10 April 2018 | Meeting Note

Hong Leong Bank Berhad
Attempting to make a mark in the digital space

Maintain **NEUTRAL**
Unchanged **Target Price (TP): RM18.55**

INVESTMENT HIGHLIGHTS

- **Attended the bank's investor day highlighting its digital transformation.**
- **Good result can be observed from the achievement of its digitization thus far.**
- **Digitization also means a transformation of its branch network.**
- **Impressive with its plans to use data analytics to boost income and reduce cost.**
- **No change to our FY18 and FY19 forecasts.**
- **Maintain NEUTRAL with unchanged TP of RM18.55 by pegging its FY19 BVPS to PBV of 1.5x.**

Investor day key take away. We attended an investor day last Thursday held by the bank. From the presentations made, we gathered that the main purpose was to highlight the banks digital achievements and plans going forward. Below a few of the key take away:

- The bank's digitization initiatives are well under way and we believe will transform how the bank will look in the medium term.
- The bank's branches are also being transform and will play a key role in on boarding its customers to its digitization efforts.
- The use of data analytics will be more prevalent as the bank lays the foundation.

Good result from digitization effort thus far. We understand that there have been a significant shift to the bank's operating model, from traditional to more digital. Its digital footprint had grown from 42% (both internet and mobile) in FY15 to 72% in 1HFY18. We observed that the immediate result from the bank's digitization effort was cost savings and cost avoidance. Based on 1HFY18 result, digitization had resulted in -3% reduction of total cost base or RM30m. In fact, CI had been on a downtrend, from 45.8% (excluding MSS cost) in FY16 to 44.1% in FY17, and in 1HFY18, it further reduced to 42.5%. From this, we concluded that there had been some contribution from digitization via increasing productivity while requiring less human resource.

Goes beyond cost savings. In addition, we believe that the result of its digitization goes beyond cost savings. We noted that it had resulted in stronger customer acquisition with the ensuing deposits and loans growth. For example, from 1QFY18 to 2QFY18, SME loans acceptance and pipeline have grown 3.6x and 2.1x to RM305m and RM380m respectively. Meanwhile, CASA grew as at 2QFY18 by +9.3%yoy to RM41.3b and was a key driver in NIM improvement.

RETURN STATS	
Price (9 April 2018)	RM18.70
Target Price	RM18.55
Expected Share Price Return	-0.8%
Expected Dividend Yield	+2.5%
Expected Total Return	**+1.7%**

STOCK INFO	
KLCI	1,849.71
Bursa / Bloomberg	5819 / HLBK MK
Board / Sector	Main / Finance
Syariah Compliant	No
Issued shares (mil)	2,045.6
Market cap. (RM'm)	37,884.5
Price over NA	1.6x
52-wk price Range	RM13.52 - RM20.02
Beta (against KLCI)	0.85
3-mth Avg Daily Vol	0.89m
3-mth Avg Daily Value	RM16.27m
Major Shareholders	
Hong Leong Financial Group	65.66%
EPF	13.42%

Some banking abbreviations used in this report:
CI = Cost-Income Ratio
CET1 = Common Equity Tier 1
GIL = Gross Impaired Loan
LDR = Loan-Deposit Ratio
NII = Net Interest Income
NOII = Non-interest income
NIM = Net Interest margin
CASA = Current and Savings Accounts
COF = Cost of Funds
PPOP = Pre-provisioning Operating Profit
LLC = Loan Loss Coverage
JV = Joint Venture with BOC in a Consumer Finance Company in China
BOC = Bank of Chengdu

Branches will be digitally transformed as well. While the bank may be changing towards mobile and online first strategy, it is not abandoning its branch network. Its branch network, which is the second largest in the country, will also be transformed with digitization at its heart. Branches will be "fit for purpose" and will take advantage of technology. For example, there will be minimal teller counters with staff redeployed to interact more with customers. Customers' data will be used to improve engagement with customers and take advantage of cross selling opportunities. The management informed us that banking halls will be reconfigured for better space utilization, such as reduction in the back room space to circa 20% of the available floor space. This will also entails more paperless transaction and digitization of information. One potential result from this initiative will be higher on boarding of new customers especially upcoming millennials and more products take up from cross selling. We also believe that there will be further cost reductions in the medium term once this initiative comes into full swing.

Branches also to be footprint to build SME business. Management also indicated that its branch network will be used to attract more SME businesses in tandem with the use of technology. Branches that are located within an SME catchment area will be used as platforms to support those SMEs that either has minimal transactions with the bank (by offering more products) or that the bank has yet to engage. Amongst the value add services that the bank is also offering are bundling of management systems such as cash management system, payroll system, HR systems and digital accounting solution amongst others. We observed that on boarding the SMEs (and corporates) towards its digital offerings have yielded results, notably the increase in product holding to 2.39 from 1.24, 70% take up rate of new product within the last 12 months and the increase in revenue (excluding cost of fund) per customer to RM14.6k from RM2.2k. We believe that this is a sound strategy as it creates a steady flow of fee income that will boost the bank's NOII in the coming years. However, we do note that the SME space is becoming more competitive and this might affect margins as rates become more commoditized. Hence, we do not discount the possibility that revenue generated from NII and NOII from SMEs might plateau later on.

Impressed with plan use of digital technology. In our opinion, the most impressive presentation had been on the bank's plan to use data analytics. The bank recognized that the banking sector has vast amount of unstructured data stemming from its customers, such as transactions done. By performing analytics on these data, the bank could engage with its customers better. Amongst the data analytics that the bank is planning or have already initiated are predictive analytics, artificial intelligence (AI), natural language processing, machine learning and deep learning. We understand that the bank have already initiated natural language processing and machine learning for its call centre where it is becoming more automated. This had resulted in higher customer satisfaction and increased productivity. For example, the number of customer relation officer (CRO) per team manager has risen from 10 to 20. Therefore, there will be potential for lowering of CI further.

Predictive analytics and AI increase likelihood of higher product take up. In terms of predictive analytics and AI, the management believe that it will be able to increase the likelihood of higher product take up. One example given was the booking of hotel for customer that had booked airline tickets using its credit card. Also, the system will be able to offer real time geo location offers for the bank's credit card customers such as restaurant discounts etc. Again, we opine that this has the potential to boost its NII and NOII from these transactions.

Worry will be on asset quality monitoring. One aspect that raised our concern was on the monitoring of asset quality. We understand that some of the lending decision will be automated. It is possible there is a build-up of assets with less favourable credit quality given the potential error in constructing the parameters. While there are available credit data such as CTOS that can be used for analysis of credit worthiness, we believe more comprehensive data is needed to ensure the robustness of the system. We understand that such data are yet to be available for usage.

Noteworthy and exciting but it will be for the medium term. Overall, we believe that the bank's achievement and plans for its digital transformation are both noteworthy and exciting. In our view, its digitization plan will change the facet of the bank in terms of operational and future direction. However, we believe that this transformation journey will bear it fruit in the medium term as the bank will have to continue to build the overlaying infrastructure. We understand that any cost savings from its current initiative will be ploughed back to invest for the initiatives planned.

FORECAST

Our FY18 and FY19 forecast remains unchanged given its digital transformation will likely yield any result in the medium term.

VALUATION AND RECOMMENDATION

While the bank's digital plan is both noteworthy and exciting, we believe that the catalyst to its earnings will only be in the medium term. Hence, we are maintaining our NEUTRAL recommendation given that we do not believe that there will be any further upside to its near term earnings. We also believe that any positives for FY19 have already been priced in. Our unchanged TP of RM18.55 is based on pegging its FY19 BVPS to its 5-year historical average PBV of 1.5x.

INVESTMENT STATISTICS

FYE June	FY16	FY17	FY18F	FY19F
Net interest income (RM'm)	2,655	2,854	3,052	3,264
Islamic banking income (RM'm)	467	550	660	673
Non-interest income (RM'm)	1,055	1,146	1,200	1,276
Total income (RM'm)	4,178	4,551	4,912	5,212
Pretax profit (RM'm)	2,382	2,748	3,060	3,194
Net profit (RM'm)	1,903	2,145	2,417	2,523
Core net profit (RM'm)	2,034	2,247	2,417	2,523
Core EPS (sen)	99.1	109.9	118.2	123.4
PER (x)	18.9	17.0	15.8	15.2
Net dividend (sen)	41	45	47	47
Net dividend yield (%)	2.2	2.4	2.5	2.5
Book value per share (RM)	10.32	11.09	11.64	12.35
PBV (x)	1.8	1.7	1.6	1.5
ROE (%)	10.7	9.8	10.4	10.3

Forecast by MIDFR

DAILY PRICE CHART
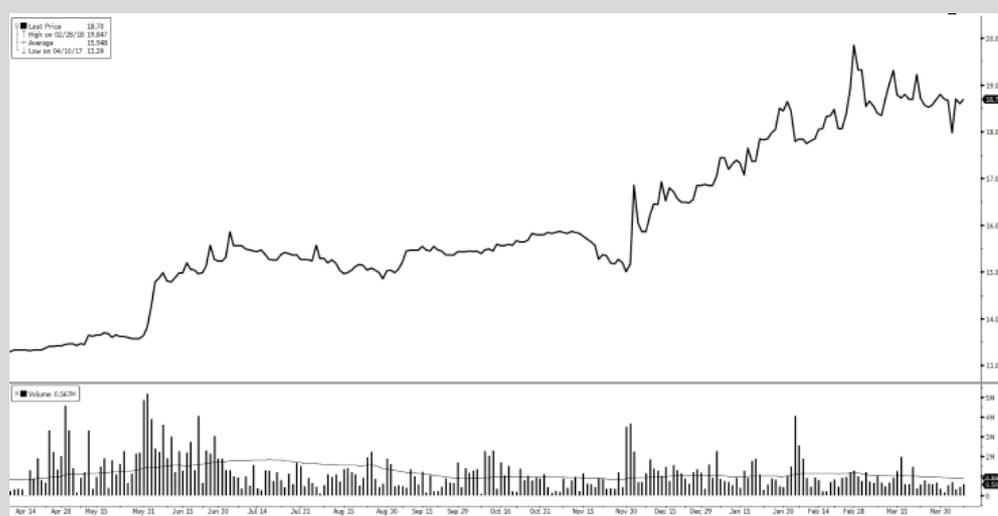
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(Bank Pelaburan)

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MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS	
STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >10% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >10% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -10% and +10% over the next 12 months.
SELL	*Negative* total return is expected, by -10% or more, over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >10% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.
SECTOR RECOMMENDATIONS	
POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.