Financials

Internet Finance: From Creative Disruption to Disruptive Creation

Key Takeaway

E-commerce entrants (ECE) are most disruptive to banks & brokers, while insurers are more insular due to product niches. We see ECE pressuring bank funding, offset by a growing Internet economy that drives higher fee income and even interest income for some banks at the expense of peripheral financiers that charge high double-digit rates. Brokers' commission rate pressure may intensify, offset by new revenues from capital market reforms.

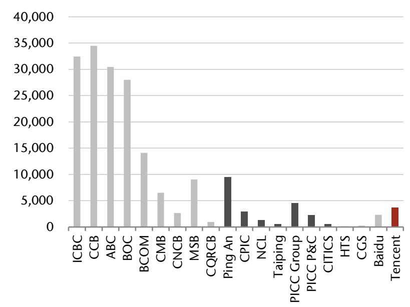
With technology potentially displacing traditional competitive edges (like network & service) in China, banks with strong retail franchise may ironically underperform. ICBC (1398 HK) and MSB (1988 HK) seem most resilient, Ping An (2318 HK) is our top pick among insurers given its first mover advantages, while we like CITICS (6030 HK) given its lower dependence on the brokerage business.

Banks – Internet hurting bank economics but it can help too: ECE's aggressive innovation in online finance is accelerating the "marketization" of funding cost that will come with full deposit rate deregulation anyway, resulting in quicker NIM compression and loss of some fee income (e.g. in settlement), in our view. However, we believe some banks will defend their turf proactively through business mix changes (e.g. capturing some of the high double-digit rates that P2P firms enjoy), while simultaneously expanding their online channels to capture new business opportunities (e.g. bank-owned e-commerce platform). For all its disruptions, we see a growing Internet economy that results in a consumption/ private-sector driven economy as ultimately beneficial for banks too, as exemplified in the rapid growth in card usage. Finally, while regulators are currently tolerant of ECE's foray into finance to spur private sector growth, we believe stricter rules will be in place once they become sizeable enough to create systemic risks, as shown by the Dec 5 clampdown on Bitcoin by the PBOC. In fact, the PBOC is currently tasked under Doc 107 from the State Council to come up with rules to regulate Internet financing companies to prevent them from using technologies to operate beyond their scope of business. Thus, we believe banks will remain the dominant players in finance.

Insurance – e-commerce distribution suitable only for standardized products: In exploring new distribution channels for insurance products, Internet is perhaps one of the most obvious opportunities out there. In our view, successful application of e-commerce platform for insurance distribution is highly dependent on insurance product lines, with the level of personalization for life insurance products ill-suited for Internet distribution. Ping An is the only listed insurance company in China that actively attempts to build out its own e-commerce platform thus far, and it appears that a large part of its efforts is not to directly apply e-commerce to build new distribution, but to use e-commerce data to support its traditional business lines.

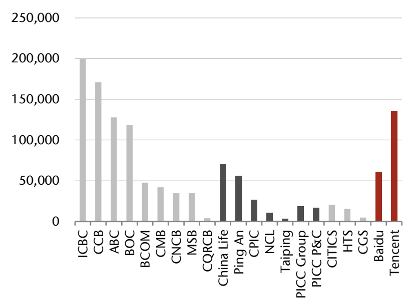
Brokers – commission rate challenged, but new business drivers abound with capital market reforms: Even without ECE, we expect brokers' commission rate to be pressured by the advent of online & witness-based securities account opening, though the development of online brokers may still exacerbate price competition in the industry. Given the uncertainty surrounding the issuance of new online brokerage license and the rapid development of brokers' own online channels, we believe the industry's leading brokers will grab market share before ECE join the competition. While still meaningful, the brokerage business now accounts for less than 50% of the industry's revenue, and we expect its share to fall with capital market reforms in China boosting contributions from other businesses like margin lending and asset management, which may be positively impacted by the Internet's channel advantages (e.g. cost & scale of distribution).

Financials vs. Internet - capex (FY12, Rmb mn)



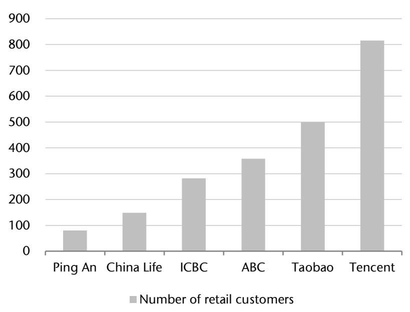
Source: Company data, Jefferies

Financials vs. Internet - market cap (US$ mn)



Source: Bloomberg, Jefferies

Financials vs. Internet - customer base (mn)



Source: Company data, Jefferies

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Exhibit 1: Internet's impact on China Financials

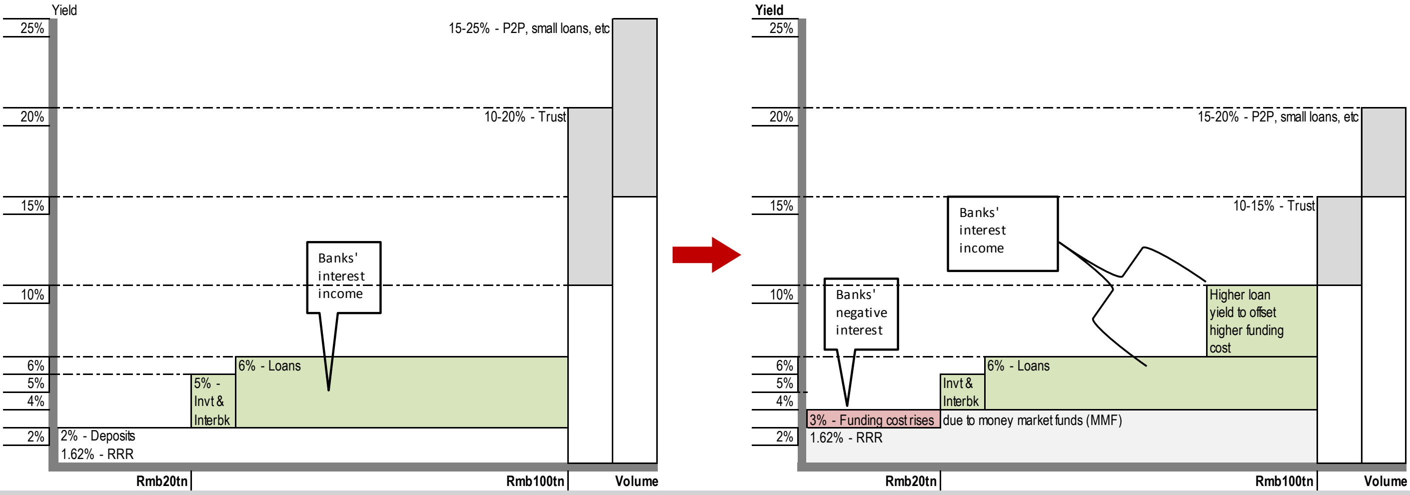
Banks		ECE?	Remarks	ICBC	CCB	ABC	BOC	BCOM	CMB	CNCB	MSB	CQRCB	Avg
Spread													
Negative	Deposits - Household	Yes	Demand deposit mix, 1H13	21%	19%	28%	18%	12%	21%	4%	6%	20%	17%
	Deposits - Corporate	Maybe	Demand deposit mix, 1H13	27%	32%	24%	26%	31%	30%	37%	29%	22%	29%
			Total demand deposit mix, 1H13	48%	51%	52%	44%	43%	52%	41%	35%	42%	45%
Positive	Loans	Yes	1. Bank rates cheaper than ECE's; 2. Internet allows banks to tap smaller customers										
Fees													
Negative	Settlement, clearing, cash management	Yes	% revenue, FY12	5%	2%	5%	4%	1%	2%	3%	2%	0%	3%
	Trust & agency services	Yes	% revenue, FY12	0%	3%	4%	4%	1%	3%	1%	6%	1%	2%
			Total % revenue, FY12	**5%**	**5%**	**9%**	**7%**	**2%**	**5%**	**4%**	**8%**	**1%**	**5%**
Neutral	Investment banking / consultancy & advisory	Unlikely	Bespoke products/services										
	Wealth management & private banking	Unlikely	Bespoke products/services										
	Guarantee & commitment services	Unlikely	Bank-specific products/services										
Positive	Bank card services	Yes	% revenue, FY12	4%	4%	3%	4%	5%	5%	4%	5%	1%	4%
	Asset custody	Yes	% revenue, FY12	1%	2%	1%	1%		4%	0%	2%	0%	1%
			Total % revenue, FY12	**5%**	**6%**	**3%**	**4%**	**5%**	**9%**	**4%**	**7%**	**1%**	**5%**

Brokers		ECE?	Remarks	CITICS	HTS	CGS	Avg
Negative	Brokerage	Yes	% revenue, FY12	28%	31%	51%	37%
Neutral	Investment banking	Unlikely	Bespoke products/services				
	Margin lending	Maybe	ECE does not have funding advantage				
Positive	Asset management	Yes	% revenue, FY12	2%	8%	1%	4%

Insurance		ECE?	Remarks	Ping An	China Life	CPIC	NCL	Taiping	PICC Group	PICC	Avg
Negative	Auto insurance	Yes	% revenue, 1H13	23%	0%	32%	0%	14%	50%	69%	27%
	Accident and other short-term insurance	Yes	% revenue, 1H13	3%	6%	3%	3%	1%	6%	5%	4%
			Total % revenue, 1H13	**26%**	**6%**	**35%**	**3%**	**15%**	**57%**	**73%**	**31%**
Positive	Product distribution	Yes	Internet helps industry to grow faster								

Source: Company data, Jefferies estimates

Exhibit 2: Banks may leverage on the Internet's platform to reach a larger group of under-served & high-paying customers, at the expense of peripheral financing companies like P2P and small loan companies but net positive for the economy



Source: Jefferies estimates

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Exhibit 3: China Financials' valuation comparison

Ticker HK	Ticker CH	Rmb/HK$ 1.267	Price on 20-Feb-14 HK (HK$)	Price on 20-Feb-14 CH (Rmb)	Mkt Cap (LC mn)	P/B 2013E	P/B 2014E	P/E 2013E	P/E 2014E	Dividend Yield 2013E	Dividend Yield 2014E	P/EV 2013E	P/EV 2014E	3M ADT LC mn	PT (LC)	Upside/ Downside	JEF Rating	YTD Total Rtn
1398	601398	ICBC-H	4.71	3.44	1,554,447	1.00x	0.87x	5.0x	4.7x	7.1%	7.6%			1,232	6.80	44.4%	BUY	-10.1%
939	601939	CCB-H	5.32	3.99	1,327,519	0.97x	0.85x	5.0x	4.6x	7.1%	7.6%			1,528	7.90	48.5%	BUY	-9.1%
1288	601288	ABC-H	3.38	2.38	990,609	1.00x	0.88x	5.2x	4.8x	6.7%	7.3%			440	4.70	39.1%	BUY	-11.3%
3988	601988	BOC-H	3.27	2.61	920,021	0.78x	0.69x	4.9x	4.4x	7.4%	8.3%			982	4.90	49.8%	BUY	-8.4%
3328	601328	BCOM-H	5.04	3.90	370,410	0.70x	0.62x	4.7x	4.3x	6.4%	7.0%			119	6.50	29.0%	HOLD	-7.9%
3968	600036	CMB-H	14.40	10.35	326,828	1.06x	0.92x	5.3x	5.0x	5.3%	6.0%			369	17.70	22.9%	BUY	-12.8%
998	601998	CNCB-H	4.29	5.08	269,198	0.71x	0.62x	4.9x	4.2x	4.1%	4.8%			149	5.20	21.2%	BUY	1.9%
1988	600016	MSB-H	7.98	7.80	269,333	0.89x	0.72x	4.1x	3.5x	4.9%	5.8%			378	11.90	49.1%	BUY	-7.3%
3618		CQRCB	3.35		31,155	0.67x	0.60x	4.1x	3.7x	7.4%	8.1%			51	4.60	37.3%	BUY	-10.9%
		Average				0.86x	0.75x	4.8x	4.3x	6.3%	7.0%					37.9%		-8.4%
2628	601628	China Life-H	22.80	14.20	544,303	2.08x	1.84x	18.8x	15.1x	1.9%	2.4%	1.32x	1.18x	882	23.50	3.1%	HOLD	-6.0%
2318	601318	Ping An-H	64.45	38.58	435,675	2.20x	1.87x	14.3x	11.9x	1.4%	1.7%	1.19x	1.02x	1,131	83.10	28.9%	BUY	-7.2%
2601	601601	CPIC-H	27.30	16.44	206,639	1.89x	1.75x	18.9x	16.3x	1.9%	2.1%	1.31x	1.20x	284	33.00	20.9%	BUY	-10.2%
1336	601336	NCL-H	24.75	22.34	84,622	1.51x	1.31x	13.5x	10.2x	0.7%	1.0%	0.92x	0.81x	244	29.00	17.2%	BUY	-4.8%
966		CTIH	14.26		24,317	1.61x	1.39x	19.4x	12.4x	0.0%	0.0%	0.85x	0.74x	54	14.50	1.7%	HOLD	-10.0%
1339		PICC Group	3.47		147,210	1.56x	1.31x	13.3x	10.3x	0.0%	0.0%	1.28x	1.12x	3	3.60	3.9%	HOLD	-7.5%
2328		PICC P&C	10.72		131,386	1.87x	1.58x	10.7x	10.3x	0.0%	0.0%			210	10.50	-2.1%	HOLD	-6.8%
		Average				1.82x	1.58x	15.6x	12.4x	0.8%	1.0%	1.15x	1.01x			10.5%		-7.5%
1299		AIA	37.35		449,843	2.12x	1.94x	19.7x	17.5x	1.1%	1.3%	1.74x	1.58x	820	44.00	17.8%	BUY	-4.0%
6030	600030	CITICS-H	16.72	11.15	158,692	1.65x	1.54x	29.2x	18.1x	1.4%	2.2%			229	22.00	31.6%	BUY	-20.9%
6837	600837	Haitong-H	11.04	10.11	120,133	1.36x	1.28x	22.1x	15.6x	1.8%	2.6%			166	14.80	34.1%	BUY	-18.2%
6881		CGS	5.07		38,213	1.16x	1.07x	13.4x	10.9x	1.7%	2.3%			112	7.00	38.1%	HOLD	
		Average				1.39x	1.30x	21.6x	14.9x	1.6%	2.4%					32.8%		-19.6%
1359		Cinda	4.80		174,032	1.71x	1.55x	13.6x	12.3x	1.3%	2.0%			n/a	5.80	20.8%	HOLD	-0.8%

Ticker HK	Ticker CH	US$/HK$ 7.76	A/H Premium	Mkt Cap (US$ mn)	ROAE 2013E	ROAE 2014E	ROAA 2013E	ROAA 2014E	BVPS Growth 2013E	BVPS Growth 2014E	Profit Growth 2013E	Profit Growth 2014E	ROEV 2013E	ROEV 2014E	NBV Growth 2013E	NBV Growth 2014E
1398	601398	ICBC	-7.5%	200,315	21.7%	20.4%	1.43%	1.41%	15.2%	14.8%	10.3%	7.9%				
939	601939	CCB	-5.0%	171,072	20.9%	19.6%	1.44%	1.39%	15.2%	14.2%	9.6%	7.5%				
1288	601288	ABC	-10.8%	127,656	20.5%	19.5%	1.19%	1.18%	15.0%	14.2%	13.8%	9.0%				
3988	601988	BOC	1.1%	118,559	17.5%	17.5%	1.21%	1.22%	11.9%	12.8%	9.9%	12.0%				
3328	601328	BCOM	-2.0%	47,733	15.6%	15.3%	1.12%	1.08%	11.7%	11.7%	7.6%	9.3%				
3968	600036	CMB	-8.9%	42,117	21.4%	19.8%	1.36%	1.36%	15.4%	15.8%	11.4%	15.0%				
998	601998	CNCB	50.0%	34,690	15.3%	15.9%	1.01%	1.04%	12.4%	14.2%	4.1%	17.9%				
1988	600016	MSB	23.8%	34,708	24.1%	22.9%	1.34%	1.46%	23.6%	23.5%	16.8%	17.6%				
3618		CQRCB		4,015	17.7%	17.1%	1.29%	1.21%	14.2%	13.3%	13.0%	9.8%				
		Average			19.4%	18.7%	1.27%	1.26%	15.0%	14.9%	10.7%	11.8%				
2628	601628	China Life	-21.1%	70,142	11.7%	13.1%	1.38%	1.59%	10.5%	13.2%	144.3%	25.1%	15.4%	14.7%	1.2%	3.0%
2318	601318	Ping An	-24.2%	56,144	16.5%	17.0%	1.14%	1.13%	14.7%	17.0%	40.8%	20.1%	19.2%	18.4%	10.0%	7.1%
2601	601601	CPIC	-23.7%	26,629	10.3%	11.1%	1.45%	1.51%	7.6%	8.1%	103.3%	15.8%	17.9%	16.8%	5.6%	6.4%
1336	601336	NCL	14.4%	10,905	11.9%	13.7%	0.85%	0.98%	12.7%	15.4%	54.4%	31.8%	16.2%	15.1%	-3.0%	2.8%
966		CTIH		3,134	8.7%	12.1%	0.46%	0.58%	16.5%	13.7%	33.8%	56.9%	20.2%	16.0%	25.9%	5.6%
1339		PICC Group		18,970	13.7%	14.7%	1.69%	1.90%	15.3%	19.8%	27.8%	29.6%			0.7%	14.1%
2328		PICC P&C		16,931	19.2%	16.6%	3.34%	3.24%	35.3%	18.1%	-1.4%	8.6%				
		Average			13.1%	14.0%	1.47%	1.56%	16.1%	15.1%	57.5%	26.8%	17.8%	16.2%	6.7%	6.5%
1299		AIA		57,970	10.9%	11.6%	2.06%	2.08%	2.0%	9.4%	-2.4%	12.3%	12.7%	13.5%	22.6%	17.1%
6030	600030	CITICS-H	-15.5%	20,450	5.7%	8.8%	2.32%	2.74%	1.9%	6.8%	17.5%	61.0%				
6837	600837	Haitong-H	16.0%	15,481	6.3%	8.5%	2.74%	3.11%	4.5%	6.3%	24.9%	41.7%				
6881		CGS		4,924	9.6%	10.3%	2.73%	2.71%	48.7%	8.7%	46.4%	33.5%				
		Average			7.2%	9.2%	2.60%	2.85%	18.4%	7.3%	29.6%	45.4%				
1359		Cinda		22,427	12.5%	13.2%	2.82%	3.01%	20.6%	10.2%	14.4%	32.3%				

Source: Bloomberg, Jefferies estimates

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Banks: Internet hurting bank economics but it can help too

For all its disruptions, we see a growing Internet economy that results in a consumption/private-sector driven economy as ultimately beneficial for banks too

We believe ECE's aggressive innovation in online finance is accelerating the deregulation of funding costs, resulting in quicker NIM compression and loss of some fee income. However, we expect some banks to defend their turf proactively through business mix changes, while simultaneously expanding their online channels to capture new business opportunities. For all its disruptions, we see a growing Internet economy that results in a consumption/private-sector driven economy as ultimately beneficial for banks too, as exemplified in the rapid growth in card usage. Finally, while regulators are currently tolerant of ECE's foray into finance to spur private sector growth, we believe stricter rules will be in place once they become sizeable enough to create systemic risks. Thus, we believe banks will remain the dominant players in finance.

Spread business seeing higher funding costs but can reach more profitable customers

Interest rate deregulation is bound to happen even without ECE; banks may offset higher funding cost with more high-yield lending

Online WMP innovations are accelerating the "marketization" of funding costs for banks, which are bound to see higher funding cost when deposit rates are fully deregulated anyway, in our view. However, we believe the Internet also offers banks the opportunities to offset the higher funding cost, by leveraging the platform's scale and cost advantages to reach a larger group of small borrowers who hitherto are not well served by banks and are paying high double-digit interest rates to get credit.

Online WMP innovations accelerating the "marketization" of funding costs…

AUM of the most popular online WMP, YuEBao, a money market fund (MMF) issued by Alibaba (unlisted) and Tianhong Fund in mid-2013, has increased to Rmb400bn by mid-February in less than 8 months. YuEBao is attractive given its good liquidity, online payment function, money market yield and low entry barrier. Following the success of YuEBao, other similar ECE products are now available, such as Tencent's (700 HK; Buy) LiCaiTong and Baidu's (BIDU; Buy) BaiFa & BaiZhuan products.

Exhibit 4: YuEBao is attractive vs. other similar investment choices

	Demand deposit	Time deposit	Low-risk bank WMP	Money market fund	YuEBao
Yield	0.350-0.385%	3.00-4.75% (1-5Y)	4-6% (money market rate)	4-6% (money market rate)	4-6% (money market rate)
Term	On demand	1-5 years	1-6 months	On demand (T+1)	On demand
Payment function	Payable	Payable	N/A	N/A	Payable online
Entry barrier	N/A	Rmb50	Rmb50k	Rmb1-1000	Rmb1

Source: Jefferies

Banks' funding cost may rise even without deposit rate deregulation as rapidly growing money market funds invest in contractual or interbank deposits

We do not believe system deposits will decline meaningfully as a result of the development of MMF, as a big proportion of these funds (80-90%) invest in bank deposits as contractual or interbank deposits (remaining 10-20% invest in low-risk bonds and interbank repo securities). However, these contractual/interbank deposits require much higher interest rates than demand deposits. Thus, banks' funding cost may rise even without deposit rate deregulation, and we expect banks' deposit cost to increase from c.2% to 3% over time, as demand deposits (esp. household demand deposits) shift to MMF and return to banks' balance sheets at higher interbank market rates (c.3-5%).

In the US, banks have been offering money market accounts since 1982 before interest rates were fully deregulated in 1986. The proportion of time deposits was generally stable during interest rate deregulation in the US (actually increased during 1973-1982, but declined significantly when interest rates collapsed post-GFC), as deposit mix shift occurred mainly from demand deposits to savings deposits (which include money market deposits), with demand deposits declining from 38% in 1973 to 20% in 1986 (when interest rates were fully deregulated) and 11% in 2013 (i.e. 70% of demand deposits shifted to savings deposits).

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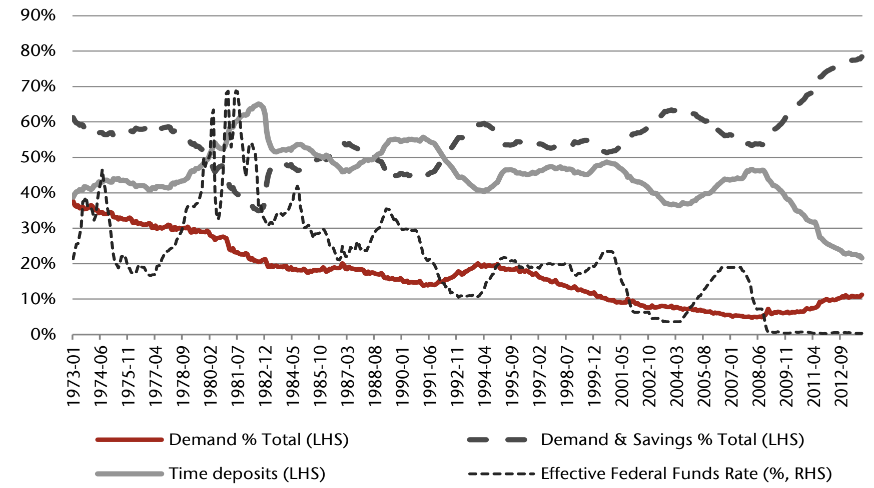
Exhibit 5: Deposit mix shifts mainly from demand to savings in the US



Source: Federal Reserve Economic Data, Jefferies

ABC's profitability is most at risk of higher funding cost due to its higher-than-peers' mix of household demand deposits; technology may displace its network advantage in rural China

...potentially eroding the competitive edge of some banks with strong retail deposit franchise as technology displaces network & service advantages...

We assume China sees similar long-term demand deposit trend as in the US (i.e. 70% of demand deposits shift to MMF), consisting roughly of:

- 90% of household demand deposits shifting to MMF, given more flexibility in consumption behavior and timing; and
- 50% of corporate demand deposits making such a shift, given more constraints in daily operating cash needs for businesses to function smoothly.

Exhibit 6: Financial impact (<u>static & compressed in single-year impact</u>) as demand deposits shift to money market funds (MMF) – ABC most at risk, ICBC & MSB seem most resilient, and the sector delivers about 12% ROE

2014E		ICBC	CCB	ABC	BOC	BCOM	CMB	CNCB	MSB	CQRCB	Average
Non-bank deposit cost		2.02%	2.03%	1.98%	1.93%	2.04%	1.75%	2.25%	2.44%	2.10%	2.06%
Interbank deposit cost		2.55%	3.03%	3.54%	2.84%	4.77%	3.82%	3.16%	4.31%	4.46%	3.61%
Interest cost delta:	**% to MMF**										
Corporate demand deposits	50%	0.93%	1.16%	1.42%	1.07%	2.04%	1.56%	1.23%	1.81%	1.88%	1.45%
Corporate time deposits	0%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Personal demand deposits	90%	1.95%	2.37%	2.84%	2.21%	3.95%	3.09%	2.49%	3.53%	3.66%	2.90%
Personal time deposits	0%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
1H13 deposit mix:											
Corporate demand deposits		27%	32%	24%	26%	31%	30%	37%	29%	22%	29%
Corporate time deposits		23%	21%	13%	27%	35%	33%	45%	48%	3%	28%
Personal demand deposits		21%	19%	28%	18%	12%	21%	4%	6%	20%	17%
Personal time deposits		27%	27%	31%	26%	21%	15%	13%	17%	53%	26%
Funding cost increase		**0.66%**	**0.83%**	**1.14%**	**0.67%**	**1.11%**	**1.13%**	**0.57%**	**0.73%**	**1.15%**	**0.89%**
Non-bank deposit avg. balance		15,982,679	13,251,507	12,768,992	10,732,205	4,448,873	3,101,546	2,863,161	2,372,472	379,391	
Additional funding cost		104,802	109,889	145,661	72,283	49,314	34,962	16,192	17,281	4,359	
PBT		368,842	296,273	233,976	229,011	89,337	76,290	51,263	69,774	8,771	
Impact on PBT		(27%)	(35%)	(59%)	(30%)	(52%)	(43%)	(30%)	(23%)	(47%)	(38%)
Adjusted ROE		**14.9%**	**12.7%**	**8.0%**	**12.3%**	**7.3%**	**11.2%**	**11.2%**	**17.5%**	**9.1%**	**11.6%**
COE		12.5%	12.5%	13.4%	13.0%	14.3%	14.7%	14.3%	15.3%	16.0%	14.0%
Terminal growth		3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
Fair P/B		**1.25x**	**1.02x**	**0.49x**	**0.92x**	**0.38x**	**0.70x**	**0.72x**	**1.18x**	**0.47x**	**0.79x**
Current 2014E P/B	20-Feb-14	0.87x	0.85x	0.88x	0.69x	0.62x	0.92x	0.62x	0.72x	0.60x	0.75x
Upside/downside		**44%**	**20%**	**(45%)**	**33%**	**(39%)**	**(24%)**	**16%**	**65%**	**(22%)**	**6%**

Source: Company data, Jefferies estimates

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Sector ROE may range from 8% to 14% depending on regulatory actions and magnitude of demand deposits shifting to MMF, if banks do not offset the higher funding cost by deploying the funds in higher yielding assets

Under these assumptions, our static analysis of the financial impact on individual banks as demand deposits shift to higher-yielding MMF, compressing this shift into a single-year event, suggests ABC's profitability is most at risk of higher funding cost due to its higher-than-peers' mix of household demand deposits. Technology may thus displace its network advantage in getting low-cost deposits from rural China. ICBC & MSB seem most resilient, while the sector delivers about 12% ROE.

Assuming regulatory constraints reduce the magnitude of demand deposits shifting to MMF, and only 30% of corporate and 70% of household demand deposits (about 50% of overall demand deposits) make the shift, the sector's average ROE increases to 14%. In a worst case scenario, assuming 90% of all demand deposits shift to MMF, the sector's average ROE drops to 8%, with only ICBC, BOC & MSB delivering double-digit returns.

Exhibit 7: Sector may deliver 14% ROE if regulatory constraints limit the magnitude of demand deposits shifting to MMF

2014E		ICBC	CCB	ABC	BOC	BCOM	CMB	CNCB	MSB	CQRCB	Average
Interest cost delta:	**% to MMF**										
Corporate demand deposits	30%	0.42%	0.56%	0.71%	0.50%	1.08%	0.80%	0.60%	0.94%	0.99%	0.73%
Corporate time deposits	0%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Personal demand deposits	70%	1.44%	1.77%	2.13%	1.64%	2.99%	2.32%	1.86%	2.67%	2.77%	2.18%
Personal time deposits	0%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Impact on PBT		**(17%)**	**(22%)**	**(40%)**	**(19%)**	**(33%)**	**(28%)**	**(16%)**	**(14%)**	**(32%)**	**(24%)**
Adjusted ROE		**17.0%**	**15.3%**	**11.7%**	**14.2%**	**10.3%**	**14.2%**	**13.4%**	**19.8%**	**11.7%**	**14.2%**

Source: Company data, Jefferies estimates

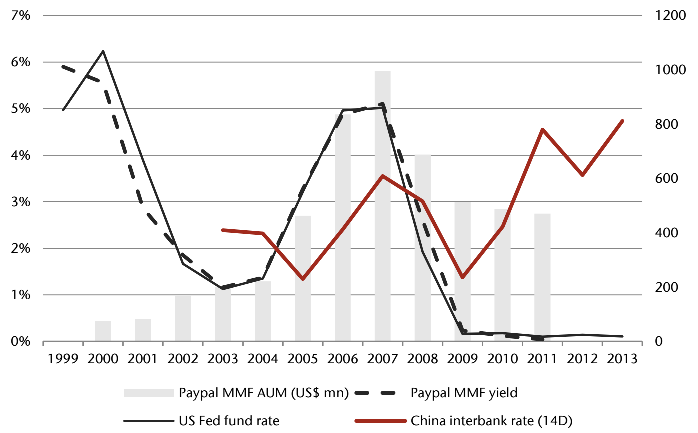
Exhibit 8: Sector ROE may fall to 8% ROE if 90% of all demand deposits shift to MMF, with only ICBC, BOC & MSB delivering double-digit returns

2014E		ICBC	CCB	ABC	BOC	BCOM	CMB	CNCB	MSB	CQRCB	Average
Interest cost delta:	**% to MMF**										
Corporate demand deposits	90%	1.95%	2.37%	2.84%	2.21%	3.95%	3.09%	2.49%	3.53%	3.66%	2.90%
Corporate time deposits	0%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Personal demand deposits	90%	1.95%	2.37%	2.84%	2.21%	3.95%	3.09%	2.49%	3.53%	3.66%	2.90%
Personal time deposits	0%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Impact on PBT		**(38%)**	**(52%)**	**(76%)**	**(43%)**	**(80%)**	**(61%)**	**(55%)**	**(39%)**	**(63%)**	**(56%)**
Adjusted ROE		**12.6%**	**9.5%**	**4.6%**	**10.0%**	**3.0%**	**7.7%**	**7.3%**	**13.9%**	**6.3%**	**8.3%**

Source: Company data, Jefferies estimates

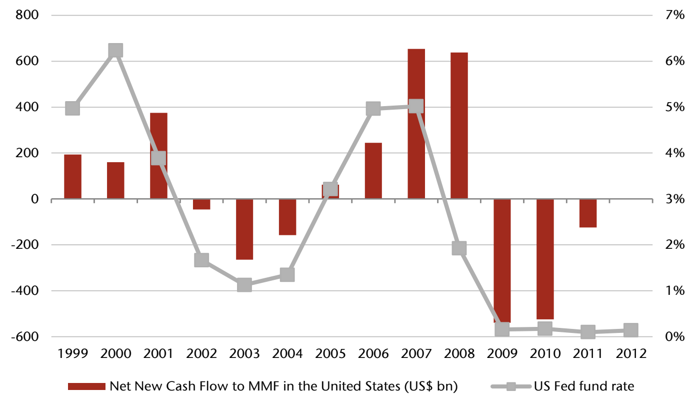
Even though US banks have been offering money market accounts since 1982 before interest rates were fully deregulated in 1986, Paypal's MMF took off in 2005-2007, riding on the rising interest rate cycle and the product's novelty, in our view. As interest rates collapsed post-GFC, Paypal's MMF had to shut down in 2011 as it began to incur losses since 2009 (as Paypal had to cut mgmt fees to maintain product yield).

Exhibit 9: Paypal's MMF experience – a (multi-year) fad...



Source: Paypal, Wind, CEIC, Jefferies

Exhibit 10: ...riding on high interest rates



Source: Investment Company Institute, CEIC, Jefferies

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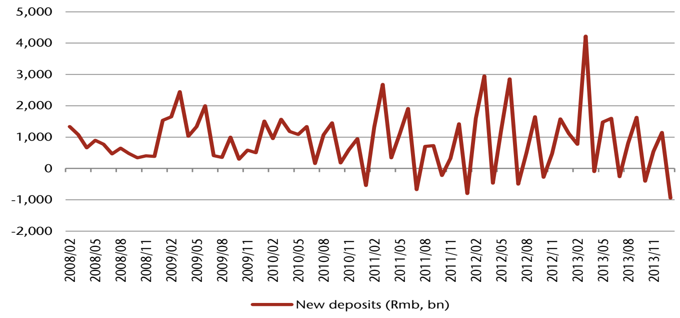
While most other financial systems were deregulated (thus more competitive) before being challenged by ECE, we believe the reverse is happening in China, with the rapid development of online WMP pressuring the banks to offer even more higher-yielding savings products (e.g. WMP) before full deposit rate deregulation. In fact, Jan 2014's system RMB deposits had the steepest decline since PBOC data was available from Jan 2000.

Exhibit 11: Jan 2014's system RMB deposits had the steepest decline since PBOC data was available



Source: PBOC, Jefferies

Exhibit 12: Bank funding cost may increase by 1ppt as demand deposits shift to MMF…

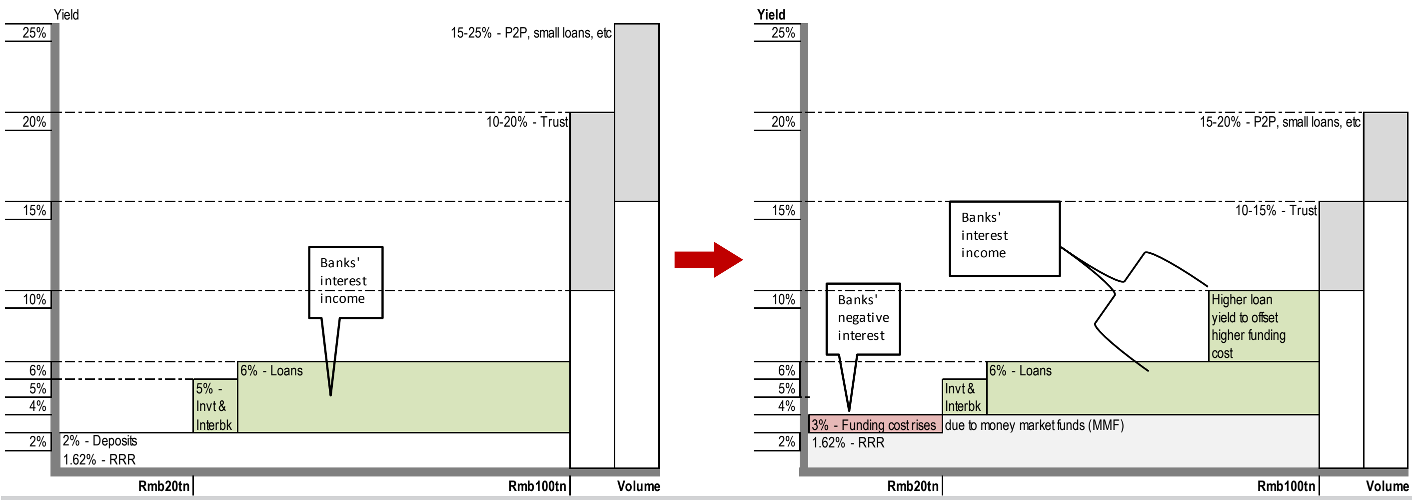
Dec 2013 System RMB deposits	Rmb bn	Mix	% shift to MMF at 4%	Interest delta
Household	46,137	56%		
Demand	17,805	22%	90%	3.25%
Time	28,332	34%	0%	0%
Corporate	36,156	44%		
Demand	14,552	18%	50%	1.65%
Time	21,603	26%	0%	0%
Total	**82,293**	**100%**		**0.99%**

Source: PBOC, Jefferies estimates

…but the Internet also offers banks the opportunities to reach a larger group of high-paying customers

Although higher funding cost may be inevitable (either with online WMP or interest rate deregulation), we believe banks may be able to offset this by leveraging the Internet platform's scale and cost advantages to reach a larger group of small borrowers who hitherto are not well served by banks and are paying high double-digit interest rates to get credit. Currently, bank loans only yield around 6.5%, which is much lower than the yield trust companies (10-20%) or small loan companies (15-25%) are getting, as big company loans still account for a large part of the banks' loan books.

Exhibit 13: …But banks may leverage on the Internet's platform to reach a larger group of under-served & high-paying customers, at the expense of peripheral financing companies like P2P and small loan companies but net positive for the economy



Source: Jefferies estimates

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With recent news (SCMP, Feb 10) that investors who lent on China's P2P lending platforms saw Rmb1.2bn in losses in 2013 due to a surge in defaults and collapses at such firms, the window may be open for more established financial companies to serve this market segment. Early movers in this regard are CMB and Ping An, targeting SMEs and individuals through their e-Home and Lufax platforms, respectively.

Exhibit 14: CMB's P2P platform targets SMEs

Source: Company data, Jefferies

Exhibit 15: Ping An's P2P platform targets individuals

Source: Company data, Jefferies

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Exhibit 16: P2P platform comparison – CMB vs. Ping An

P2P platform	CMB	Ping An
Target customers	SMEs	Individuals
Amount per deal	Rmb0.9-50mn	Rmb10-300K
Investment yield to investor:	1.2x benchmark rates	1.4x benchmark rates
Charges to platform provider:	Guaranteed by acceptance issued by CMB; acceptance issuance fees and P2P commissions charged by CMB	Guarantee fees approx 9.6%-13.2% p.a.

Source: Company data, Jefferies

Fee business not a zero-sum game

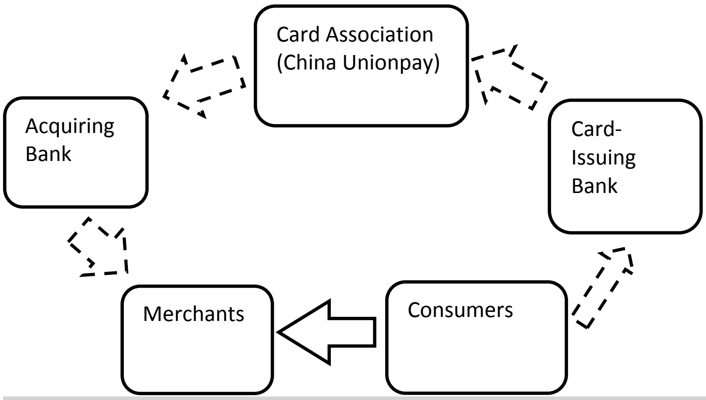
The rapid growth of e-commerce (including sales of financial products online) and the accompanying third-party payment providers has resulted in lower fees for banks in some regards (e.g. settlement). But the development of e-commerce and a growing Internet economy also helps banks to expand fees in other areas (e.g. their card business, with positive externality for their spread business), in our view.

Third-party payment providers eating into banks' settlement fee income…

The rapid growth of e-commerce and thus third-party payment providers has resulted in lower settlement fees for banks. While banks are still the final settlement agents for online businesses, third-party payment companies play an important role in the process and, given their strong bargaining power, take a meaningful chunk of the settlement fees from banks.

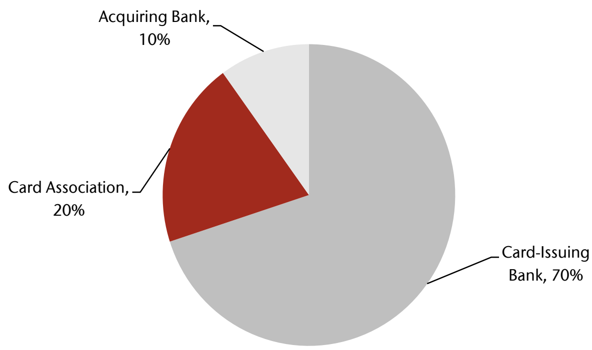
In a normal offline card settlement, the acquiring bank, the card association and the card-issuing bank share in the transaction's settlement fees following a 1:2:7 split rule. The settlement fee rate is around 0.4-1.3% of a transaction's value, as determined by the NDRC.

Exhibit 17: Offline card settlement flow



Source: Jefferies

Exhibit 18: Fee distribution (offline) favors banks



Source: NDRC, Jefferies

Exhibit 19: Card settlement fee charges: Benchmark rates (Offline)

Merchant type	Card-issuing bank	Bank card settlement association	Acquiring bank	Total
Restaurants and entertainment	0.90%	0.13%	0.22%	1.25%
Normal: Retail, wholesale, training	0.55%	0.08%	0.15%	0.78%
Supermarkets, transportation, utilitie:	0.26%	0.04%	0.08%	0.38%
Non-profit	0.00%	0.00%	Charge on cost	
Actual charges +/-10% based on benchmark rates				

Source: NDRC, Jefferies

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In an online card settlement, the third-party payment companies take the responsibilities of both the acquiring bank and the card association

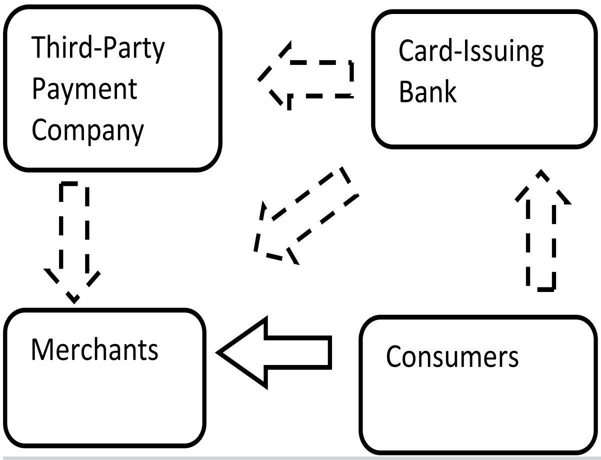
However, in an online card settlement, the third-party payment companies take the responsibilities of both the acquiring bank and the card association. Banks thus lose the acquiring banks' fee income. Furthermore, given the dominant position of some big third-party payment companies, the settlement fee income distribution favors the online third-party payment companies. Card-issuing banks can only get around 40% of the total fee income vs. 70% in an offline card payment settlement, and the total settlement fee rate is only around 0.15-1.20% for online payments vs. 0.40-1.30% offline.

Exhibit 20: Card settlement fee charges: Online

Card type	Card-issuing bank	Third-party payment companies	Total
Credit card	0.1%-0.4%	0.6%-0.8%	0.7%-1.2%
Debit card	0-0.05%	0-0.10%	0-0.15%

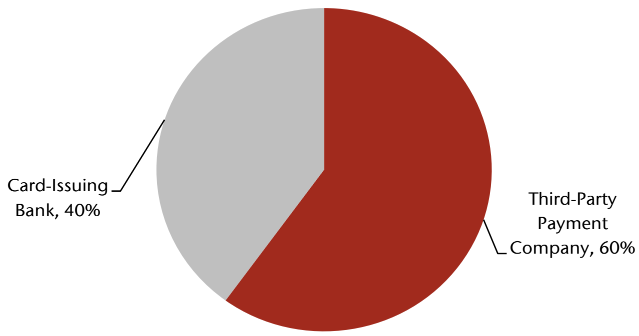
Source: Jefferies

Exhibit 21: Online card settlement flow



Source: Jefferies

Exhibit 22: Fee distribution (online) favors 3rd-party payment companies



Source: Jefferies

...but a growing Internet economy also helps banks to expand their card business (with positive externality for their spread business)

Although banks do lose some fee income in online payment settlements, we believe the fast-growing Internet economy has also driven the rapid growth of bank card transaction volume, which may more than offset the negative impact of lower settlement fee charge rates.

Strong online consumption also leads to more credit card business for banks

Furthermore, strong online consumption also leads to more credit card installment business for banks, and thus may boost banks' fee or interest income from credit cards. According to our channel checks, pure settlement fee income may only account for 10-20% of total bank card income, while other fee/interest income related to installments or lending are the main income drivers of banks' card business.

Banks' card fees income actually increased meaningfully in the past few years as online payment transactions took off.

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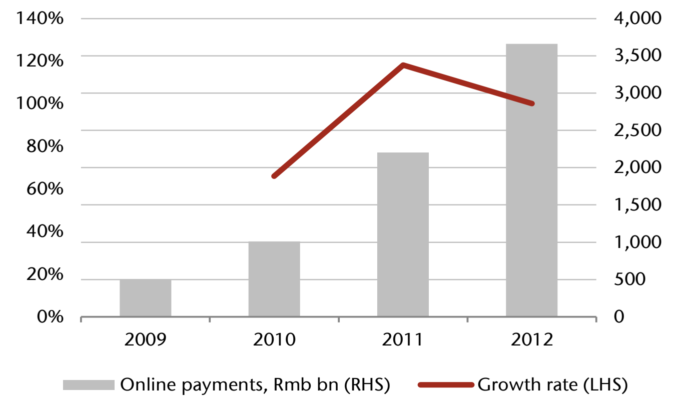
Exhibit 23: Online payments took off…



Source: iresearch, Jefferies

Exhibit 24: …driving banks' strong card fee growth

	2012	2011	2010	2009-12 CAGR
ICBC	36%	26%	45%	36%
CCB	35%	21%	34%	30%
ABC	16%	68%	34%	38%
BOC	39%	12%	57%	35%
BCOM	29%	19%	30%	26%
CMB	34%	17%	43%	31%
CNCB	67%	57%	26%	49%
MSB	151%	111%	-17%	64%
CQRCB	55%	36%	48%	46%
Average	51%	41%	33%	39%

Source: Company data, Jefferies

Exhibit 25: A growing Internet economy that results in a consumption/private-sector driven economy ultimately helps banks too

	Nationwide	City	Countryside	Eastern Reg	Central Reg	Western Reg
Online shopping experience last year	**22.56%**	**35.14%**	**6.44%**	**28.43%**	**16.38%**	**19.80%**
Items purchased						
1. Daily supplies (Shampoo, shower gel, toothpaste, detergent, toilet paper, etc.)	33.08%	34.69%	21.85%	36.75%	29.59%	28.21%
2. Food and beverage	12.52%	13.51%	5.68%	15.57%	10.67%	7.65%
3. Fruits and vegetables	1.88%	2.04%	0.74%	2.41%	1.69%	0.95%
4. Baby products and health food	13.01%	13.87%	7.01%	14.96%	12.05%	9.63%
5. Clothing and footwear	80.16%	80.04%	81.04%	77.59%	82.34%	83.82%
6. Mobile phones, computers, cameras and other electronic products	22.71%	23.60%	16.49%	24.88%	20.65%	19.80%
7. Household appliances	15.50%	16.61%	7.76%	18.14%	14.04%	11.23%
8. Furniture, kitchenware and other household products	10.34%	11.28%	3.77%	11.19%	9.15%	9.45%
9. Audio products and books	20.50%	22.08%	9.50%	24.92%	14.66%	15.86%
10. Auto accessories	6.88%	7.32%	3.84%	8.22%	5.38%	5.29%
Total spending online (Rmb)	5,237	5,606	2,584	6,179	3,936	4,329

Payment methods	Nationwide	City	Countryside	Eastern Reg	Central Reg	Western Reg
Online banking	36.03%	34.89%	44.36%	34.33%	37.49%	38.46%
Alipay	42.38%	43.51%	34.08%	44.43%	39.66%	40.34%
Credit cards	5.48%	6.09%	1.05%	6.49%	5.15%	3.71%
Tenpay	0.48%	0.49%	0.42%	0.47%	0.49%	0.50%
Paid by someone else	5.94%	5.59%	8.56%	3.82%	9.46%	7.57%
Pay on delivery (cash)	9.69%	9.43%	11.53%	10.48%	7.75%	9.40%

Source: China Household Finance Survey (2013), Jefferies

The Internet's reach has its limits at the high-end

The Internet offers a large and relatively cheap distribution platform for ECE, which may threaten banks' agency business. We note that low-risk standardized financial products (e.g. money market and bond funds) are easier to sell online given limited service requirements from buyers of these products.

As the capital market and wealth management business in China are changing rapidly, professional advisory services will become more important for agency businesses

However, high-risk and complicated equity or derivative related products are unlikely to be sold online, as professional advisory services for these products are important for consumer protection as well as regulatory considerations, in our view. We believe tailor-made products and services are the key competitive advantages that banks have over ECE. As the capital market and wealth management business in China are changing rapidly, professional advisory services will become more important for agency businesses, especially for high-net-worth customers, in our view. Banks' high-margin agency business is thus unlikely to be replaced by ECE and may even grow strongly, in our view.

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Banks' online strategies evolving differently

Banks' online strategies include both cooperating and competing with ECE

In the face of aggressive competition from ECE, with the regulators' acquiescence in order to promote the growth of the private sector and consumption demand, the Chinese banks have been compelled to come up with their own Internet strategies to both defend their existing business and capture new opportunities. While still evolving, these strategies include both cooperating and competing with ECE.

Exhibit 26: Most banks have their online strategies already

Bank	Strategy
ICBC	Cooperation w/internet companies + own e-commerce (B2C) platform
CCB	Cooperation w/internet companies + own e-commerce (B2C) platform
ABC	Own e-commerce platform (B2B)
BOC	E-financing app, open platform
BCOM	Own E-commerce platform (B2C)
CMB	P2P platform
CNCB	Cooperation w/internet companies + own financial supermarket
MSB	Cooperation w/Alibaba + own direct banking

Source: Jefferies

Some of these strategies include: 1) setting up an online direct sales platform to serve their customers better at lower cost; 2) establishing a P2P platform to capture customers who are not well served by the traditional banking channels; and 3) building an e-commerce platform to connect their retail customers with their corporate clients to maximize their customers' benefits and resources.

Online direct sales: A low-cost customer channel; traditional banks have the edge over ECE

Setting up an online direct sales platform allows banks to provide financial services with limited labor costs. Basic financial services (e.g. settlement, small loans and deposits) and standardized financial products (e.g. simple WMPs, money market and bond funds) are suitable for Internet delivery. Currently, all the H-share Chinese banks that we cover are able to provide basic financial services via their online banking system, although some risk control processes still need offline verification. We believe if the banks expand their online banking system to enable direct sales online, they will be able to attract more retail customers at much lower acquisition cost than through network expansion.

ECE operating as independent direct-sales banks are unlikely to win; most direct-sales banks in the world are subsidiaries of big banks

ECE operating as independent direct-sales banks are unlikely to win in the competition with traditional banks that have their own direct sales distribution capabilities, in our view. Offline risk control and product innovation are important for direct sales to succeed, both which traditional banks with longer operating history and stronger balance sheet have the competitive edge, in our view. Currently, most direct-sales banks in the world are subsidiaries of big banks, such as ING Direct (ING Group, INGA NA, Buy) and First Direct (HSBC, 5 HK, NC).

P2P platform: Capturing underserved customers

P2P (peer-to-peer) lending companies provide a platform for investors and borrowers to match their investment and financing demand, and charge commission fees for the service. The Internet lowers the cost of information asymmetry, thus helping to accelerate the development of P2P lending.

The amount per loan for P2P lending is much lower than banks' normal individual or SME loan. According to Ren Ren Dai, one of the leading P2P lending companies in China, the average amount per loan ranged from Rmb3-500k (avg. Rmb70k) in 2012, vs. Minsheng's Rmb1.0-1.5mn per MSE loan. However, the interest rates for P2P loans are much higher than normal bank loans at 10-24% p.a.

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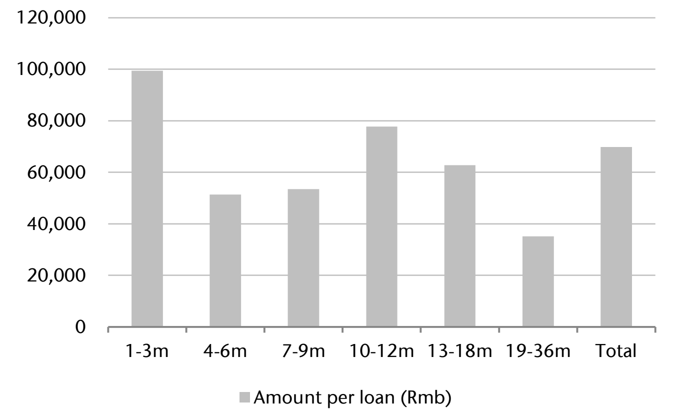
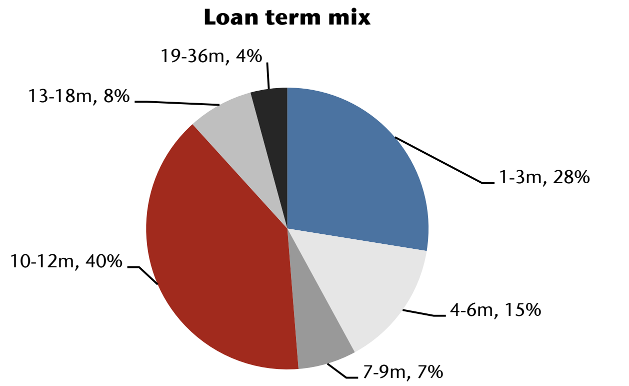
Exhibit 27: Avg. amount per loan for Ren Ren Dai was Rm70k in 2012



Source: Company data, Jefferies

Exhibit 28: Loans for 10-12 months accounted for the largest proportion of loans at Ren Ren Dai



Source: Company data, Jefferies

With rising funding cost pressuring banks' NIM and technology lowering maintenance cost, some banks have started to develop their own P2P platform to capture these high-paying customers

Customers of P2P lending companies are not typically targeted by banks given their small transaction volume and high maintenance cost, until now. With rising funding cost pressuring banks' NIM and Internet technologies lowering maintenance cost, some banks (e.g. CMB) have started to develop their own P2P platform to capture these high-paying customers. Banks' strong balance sheet and risk control experience are the key competitive advantages that they have when competing against existing P2P players.

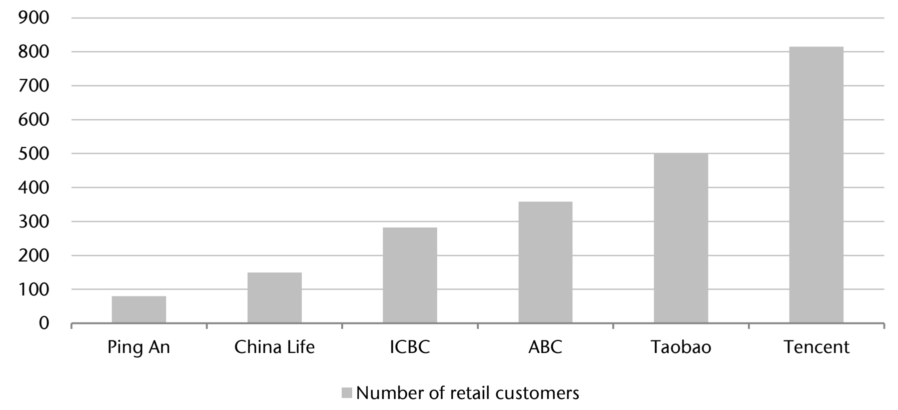
Bank-owned e-commerce platform: Bringing competition to ECE's turf

Several of the H-share banks that we cover are now experimenting with building their own e-commerce platform, bringing competition to the ECE's turf. Big banks with large corporate and retail customer base are well placed to connect their retail customers with their corporate clients, in our view.

Big banks with large corporate and retail customer base are well placed to connect their retail customers with their corporate clients

By way of comparison, Taobao (the largest e-commerce platform in China) owns around 500mn registered customers, while Tencent (China's largest social network) has 816mn QQ instant-messaging monthly active users (MAU) as well as 272mn combined Weixin/WeChat MAU. ICBC (the largest commercial bank in China) owns 282mn retail customers, of which more than 150mn are Internet-banking customers. Thus, if ICBC executes its e-commerce strategy well, it may become a meaningful competitor in the e-commerce market, in our view. ICBC is currently running a pilot e-commerce platform internally, which offers extra rewards for its retail customers while providing a distribution channel for its corporate customers.

Exhibit 29: Big banks' retail customer base vs. ECE



Source: Company data, Jefferies

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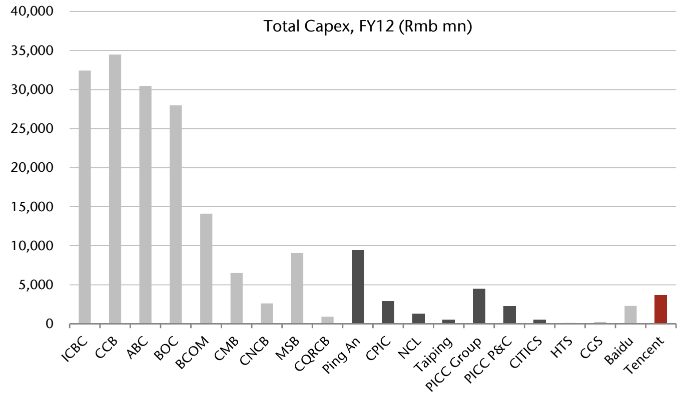
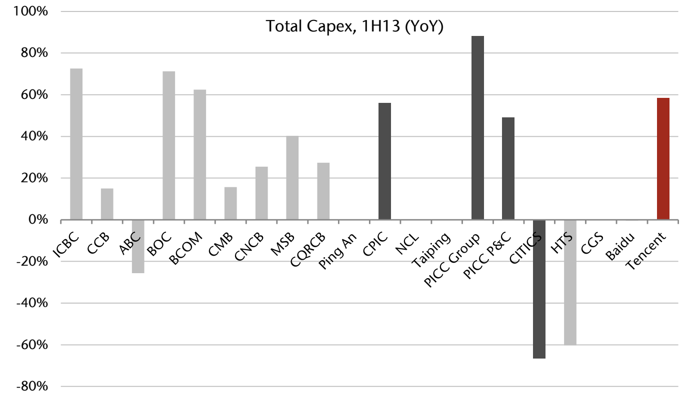
Is it far-fetched for a bank to operate an e-commerce platform? Perhaps, but think of how far Amazon (AMZN; Buy) has evolved from its humble beginnings as an online book retailer to now a disruptive force in many businesses (e.g. cloud computing). In fact, looking at the levels of capex spend by the banks vs. the ECE and the rate of growth, we believe funding such online endeavors is not an issue for the banks. Instead, the challenges the banks face in dealing with ECE are having the technology know-how, changing from traditional banking's cautious/glacier pace to ECE's Internet-era speed of execution, while dealing with uncertainty & changes in its core business (e.g. interest rate deregulation, slower economic growth, rising NPL cycle), in our view.

Exhibit 30: Funding online endeavors...



Source: Company data, Jefferies

Exhibit 31: ...is not an issue for the banks



Source: Company data, Jefferies

Exhibit 32: Challenges banks face in dealing with ECE are having the technology know-how, changing from traditional banking's cautious/glacier pace to ECE's Internet-era speed of execution, while dealing with uncertainty & changes in its core business (e.g. interest rate deregulation, slower economic growth, rising NPL cycle)

ECE's financial business: launched

	Third Party Payment/Settlement	Lending (Small-Loan Company)	Wealth Management: Pure Distribution	Wealth Management: Own Products (Partner)
Alibaba	Alipay	Aliloan	Taobao.com	YuEBao/ DingQiBao (majority-owned Tianhong Fund)
Baidu	Baidu wallet		Baidu Caifu	Baifa/Baizhuan (Jiashi Fund, China AMC)
Tencent	Tenpay/ WeChat payment	Tenpay Small Loan		LiCaiTong (China AMC)

ECE's financial business: under discussion or in the news

	Banking	Securities	Wealth Management
Alibaba	Partner existing banks to offer direct banking		
Tencent	Establish own bank	Online broker	Distribution via Wechat

Bank response

Bank	Management	Comments & actions
ICBC	JIANG Jianqing	There are challenges for banks from ECE, but so are opportunities If traditional banks are bricks, then mouse+brick is the model to win
CCB	WANG Hongzhang	ECE a big challege but traditional banks can provide Internet channels too Internet financing is forcing banks to innovate more
CMB	MA Weihua (ex-President)	Internet unlikely to end traditional banking; there are conflicts but also cooperation Survey of investor/analyst views on Internet's impact & online strategy for CMB Launched P2P platform
CNCB		Set up testing room for Internet product innovation Internet micro lending without face-to-face interview, a cooperation project w/Tencent)
MSB	DONG Wenbiao	The challenges from ECE is not big; Internet financing is still at the beginning stage Announced strategic cooperation framework agreement with Alibaba
Ping An	MA Mingzhe	Internet will change the financial industry significantly; Ping An wants to lead the change Launched P2P platform

Source: Jefferies, company data

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Exhibit 33: ICBC's B2C e-commerce platform

Source: Company data, Jefferies

Exhibit 34: CCB's B2C e-commerce platform

Source: Company data, Jefferies

Exhibit 35: ABC's B2B e-commerce platform

Source: Company data, Jefferies

Exhibit 36: BCOM's B2C e-commerce platform

Source: Company data, Jefferies

Exhibit 37: CMB's P2P platform

Source: Company data, Jefferies

Exhibit 38: CNCB's B2C financial supermarket

Source: Company data, Jefferies

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Entry barriers: Banking is still a heavily regulated & high-touch industry

Stricter rules will be in place once ECE become sizeable enough to create systemic risks, as shown by the clampdown on Bitcoin and PBOC's work under Doc 107

While regulators are currently tolerant of ECE's foray into finance to spur private sector growth, we believe stricter rules will be in place once they become sizeable enough to create systemic risks, as shown by the Dec 5 clampdown on Bitcoin by the PBOC (financial institutions banned from handling the virtual currency). In fact, the PBOC is currently tasked under Doc 107 from the State Council to come up with rules to regulate Internet financing companies to prevent them from using technologies to operate beyond their scope of business – a task made urgent with investors who lent on China's P2P lending platforms losing Rmb1.2bn in 2013 due to a surge in defaults and collapses at such firms. The customized services provided by traditional banks are also unlikely to be replaced by ECE, and it is easier for ECE to cooperate with banks than set up on their own, in our view. Thus, we believe banks will remain the dominant players in finance.

It remains highly uncertain whether the regulator will issue banking license to ECE, especially before deposit insurance is in place

Banking license not easy to get

Banks are highly regulated due to their systemic importance, and it remains very uncertain whether the regulator will issue banking licenses to ECE, especially before deposit insurance is in place, in our view. Even if they get a banking license, their business development will still be restricted by regulations (e.g. capital adequacy and risk control requirements). In any case, banking is already highly competitive with more than 2,600 depository institutions and 17 nationwide banks.

Meaningful capital-volume gap

We believe ECE are unlikely to have the scale of capital required to compete with banks in the near/mid-term. By end-Sep 2013, the Chinese banks have total/net assets of Rmb147tn/Rmb10tn. ICBC, the largest commercial bank, has total/net assets of Rmb18.7tn/Rmb1.2tn by end-Sep 2013. By comparison, Tencent (700 HK; Buy), one of the largest Internet companies in China, only has 2013E total assets of Rmb97bn.

ECE may attract some mass market interest in their products and services, but are unlikely to capture a meaningful portion of their wallets due to safety considerations

Safety consideration

ECE may attract some mass market interest in their products & services, but are unlikely to capture a meaningful portion of their wallets due to safety considerations, in our view. Since deposit insurance has not been established in China, banks (especially state-owned banks) are a safer repository of money in China than ECE, which may need more time to establish their credibility.

Tailor-made wealth management products or corporate finance services may even become more important as more investment and financial tools become available with China's capital markets still undergoing significant changes

Customized services and products cannot be replaced

We believe e-finance is only suitable for standardized products, while customized services and products still require the human touch, especially by high-net-worth individuals and mid/big-sized corporate customers. Tailor-made wealth management products or corporate finance services may even become more important as more investment and financial tools become available with China's capital markets still undergoing significant changes.

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Insurance: E-commerce distribution suitable only for standardized products

In exploring new distribution channels for insurance products, Internet is perhaps one of the most obvious opportunities out there. In our view, successful application of e-commerce platform for insurance distribution is highly dependent on insurance product lines.

Life insurance

For traditional long-term life insurance business, due to its relatively high level of complexity and the needs of more tailored-made services and explanations, for the near future, we see e-commerce more likely to play a supporting role (for example, as a data gathering tool and information dissemination), rather than becoming a key distribution channel on its own.

Life insurance is sold rather than bought; based on overseas experience, online distribution is unlikely to take off for this business

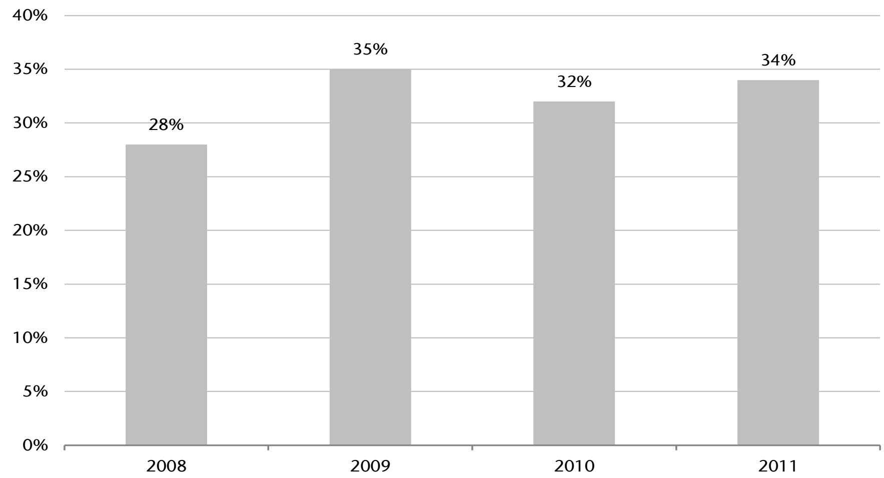
Even in more developed countries, it has been difficult for online sales of life insurance products to take off. According to China Life's studies, less than 1% of life insurance products are distributed via the Internet, and most of these products are of simple forms such as term-life insurance policies.

We continue to believe in the truism that life insurance is sold rather than bought. As a result, we see agency distribution more likely to remain as the key life business sales model in China for life business in the years to come.

P&C insurance

On the P&C side, thanks to more standardized and simpler product structures, we believe e-commerce could introduce a brand new landscape into the business, especially for products such as auto-insurance and accident insurance. In the case of U.S., according to Comscore already 34% of the respondents are willing to purchase auto-insurance online.

Exhibit 39: Respondents likely to purchase auto-insurance online



Source: Comscore

In the case of China, we expect two key changes to be introduced by e-commerce into the P&C business: firstly, Internet distribution allows insurers to lower their acquisition costs, which could lead to lower combined ratios. However, at the same time, more transparent online pricing also allows for more direct comparison for consumers, leading to potential pricing competition. For longer term, in our view, this will lead to higher requirements on risk pricing and product/service differentiation from insurance companies.

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Ping An's e-commerce strategy: A data gathering platform

So far, Ping An is the only listed insurance company in China that actively attempts to build out its own e-commerce platforms. It appears that large part of Ping An's effort is not to directly apply e-commerce to build new distributions, but to use e-commerce data to support its traditional business lines.

Recently, we have seen visible launches and increasing popularities of some of its e-commerce business lines, such as Lufax (www.lufax.com); Wanlitong (www.wanlitong.com); Ping An Hao Che (www.pahaoche.com) and 24 money (www.24money.com).

As an example, Ping An launched its second-hand car sales website (Ping An Hao Che) in mid-2013. The platform leverages on its large auto-insurance database and integrated financial service platform, offering value-added service to consumers in addition to second-hand car searches, such as auto-insurance and banking products (e.g. auto loans).

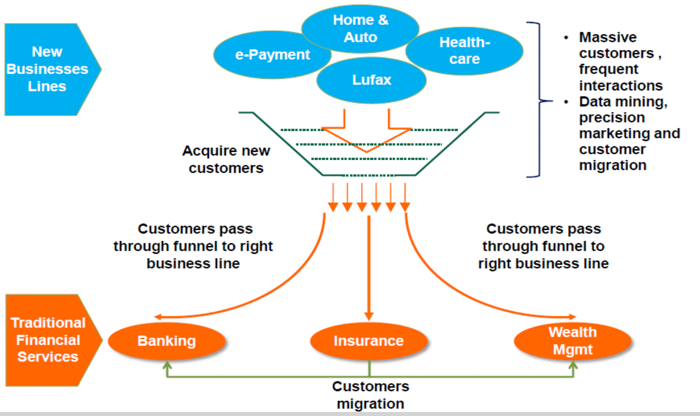
According to management, Ping An's e-commerce strategy aims to

1) Massively increase potential customer base;
2) Upscale consumer interaction and improve consumer experience;
3) Allow for customer data mining and better understanding of consumer behavior;
4) Achieve precision in marketing and customer migration.

Exhibit 40: Samples of Ping An e-commerce platform

Source: Company data, Jefferies

Exhibit 41: The strategy



Source: Jefferies

In addition to the above, Ping An is also trying to establish a platform in the mobile-commerce space, with the introduction of an application called "Yi Qian Bao" (1-wallet) in January 2014 (only a beta version was launched). The product was launched by Ping An Fu ("平安付", a subsidiary of Ping An), and is a mobile application which includes both social functions and financial services.

The official version of "Yi Qian Bao" is not yet available, but the aim is to gradually include various functionalities, including social functions via "Tian Xia Tong"; third-party payment functions; online shopping service via Wanlitong; wealth management functions via Lufax (which potentially will start selling financial products from different manufacturers in addition to Ping An's own). While it is too early to assess whether the launch will be a success, it does offer upside potentials in terms of consumer data collections, and potentially more accurately pinpoint consumer needs for insurance product distributions.

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Exhibit 42: Ping An Yi Qian Bao functionalities

Source: Company data; Jefferies

Further to the e-commerce platform efforts, Ping An has also entered into a joint venture with Tencent and Alibaba (unlisted), forming an Internet insurance company called ZhongAn P&C Insurance, being the first of its kind in China. The company recently launched its first product – "Zhong Le Bao", a credit insurance P&C policy aiming to cover online transaction credit risks.

In our view, the formation of ZhongAn Insurance is an encouraging attempt to test the combination of e-commerce and certain P&C insurance products, which introduces new insurance business opportunities within the e-commerce space. In addition, we believe e-commerce could potentially change the future distribution landscape for some traditional P&C products, such as auto-insurance, credit-insurance and accident insurance.

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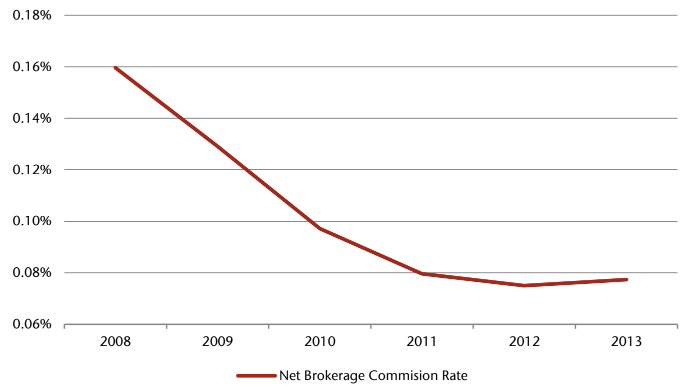
Brokers: Commission rate challenged, but new business drivers abound

Even without ECE, we expect brokers' commission rate to be pressured by the advent of online & witness-based securities account opening, though the development of online brokers may still exacerbate price competition in the industry. Given the uncertainty surrounding the issuance of new online brokerage license and the rapid development of brokers' own online channels, we believe the industry's leading brokers will grab market share before ECE join the competition. While still meaningful, the brokerage business now accounts for less than 50% of the industry's revenue, and we expect its share to fall with capital market reforms in China boosting contributions from other businesses like margin lending and asset management, which may be positively impacted by the Internet's channel advantages (e.g. cost & scale of distribution).

Brokerage business most challenged by the Internet…

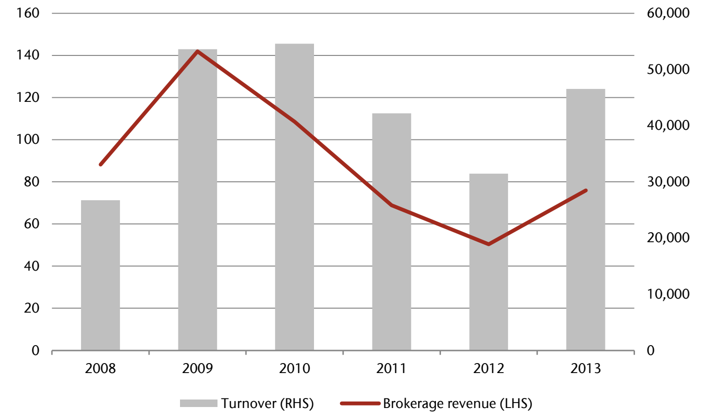
Brokerage commission rates have declined significantly in the past few years due to fierce competition and commoditization of the brokerage business. With the development of online channels, we believe another round of price competition is very likely.

Exhibit 43: Commission rate has declined meaningfully in the past few years, and online channels may trigger another round of price competition



Source: Jefferies

Exhibit 44: Brokerage income growth may underperform turnover growth due to lower commission rates (Rmb bn)



Source: Jefferies

Some big brokers have started to offer commission rates as low as 3bps for customers who open brokerage accounts online, leaving little room for ECE to cut rates further to be competitive against the leading brokers, especially given ECE's inability to offer offline services

As online and witness-based securities account openings are widely implemented in late 2013 and more than 90% of brokerage customers are using online trading systems now, we believe current leading brokers will expand their online brokerage business aggressively before new ECE are allowed to operate in the industry. Some big brokers have started to offer commission rates as low as 3bps (vs. industry avg. of 8bps) for customers who open brokerage accounts online, leaving little room for ECE to cut rates further to be competitive against the leading brokers, especially given ECE's inability to offer offline services.

In fact, Sinolink (600109 CH; NC), a small broker, recently offered 2bp commission rates to new accounts opened on its website. As there is currently no regulatory guidance for the issuance of online brokerage license, we believe the industry's existing brokers will grab market share before ECE join the competition.

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Exhibit 45: CITICS and HTS are less sensitive to brokerage commission rate given their diversified revenue base

	Stock Turnover	Net brokerage commission rate
Changes	**10%**	**1bps**
Impact on 2014E PBT		
CITICS	4.9%	6.1%
HTS	5.5%	8.0%
CGS	12.6%	14.8%
Average	**7.6%**	**7.1%**

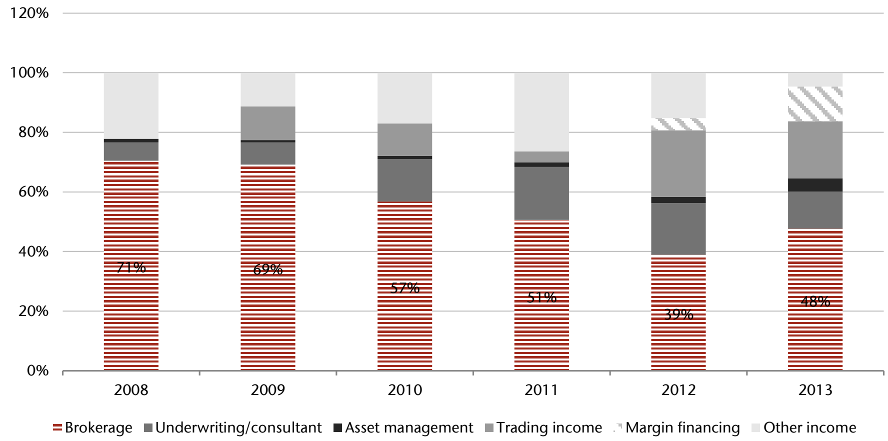
Source: Jefferies estimates

...But plenty of new business drivers...

Brokerage income has traditionally been the largest contributor to the Chinese brokers' revenues, but its share has been falling. Though the negative impact of commission rate compression may be offset by turnover growth, we believe the key drivers of future revenue & profit growth will come from new businesses like investment banking, asset management and margin trading.

Driven by top-down capital market reforms and bottom-up disintermediation, we believe investment banking will rebound strongly with the resumption of A-share IPOs in 2014, and brokers' asset management and margin lending businesses will continue to deliver strong growth after taking off in 2013. These three businesses will drive the brokers' profitability improvement rather than brokerage in the future, in our view.

Exhibit 46: Brokerage is the largest revenue contributor but its share is falling



Source: CSRC, Jefferies

...Which may benefit from the Internet

While the investment banking business still requires professional customized services and thus likely unaffected by the Internet, we believe the brokers' margin lending and asset management businesses will benefit from the low-cost distribution capabilities that the Internet offers.

Leading brokers with strong capital positions and O2O services should still emerge as winners

Margin lending may become available online

Margin lending may become available through online channels, though the profit margin depends on system liquidity, in our view. Competition from ECE may compress interest margins if they can use customer cash for margin lending (currently disallowed), but we believe leading brokers with strong capital positions and O2O (Online-to-Offline) services should still emerge as winners.

A low-cost channel for asset management product sales

The development of online channels provides a cheap and scalable distribution network for brokers' asset management products, especially standardized products, in our view.

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- China CITIC Bank Corporation Limited (998 HK: HK$4.25, BUY)
- China Construction Bank Corporation (939 HK: HK$5.31, BUY)
- China Galaxy Securities Co., LTD. (6881 HK: HK$4.98, HOLD)
- China Life Insurance Company Limited (2628 HK: HK$22.85, HOLD)
- China Merchants Bank Co., Ltd. (3968 HK: HK$14.12, BUY)
- China Minsheng Banking Corp., Ltd. (1988 HK: HK$7.92, BUY)
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- Chongqing Rural Commercial Bank Co., Ltd. (3618 HK: HK$3.33, BUY)
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- Industrial and Commercial Bank of China Limited (1398 HK: HK$4.68, BUY)
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- New China Life Insurance Company Ltd. (1336 HK: HK$24.70, BUY)
- PICC Group (1339 HK: HK$3.45, HOLD)
- PICC Property and Casualty Company Limited (2328 HK: HK$10.92, HOLD)
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