131	945,857

Source: Factset Research Systems, Inc.

Notes: Bubble sizes are proportionate to the relative total assets of each bank. Data are as of November 24, 2006.

Table D

MSCI CHINA INDEX SECTOR WEIGHTS (%)

	December 31, 2000	December 31, 2004	October 31, 2006
Consumer Discretionary	1.91	6.05	4.53
Consumer Staples	0.35	0.66	1.96
Energy	4.44	23.80	22.63
Financials	1.16	10.69	26.45 *
Health Care	0.19	0.21	---
Industrials	20.89	17.31	10.39
Information Technology	6.36	2.95	2.31
Materials	1.05	8.33	5.81
Telecommunication Services	61.55	24.86	22.15
Utilities	2.11	5.14	3.78

Sources: Factset Research Systems, Inc. and Morgan Stanley Capital International. MSCI data provided "as is" without any expressed or implied warranties.

Note: Percentages may not total due to rounding.

*As of October 31, 2006 banks made up 12.6% of the MSCI China Index.

Table E

COMPARATIVE FIGURES FOR DEVELOPED COUNTRY MEGA BANKS AND CHINESE BANKS

	Market P/E	Price-Earnings Ratio	Price-Book Ratio	Dividend Yield (%)	Net Income (US$ billions)	Revenue Per Employee
China (Domestic Listings)	**16.2**					
Mega Banks						
ICBC		35.2	5.2	N/A	4.7	$12,869
Bank of China Ltd.		25.7	3.7	0.0	3.4	$16,280
China Construction Bank Corp.		19.4	3.3	0.4	5.8	$19,438
Other Listed Chinese Banks						
Bank of Communications Co. Ltd.		30.3	4.0	1.1	1.1	$19,994
China Merchants Bank Co. Ltd.		32.9	5.7	0.6	0.5	$22,493
China Minsheng Banking Corp. Ltd.		26.0	4.7	0.5	0.3	$36,202
Shanghai Pudong Development Bank Co. Ltd.		21.8	3.9	0.8	0.3	$33,462
Hua Xia Bank Co. Ltd.		24.5	3.1	1.4	0.2	$22,371
Shenzhen Development Bank Co. Ltd.		84.5	4.9	0.0	0.0	$4,971
U.S.	**18.0**					
Citigroup Inc.		11.7	2.1	3.9	21.1	$68,704
Bank of America Corp.		12.3	1.8	4.2	19.5	$110,118
JPMorgan Chase & Co.		13.2	1.4	2.9	12.4	$73,682
Wells Fargo & Co.		14.8	2.7	3.1	8.2	$53,622
Wachovia Corp.		12.4	1.7	4.0	7.0	$74,303
Japan	**20.4**					
Mitsubishi UFJ Financial Group Inc.		14.1	1.9	0.7	6.6	$79,176
Mizuho Financial Group Inc.		14.2	2.9	0.9	5.5	$120,868
Sumitomo Mitsui Financial Group Inc.		13.6	2.8	0.6	5.8	$143,679
U.K.	**13.1**					
HSBC Holdings PLC		12.7	1.9	4.1	14.3	$53,227
Royal Bank of Scotland Group PLC		10.2	1.6	4.1	9.5	$68,992
Barclays PLC		11.2	2.4	4.0	5.9	$52,274
HBOS PLC		12.0	2.2	3.6	5.5	$87,145
Lloyds TSB Group PLC		12.3	2.9	6.2	4.3	$53,817
Europe ex U.K.	**14.8**					
UBS		12.7	3.3	2.2	7.5	$107,386
Banco Santander Central Hispano S.A.		11.9	2.1	3.2	7.4	$57,382
BNP Paribas S.A.		10.6	1.7	3.1	6.9	$67,523
Unicredito Italiano S.p.A.		15.3	1.9	3.3	2.9	$21,035
Banco Bilbao Vizcaya Argentaria S.A.		11.7	3.4	2.5	4.5	$47,521

Sources: Factset Reseach System, Inc. and Thomson Datastream.

Notes: Market price-earnings ratios are as of October 31, 2006 and are represented by the following indices: MSCI China, MSCI U.S., MSCI Japan, MSCI U.K., and MSCI Europe ex U.K. Price-earnings for the MSCI China Index (16.2) is significally lower than that of the Chinese A Share Market (22.4).