

Cathay Financial Holdings

2882 TT

Target (TWD): 48.60 → 58.00

Upside: 34.9%

29 Jul price (TWD): 43.00

- 1 Buy (unchanged)
- 2 Outperform
- 3 Hold
- 4 Underperform
- 5 Sell

Still in a sweet spot

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- Likely to benefit from gradual widening of gap between US and Taiwan interest rates
- Negative spread should narrow on rising interest rates
- Raising target price to TWD58; reiterate Buy rating

■ What's new

Cathay Financial Holdings (Cathay) is due to announce full 1H13 operating details by the end of August, but its preliminary earnings of TWD15bn were about 88% of the Bloomberg-consensus forecast.

■ What's the impact

Narrowing discount to embedded value (EV). The investment yield and discount rate both rise (to determine EV) in a rising interest-rate environment, but the Taiwan insurers have been trading mostly at large discounts to EVs due to legacy books. However, rising interest rates will help to reduce the negative spread.

Manageable risks in bond portfolio. YTD, US and Taiwan 10-year government bond yields have risen by 74bps and 26bps, respectively, and we estimate that Cathay's bond portfolio (both foreign and domestic) has shrunk by about TWD20bn (or 7% of 2013E group book value). Despite a MTM loss, we continue to believe the company will be a net beneficiary of rising interest rates. This is because

its relatively short asset duration (seven years, compared with 11 years for Fubon Financial [2881 TT, TWD40.8, Buy (1)] and 10 years for Shin Kong [Not rated]) can gain the biggest advantage in an improving reinvestment environment.

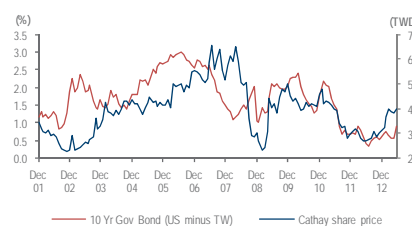
Strengthened solvency position.

Cathay already complies fully with IFRS4 phase II, which is likely to be implemented in 2015, while its solvency level should also strengthen as a result of rises in interest rates. Cathay should benefit the most among its Asia peers as more than 40% of its investment portfolio is invested overseas.

Cycle just beginning, in a sweet spot.

The gap between US and Taiwan 10-year government bond yields (US: 2.5%, Taiwan: 1.4%) has widened of late. This together with the stronger US Dollar should benefit Cathay (see following chart).

■ 10-year bond yield (US less Taiwan rates) vs. Cathay share price



Source: TEJ, Daiwa. Note: Data are as of July 24

Investor fund flow. In addition to foreign investors continuing to accumulate the stock, Taiwan investors turned net buyers in July.

We are raising our earnings forecasts by 23% for 2013 and 22% for 2014, to reflect a better investment and hedging performance.

■ What we recommend

We raise our six-month SOTP-based target price to TWD58 (from TWD48.6), now based on an implied 2013E PBR of 2.3x (2.2x previously and in line with a past-10-year average of 2.2x), and raise our 2013E EV by 20%. A risk to our view would be sharp rise in interest rates.

■ How we differ

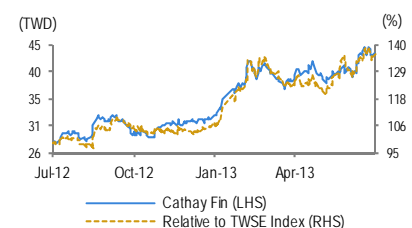
We have the highest target price among the Bloomberg-consensus constituents due to the favourable interest-rate environment, strong US Dollar, and Cathay's solvency level.

Forecast revisions (%)

Year to 31 Dec	13E	14E	15E
PPOP change	18.5	16.8	11.4
Net profit change	23.0	21.8	13.1
Core EPS (FD) change	23.0	21.8	13.1

Source: Daiwa forecasts

Share price performance



12-month range	27.57-44.23
Market cap (USDbn)	15.62
3m avg daily turnover (USDm)	36.93
Shares outstanding (m)	10,865
Major shareholder	Tsai Family (37.0%)

Financial summary (TWD)

Year to 31 Dec	13E	14E	15E
Total operating income (m)	77,487	78,553	81,612
Pre-provision operating profit(m)	40,195	41,446	44,052
Net profit (m)	33,566	34,819	36,015
Core EPS (fully-diluted)	3.089	3.205	3.315
EPS change (%)	91.0	3.7	3.4
Daiwa vs Cons. EPS (%)	26.4	23.7	28.8
PER (x)	13.9	13.4	13.0
Dividend yield (%)	2.3	2.3	2.3
DPS	1.0	1.0	1.0
PBR (x)	1.7	1.6	1.5
ROE (%)	13.0	12.3	11.8

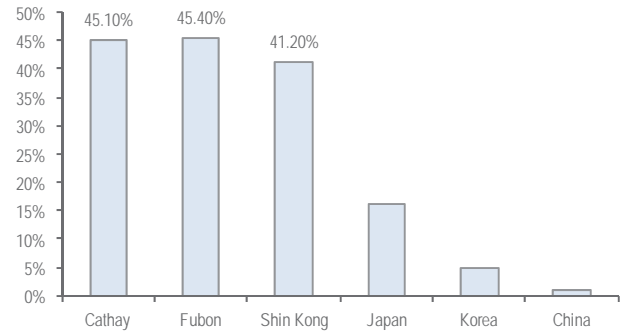
Source: FactSet, Daiwa forecasts

■ **Cathay Financial: SOTP valuation**

Entity/item	Methodology	13E Book Value	Implied 2013E PBR	Est. Value	Value per share	% of total
			(x)	(TWDm)	(TWD/share)	
Cathay Life	Adj. Embedded Value	154,682	3.2	491,518	43.8	76%
	1.0x 2013E EV			558,691	49.8	86%
	Liability MTM			(67,173)	(6.0)	(10)%
Cathay United Bank	1.3x 2013PBR	117,931	1.3	153,310	13.7	24%
Cathay Century	1.1x 2013PBR	5,427	1.1	5,969	0.5	1%
Cathay FHC	Target Price	270,622	2.4	650,798	58.0	100%
Implied upside (%)						34.9%
Current price (TWD)						43.0

Source: Daiwa estimates

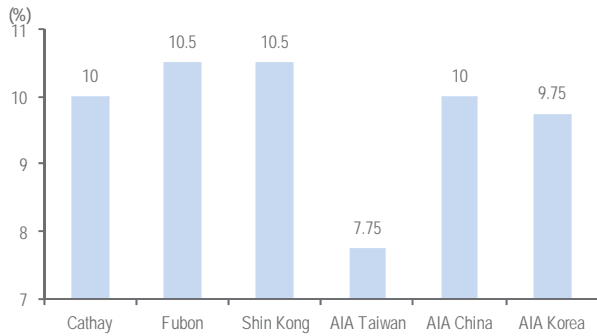
■ **Comparison: overseas investment as a % of total portfolio**



Source: Companies, Daiwa

Note: Data for Taiwan insurers is as of 1Q13

■ **Comparison of risk discount rate for EV (2012)**



Source: Companies, Daiwa

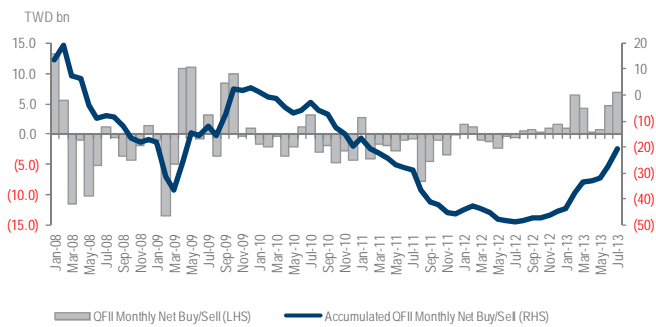
Note: Fubon adopts a value of new business rate of 10.5% and a value of in-force business rate of 11.0%

■ **Cathay Life EV forecast**

(TWDbn)	2011	2012	2013E	2014E	2015E
1) Embedded Value (EV) forecast					
Adj. Net Worth	199.0	242.0	260.0	279.1	299.7
Value of in force business (VIF)	276.0	323.0	327.7	319.3	316.4
EV	475.0	565.0	587.7	598.4	616.1
EV per share (TWD)	45.9	52.0	52.4	53.3	54.9
2) 25bps improvement in investment yield					
VIF	340.0	378.0	385.2	376.8	373.9
EV	539.0	624.0	645.2	655.9	673.6
% of improvement in EV	13%	10%	10%	10%	9%

Source: Companies, Daiwa

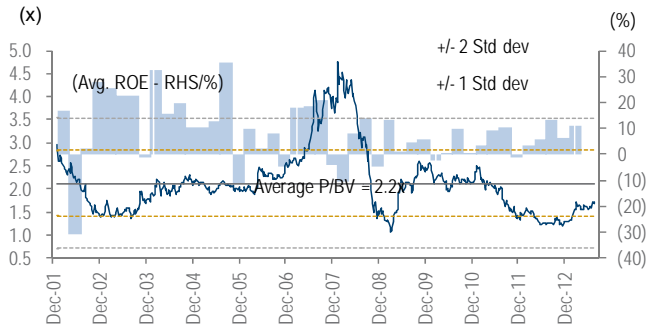
■ **Cathay Financial: QFII net buying/selling**



Source: TEJ, Daiwa

Note: Data as of 24 July 2013

■ **Cathay Financial: 12-month forward PBR vs. ROE**



Source: Taiwan Economic Journal, Daiwa

Note: Data as of 24 July 2013

Financial summary

■ Key assumptions

Year to 31 Dec	2008	2009	2010	2011	2012	2013E	2014E	2015E
FYP growth (%) - Life Insurance	19.2	27.0	26.2	(22.6)	4.6	(23.0)	(5.0)	(4.0)
Value of New Business - Life Insurance (TWD bn)	32.0	42.0	43.0	46.0	50.0	41.1	39.1	37.5
Embedded Value - Life Insurance (TWD bn)	290.0	408.0	449.0	475.0	565.0	587.7	598.4	616.1
Investment Yield (%) - Life	4.0	3.6	3.6	3.6	3.6	3.6	3.6	3.6
Net-interest margin (%) - Bank	1.7	1.1	1.0	1.2	1.3	1.3	1.3	1.3
Loan Growth (%) - Bank	6.5	1.4	9.8	11.3	0.5	5.0	5.0	10.0
Tier-1 BIS (%) - Bank	8.7	10.1	9.7	9.4	9.2	10.1	10.9	11.1
BIS (%) - Bank	11.2	12.4	11.4	11.9	12.6	13.4	14.0	13.9

■ Profit and loss (TWDm)

Year to 31 Dec	2008	2009	2010	2011	2012	2013E	2014E	2015E
Net-interest income	97,250	88,004	93,144	105,988	113,908	123,014	134,201	147,073
Net fees & commission	5,101	4,849	6,640	6,857	7,382	8,118	8,524	9,375
Trading and other income	(15,296)	11,141	17,559	10,644	33,776	80,856	71,030	61,781
Net insurance income	(54,472)	(58,091)	(84,073)	(81,561)	(101,831)	(134,501)	(135,202)	(136,617)
Total operating income	32,582	45,903	33,270	41,928	53,235	77,487	78,553	81,612
Personnel expenses	(15,995)	(16,918)	(17,676)	(19,890)	(21,143)	(23,272)	(23,056)	(23,298)
Other expenses	(11,677)	(11,839)	(12,782)	(15,291)	(17,512)	(14,019)	(14,051)	(14,261)
Total expenses	(27,671)	(28,757)	(30,458)	(35,182)	(38,655)	(37,292)	(37,107)	(37,559)
Pre-provision operating profit	4,911	17,146	2,811	6,747	14,580	40,195	41,446	44,052
Total provision	(926)	0	0	(627)	(2,126)	(1,398)	(1,165)	(2,294)
Operating profit after prov.	3,985	17,146	2,811	6,120	12,454	38,797	40,281	41,758
Non-operating income	(2,835)	(131)	865	575	607	607	626	646
Profit before tax	1,150	17,015	3,676	6,695	13,061	39,404	40,907	42,404
Tax	1,816	(4,765)	1,718	5,791	4,070	(5,709)	(5,959)	(6,261)
Min. int./pref. div./other items	(769)	(1,199)	(1,111)	(1,201)	(129)	(129)	(129)	(129)
Net profit	2,196	11,051	4,283	11,285	17,002	33,566	34,819	36,015
Adjusted net profit	2,196	11,051	4,283	11,285	17,002	33,566	34,819	36,015
EPS (TWD)	0.231	1.139	0.432	1.111	1.618	3.089	3.205	3.315
EPS (adjusted) (TWD)	0.231	1.139	0.432	1.111	1.618	3.089	3.205	3.315
EPS (adjusted fully-diluted) (TWD)	0.231	1.139	0.432	1.111	1.618	3.089	3.205	3.315
DPS (TWD)	0.000	0.500	0.600	0.500	0.700	1.000	1.000	1.000

■ Change (YoY %)

Year to 31 Dec	2008	2009	2010	2011	2012	2013E	2014E	2015E
Net-interest income	6.9	(9.5)	5.8	13.8	7.5	8.0	9.1	9.6
Non-interest income	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total operating income	(49.4)	40.9	(27.5)	26.0	27.0	45.6	1.4	3.9
Total expenses	0.9	3.9	5.9	15.5	9.9	(3.5)	(0.5)	1.2
Pre-provision operating profit	(86.7)	249.1	(83.6)	140.0	116.1	175.7	3.1	6.3
Total provisions	(77.3)	n.a.	n.a.	n.a.	239.0	(34.3)	(16.6)	96.9
Operating profit after provisions	(87.9)	330.3	(83.6)	117.7	103.5	211.5	3.8	3.7
Profit before tax	(96.6)	1,379.8	(78.4)	82.1	95.1	201.7	3.8	3.7
Net profit (adjusted)	(92.9)	403.2	(61.2)	163.5	50.7	97.4	3.7	3.4
EPS (adjusted, FD)	(93.1)	393.0	(62.1)	157.2	45.6	91.0	3.7	3.4
Gross loans	4.2	(1.8)	4.2	8.0	2.1	3.9	3.9	7.3
Deposits	5.5	17.6	2.9	9.9	3.8	3.0	3.0	3.0
Total assets	1.6	14.7	9.2	6.7	7.9	6.3	5.5	5.0
Total liabilities	4.2	13.3	9.5	7.2	7.6	6.1	5.4	4.9
Shareholders' equity	(37.2)	49.1	3.0	(2.2)	14.5	10.5	8.7	8.4
Avg interest-earning assets	4.0	8.8	11.1	7.1	6.9	8.1	7.6	7.6
Avg risk-weighted assets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Source: FactSet, Daiwa forecasts

Financial summary continued ...

■ Balance sheet (TWDm)

As at 31 Dec	2008	2009	2010	2011	2012	2013E	2014E	2015E
Cash & equivalent	448,608	723,548	742,595	814,156	806,579	1,538,606	1,709,777	1,876,977
Investment securities	1,454,037	1,657,196	1,868,219	2,040,296	2,364,406	1,959,574	2,110,793	2,259,815
Net loans and advances	1,350,093	1,328,094	1,383,988	1,493,115	1,521,106	1,578,718	1,640,283	1,759,903
Fixed assets	39,561	39,658	37,941	38,606	48,821	49,034	49,586	50,151
Goodwill	6,673	6,673	0	0	0	0	0	0
Other assets	447,297	540,368	605,529	574,974	660,276	615,434	548,950	417,570
Total assets	3,746,269	4,295,536	4,689,189	5,005,403	5,401,189	5,741,366	6,059,388	6,364,415
Customers deposits	1,114,751	1,311,397	1,349,899	1,484,029	1,539,774	1,585,967	1,633,546	1,682,553
Borrowing	158,253	84,091	94,193	80,631	86,403	90,723	95,259	100,022
Debentures	38,866	56,437	58,655	0	0	0	0	0
Other liabilities	2,288,900	2,628,187	2,963,935	3,223,031	3,526,412	3,790,362	4,032,669	4,259,131
Total liabilities	3,600,770	4,080,113	4,466,682	4,787,691	5,152,589	5,467,052	5,761,474	6,041,705
Share capital	97,375	96,709	101,544	101,544	108,654	108,654	108,654	108,654
Reserves & others	44,978	115,486	117,033	112,117	135,896	161,609	185,209	210,005
Shareholders' equity	142,353	212,195	218,577	213,661	244,549	270,263	293,863	318,659
Minority interests	3,145	3,228	3,931	4,051	4,051	4,051	4,051	4,051
Total equity & liabilities	3,746,269	4,295,536	4,689,189	5,005,403	5,401,189	5,741,366	6,059,388	6,364,415
Avg interest-earning assets	3,417,389	3,718,376	4,129,269	4,420,782	4,727,926	5,109,588	5,500,399	5,917,196
Avg risk-weighted assets	0	0	0	0	0	0	0	0
BVPS (TWD)	14.619	21.942	21.525	21.041	22.507	24.874	27.046	29.328

■ Key ratios (%)

Year to 31 Dec	2008	2009	2010	2011	2012	2013E	2014E	2015E
Loan/deposit	121.9	101.8	103.1	101.2	99.6	100.5	101.4	105.6
Tier-1 CAR	8.7	10.1	9.7	9.4	9.2	10.1	10.9	11.1
Total CAR	11.2	12.4	11.4	11.9	12.6	13.4	14.0	13.9
NPLs/gross loans	0.6	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Total loan-loss prov./NPLs	109.3	135.1	284.4	322.0	386.5	390.0	390.0	390.0
ROAA	0.1	0.3	0.1	0.2	0.3	0.6	0.6	0.6
ROAE	1.2	6.2	2.0	5.2	7.4	13.0	12.3	11.8
Net-interest margin	2.8	2.4	2.3	2.4	2.4	2.4	2.4	2.5
Gross yield	3.4	2.7	2.5	2.7	2.7	2.7	2.7	2.7
Cost of funds	1.7	0.8	0.6	0.7	0.8	0.8	0.8	0.8
Net-interest spread	1.7	1.8	1.9	1.9	1.9	1.9	1.9	1.9
Total cost/total income	84.9	62.6	91.5	83.9	72.6	48.1	47.2	46.0
Effective tax	n.a.	28.0	n.a.	n.a.	n.a.	14.5	14.6	14.8
Dividend-payout	0.0	43.9	138.9	45.0	43.3	32.4	31.2	30.2

Source: FactSet, Daiwa forecasts

■ Company profile

Cathay Financial is ranked the largest financial-holding company in Taiwan by assets, and its major subsidiaries include Cathay Life (Taiwan's largest life insurer), and Cathay Bank (Taiwan's second-largest private bank). In Mainland China, Cathay has been building up its life business since 2004, and has been operating its bank business since 2010. The Tsai family controls more than 37% of Cathay Financial.

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