Taiwan banks

The seven fat years

Seven lean years are over. Taiwan's banking and finance shares rose to a peak in early 1997, before starting a long slide that would consume most of the next seven years. In biblical fashion, we now see those seven lean years giving way to what will be, if not seven years of prosperity, at least significantly better times ahead.

Raising market weighting to Overweight. We are raising our weighting of the Taiwanese financial sector to Overweight from Underweight within a regional financials context. In addition, from a country perspective, our Taiwan strategist also considers financials an Overweighted sector.

Initiating coverage on six banks. With this report, we are initiating coverage of six Taiwanese banks: Chinatrust; First FHC; Taishin; SinoPac; E.Sun; and Cosmos. Our top picks are Chinatrust and Cosmos, both rated BUY, and we also see substantial upside in Taishin and E.Sun, also initiated with BUY ratings.

Systemic health is on an upswing. A half-decade of fears that Taiwan's banking system would implode under the weight of bad debts are starting to fade. Massive write-offs, a return to growth, and resumed access to the capital markets are setting off a virtuous cycle for the health of the system.

Getting closer to China. The chances of meaningful economic integration with mainland China are increasingly likely, in our view, with politics and the March 2004 election as likely catalysts. Taiwanese banks have a built-in client base on the mainland—all they need is access.

Trust the consumer. After an appalling record for consumer lending in Hong Kong and Korea, investors are justifiably wary of credit card businesses and consumer debt. Nevertheless, Taiwan's households are wealthy, liquid, and undergeared, with only 3% of disposable income going to pay interest, and debt to income actually lower than in 1998.

Don't forget the macro. In addition to favourable drivers for the banking industry and for our individual picks in isolation, Taiwan has a very supportive macro environment, including an undervalued currency, increasing GDP growth, and low interest rates. These are catalysts for an overall bull market—one in which the banks will uncharacteristically lead.

Taiwan banks – Forecasts and ratings

	Ticker	Rating	Price 16/10 (NT$)	12-month Target (NT$)	PER (x) 03F	PER (x) 04F	PBV (X) 04F
Chinatrust	2891 TT	**BUY**	32.30	50.00	15.0	10.2	1.6
Taishin[b]	2887 TT	**BUY**	21.80	29.65	10.8	8.0	1.3
First FHC	2892 TT	**SELL**	21.70	18.28	NM	15.8	1.4
SinoPac	2890 TT	**HOLD**	17.90	19.36	14.1	12.6	1.3
E.Sun	2884 TT	**BUY**	18.70	24.64	10.7	12.2	1.6
Cosmos	2837 TT	**BUY**	15.50	24.77	8.9	7.3	1.1

Source: Company data, ING estimates

PLEASE SEE THE IMPORTANT DISCLAIMER, COMPANY DISCLOSURES AND ANALYST CERTIFICATION ON THE LAST PAGE OF THIS REPORT

ING FINANCIAL MARKETS

Banks
Taiwan
Sector analysis
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Contents

Summary 1

Key themes and picks 2

Systemic risk: Off the table 5

Credit cards: Impending doom or continued boom? 8

Economic integration – The shape of things to come 18

M&A 20

Valuation 23

Loan portfolios and growth 27

Asset quality 34

Reserve adequacy 38

Rates and margins 39

Company section 41

Chinatrust: Local hero.... 42
Taishin: #2 tries harder.... 57
First FHC: Still distressed.... 67
SinoPac: Waiting for love.... 83
E.Sun FHC: Prodigal sun.... 92
Cosmos: A universe of consumers.... 103

See back of report for important disclosures and disclaimer

Summary

Raising Taiwan financials weighting

We have re-initiated coverage of the Taiwanese financial sector and raised our weighting of the Taiwan banks from Underweight to Overweight versus our regional portfolio of financials. We are reducing our weightings in both Korea and Thailand, and looking to these markets as a source of funds for Taiwan.

Initiating coverage on six banks

With this report we are also initiating coverage of six banks: Chinatrust, Taishin, First Financial, SinoPac, E.Sun, and Cosmos. Our preferred plays in the sector are Chinatrust and Cosmos, with significant upside present in Taishin and E.Sun as well.

Politics drives rapprochement

Our research and polling shows that the central theme of next year's elections will be closer economic integration with mainland China. We believe that a new administration will be highly motivated to secure better cross-straits relations and will lift restrictions on Taiwanese banks' ability to operate in China. This will be rapidly transformational for the banks—in effect or actuality a second CEPA for Taiwan.

Reversing corporate hollowing-out

Over the past decade, more and more Taiwanese corporates have relocated their operations to the mainland—where their banks have not been able to follow. As this changes, banks will gain access to a ready-made pool of business, which we estimate will increase loan growth by 1.5% to 2.5% per annum over the next decade.

Systemic risk fades

The failure of the Legislative Yuan to pass a meaningful RTC program notwithstanding, we believe that the systemic risk of the Taiwanese financial system has receded and continues to fall. We still believe that a number of major institutions are unviable and need to be resolved, but we no longer see a danger that doing so will pull otherwise healthy banks over the cliff.

Liquidity deployment will bolster margins

Lending spreads in Taiwan will remain compressed until rates turn around, which we don't foresee until 2005. Expect shrinkage to be especially likely in richly-priced credit and cash card margins. However, resumed loan growth in key categories and the redeployment of excess liquidity will start to boost real net interest margins from 2Q04 onwards.

Credit cards set for a cycle – not a crash

Although increasing competition will reduce rates, Taiwan's credit card lending can safely continue with a 15-25% growth rate over the next five years, due to robust credit information sharing, no personal bankruptcy, and low household leverage. Even in a depressed economy with near-record unemployment, interest payments on debt account for only 3% of average household disposable income—with net savings still at close to 20%.

Key themes and picks

Recommendations and coverage initiations

We are initiating coverage on six bank groups: First, Chinatrust, Taishin, SinoPac, E.Sun, and Cosmos. Of these, our top picks are Chinatrust and Cosmos, both rated BUY, and we have also initiated BUY ratings on Taishin and E.Sun with lesser upside.

We believe that the underlying business prospects of SinoPac are already fully valued, and we hence rate the shares as a HOLD in line with our regional practice of not setting price targets based on M&A. That said, we believe it is highly likely that SinoPac will be sold; we believe that a domestic acquiror would pay NT$21-23 per share and a foreign acquisitor potentially more.

We continue to believe that First FHC is deeply troubled both operationally and in terms of asset quality despite having raised capital this summer. We initiate coverage on the shares with a SELL rating.

Fig 1 Recommendation summary

NT$	ING Rating	Price 10/16/03	Px target	Up/downside
Chinatrust	**BUY**	32.30	50.00	54.8%
Taishin	**BUY**	21.80	29.65	36.0%
First FHC	**SELL**	21.70	18.28	-15.7%
SinoPac	**HOLD**	17.90	19.36	8.2%
E.Sun	**BUY**	18.70	24.64	31.8%
Cosmos	**BUY**	15.50	24.77	59.8%

Source: Company data, ING estimates

Key themes

The four key themes we believe are critical to assessing the prospects for Taiwan's banking sector are as follows:

- Systemic risk of troubled institutions and bad debts to the rest of the sector;
- Credit card debt and personal lending;
- Economic integration with mainland China and its banking impact; and
- Consolidation of the Taiwanese banking industry

We explore each of these themes in detail in the pages which follow.

Macro catalysts

Multi-year upcycle for TWD

We believe that the NT$ is significantly undervalued—in particular against the US dollar. Evidence for this can be found in Taiwan's large balance of payments (BoP) surplus—which last year reached a record US$33.6bn, or just under 12% of GDP on a reported basis; we think this understates the case.[1]

The NT$ also appears undervalued in terms of its real effective exchange rate (REER), which is currently 7% and 14% below its five-year and 10-year averages, respectively. Given that the US comprises 25-30% of Taiwan's trade basket, if the NTD held steady against the currencies of the remainder of its trading basket, it would need to

[1] Please refer to our recent report: _Putting NTD, RMB and Yen appreciation in perspective_, dated October 14, 2003 for further details.

appreciate 25% or from a NTD/USD rate of 33.7 to 27.0 just to reach its five-year average REER. ING Regional Economist Tim Condon forecasts that the NTD/USD rate will appreciate to NT$32.0 by year-end 2004 and NT$30.5 by year-end 2005.

Given the financials' NTD earnings stream, Taiwan strategist James Carroll ranks them as his top pick among the large cap sectors to benefit from sustained currency appreciation.

QFII liberalization and MSCI reweighting

On September 30th, Taiwan's Securities and Futures Commission (SFC) announced that it would implement QFII reform immediately. The specific QFII reforms announced in the SFC's press release include:

- Foreign investors will no longer need to apply for approvals for equity investments and will only need to register once with the stock exchange. Once approved, investors can use the same registration number forever.
- As pre-announced in mid-September, foreign investors will be allowed to dispose of their securities holdings through overseas depository receipt issues.
- Investors will be allowed to use the same ID to open multiple accounts at the same brokerage house.
- The revised rules also simplify the investment procedures and documentation required from foreign investors.

In terms of the potential impact of the elimination of the QFII system and an upward adjustment in MSCI's Taiwan weighting on fund flows, we identify two different sources of increased foreign participation in the market. [2]

- First, we estimate that if MSCI adjusts Taiwan's LIF weighting to 100%, QFIIs could add roughly US$20bn or 6%-7% of total market cap. This would raise QFII ownership of the market from 17%—where we estimate it is now—to 23%-24%. Our assumption is that when MSCI raises Taiwan's weighting it will do so in two to three stages.
- Second, indications are that there are a significant number of large pension funds that hold little to nothing in Taiwan due to the existing QFII restrictions. If the reforms are seen to address these concerns, this could be a catalyst for foreign ownership in Taiwan to move towards the levels seen in Singapore (30%) or Korea (38%).

We believe that any increase in foreign participation will be particularly beneficial for the financial sector, as it is a large-cap sector with a substantial index weighting which has underperformed. Foreign investors are already underweight banks; we think this will reverse.

Bear in mind that we shouldn't expect any immediate MSCI actions—the company has in fact already announced that it is continuing its formal review on the relaxation of restrictions on portfolio investors in Taiwan. MSCI indicated that their evaluation of these changes on the investment process will be based on feedback from market participants, which will require a minimum of three to six additional months.

[2] Please refer to our recent report: *QFII reforms accelerated – too late for MSCI November announcement?*, dated October 2, 2003 for further details.

Our view is that this implies that MSCI's own review should consume a similar period and that to avoid influencing Taiwan's March 2004 election, it is likely that they will delay their announcement until post-election. MSCI has also announced that should they decide that any change in Taiwan's limited investability factor (LIF) is warranted, they would announce the change well in advance, typically four to six months prior to implementation.

Risks

Key risks to our positive thesis include:

- A severe decline in US demand which impacts Taiwanese GDP and overall consumer confidence.
- Falling interest rates, which would compress bank spreads.
- Widespread defaults on credit and cash card loans, hitting Chinatrust, Taishin, and Cosmos—all companies we like—most heavily.
- A worsening of Taiwan's relationship with the mainland, and the retraction of existing privileges for banks and borrowers.
- Extended delay in cleaning up the state bank sector, potentially coupled with a desire to make healthy banks shoulder the burden of paying off bank failures.

Systemic risk: Off the table

Our single greatest fear for the Taiwanese banking sector over the past four years has been systemic risk—the possibility that a cascade of bank failures could imperil the health of even the best banks and leach away confidence in the financial system as a whole. The risk was that Taiwan would become a Thailand, an Indonesia, or a Japan in terms of the breadth and severity of its banking problems.

We have been waiting for decisive action on the part of the government to address this issue; while some progress has clearly been made (witness the 2-5-8 plan), there has been no major push to address the legacy problems of the past as yet. The once-vaunted RTC has remained largely an unfunded idea, and no problem banks have been taken out of the market.

Why then has our concern receded?

Our view was predicated on the following key observations and beliefs:

1. The banking system as a whole was insolvent in aggregate, with most of the bad debt in the larger state-owned institutions.

2. Reported credit quality was not a useful measure of true NPLs.

3. Large banks were not able to access the capital markets to obtain funds for a one-time write-off of their bad debts.

4. Smaller private banks, although generally healthier as a class, were in most products price-takers—and hence, any panicked or irrational pricing decisions made by the larger and more-distressed banks would impact their profitability as well.

5. The overall size of the industry was shrinking and margins were falling—in essence less aggregate profitability was available to offset bad assets.

Let's address these issues one by one:

1. Asset quality clearly remains a critical issue—for some banks, the only issue. We continue to believe that the banking sector as a whole would be at least minimally-capitalized if not insolvent if required to account for the full cost of legacy bad debts now. Although this is much more of an issue at the larger state-owned institutions and credit cooperatives, all Taiwanese banks have been affected by the burden of NPLs.

2. As for reported credit quality, one of the steps the government has taken (in conjunction with the 2-5-8 plan measures) has been to move towards international standards for loan classification, including the disclosure of loans under surveillance and classification under forward-looking criteria instead of simply the period of delinquency. This is both a genuine catalyst for reform and a boon to investors, who hate uncertainty much more than they do NPLs.

   We do continue to believe that the government will pass an RTC bill at some point (most likely following the Presidential election in March of 2004); expect some degree of help from the national AMC, but not the impact on healthy banks that it would have had if passed in 2001 or 2002.

3. The (controversial but) completed First FHC offering, and a similar upcoming deal for Mega FHC signal the return of Taiwan's large banks to the capital markets. In addition, a very robust market has sprung up to bid for banks' defaulted or impaired loans, a further way of cleaning up balance sheets. The ability for banks to amortize losses on sale of NPLs over five years is a powerful incentive to push bad assets out the door now—exactly what we wish to see as investors.

4. Smaller private banks are still in many ways price-takers, but significant consolidation is taking place among the healthy banks—and many are no longer so small. Irrational behavior on the part of larger banks remains a key risk in the consumer sector, where all banks are pushing for greater share of mortgages, credit cards, and cash cards.

5. We believe that Taiwan's asset contraction in the banking sector has already passed its nadir, and with our recent upgrade of GDP growth estimates for 2003 and 2004 we are much more positive on consumer spending and the chances for domestic, organic loan growth. In addition, excess liquidity in the system has already begun to run off, with LDR picking up slightly throughout 2Q03. This is generally associated with an improvement in margins, as we will discuss below.

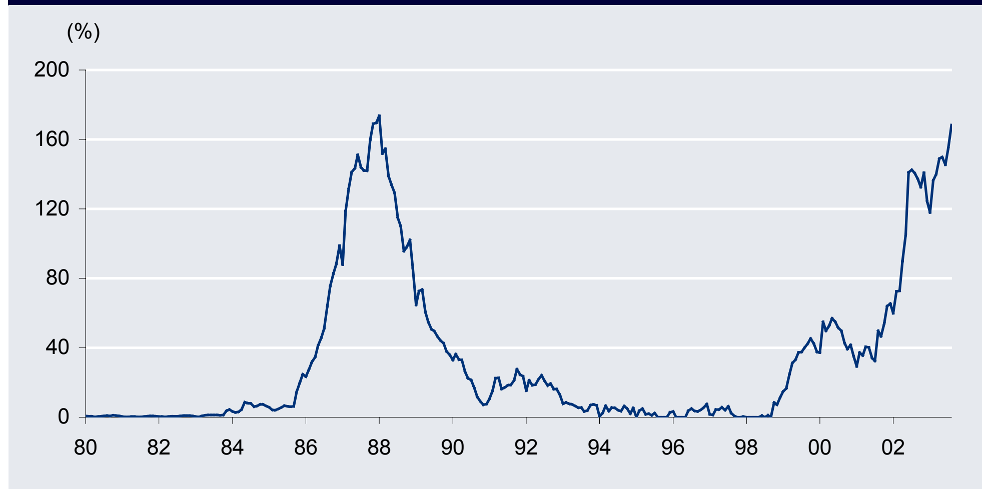
For these reasons, then, we believe that systemic collapse is no longer a realistic scenario for the Taiwanese banking sector. Individual institutions will have their problems, and some will almost inevitably have to be taken over and/or wound up, but careful attention to individual banks' balance sheets should allow us to avoid damage from this resolution of problem companies.

Supportive macro environment

In addition to the factors enumerated above, our strategist James Carroll points out several economic trends which are at odds with the idea of high or rising systematic risk.

Taiwan's currency is overvalued and the country runs a substantial balance of payments surplus even on an official basis (we think the true level is probably even higher). Taiwan's Central Bank has sterilized almost all of Taiwan's BoP surplus for the past three years. These factors combined mean that Taiwan will be under no pressure to raise rates even if the US does turn around in the next year—low rates mean pressure is kept off of weak borrowers and banks as the industry restructures.

Fig 2 Politics necessitates sterilization



Source: Central Bank of China

When combined with very high existing liquidity and low debt, conditions are probably more conducive to an asset bubble rather than a deflationary debt spiral. This is something that will take at least three years to develop if it does come, so it's not a big factor in our current investment analysis, although it's on the radar screen. We note that the degree of Central Bank sterilization is comparable to levels in Taiwan's asset bubble from 1986-90.

Key downside risks

What would cause us to re-evaluate this call on systemic risk? Drastic downward revisions to our GDP forecasts, interference by the new government (or, for that matter, the old government) in lending at the state-owned banks, or an adversarial relationship with the mainland government would all be associated with an increased incidence of shocks to the financial system. As Taiwan's banking sector is still healing, even a moderate shock could have a disproportionate impact on credit quality and capital levels.

Credit cards: Impending doom or continued boom?

Taiwan does not have a long history of unsecured consumer credit. Even the Government Information Office notes that "banks in Taiwan used to be notoriously reluctant to grant personal loans," and many potential borrowers felt that it was essential to "know someone" at a bank in order to receive a loan. As in other Asian countries, the gap was filled by loan sharks and private loan associations (where everyone would contribute money to the pot for one member to borrow).

Rapid growth in bank consumer lending since the mid-1990s is probably a red flag for investors given our experiences in Korea and Hong Kong, particularly. However, we believe that the asset quality of Taiwan's consumer credit portfolios (largely comprised of credit card and cash card receivables) will stay reasonably high. Key differences in the Taiwanese system:

- **Low household leverage.** Taiwanese households pay only 3% of their disposable income in interest costs, and the burden of debt to disposable income has actually fallen since 1998.
- **Robust credit data sharing.** Unlike Hong Kong[3], Taiwan has an existing and strong credit information clearinghouse (the Joint Credit Information Centre), which provides both positive and negative consumer credit data. This is a key factor in keeping credit costs low.
- **No personal bankruptcy.** Taiwan has no provision for personal bankruptcy, and debts are not legally discharged even after they are charged-off. This eliminates a certain amount of opportunistic default and gives banks more bargaining power. Anecdotal reports have banks recovering 30-50% of charged-off credit card loans—far higher than the single-digit recoveries that are typically seen in other Asian markets where bankruptcy and discharge are possible.

We do anticipate some erosion of yields in the credit and cash card business (125 and 150bps over the next two years, respectively), but believe that this will be more than offset by lower funding costs and resumed consumer spending.

Rapid expansion

Taiwan's credit card market has been expanding at a torrid pace in balance sheet terms for some time, with balances accruing at a 28% CAGR from year-end 1997 to present. Margins have also been well-maintained, with the average posted rate for the top ten card issuers still at 19.4% and no major players below 18.25%.

Credit losses have been relatively low, with the industry average holding steady at 5-6% despite recession and unemployment.

In an otherwise bleak environment for corporate lending, high-margin credit card portfolios have become a significant driver of Taiwanese bank earnings, contributing 14% of total sector interest income. Naturally, their share of net income is considerably lower (estimated at 7%) as servicing and credit costs for these products are well above the total for the institutions.

[3] Hong Kong implemented positive credit data sharing in August, 2003, but it has yet to have any material impact on the financial sector.

However, cracks are beginning to appear in the foundations of the market for credit cards. Although receivables continued to rise in the first five months of 2003 at a 22% annualized rate—the same as for all of 2002—annualized charge volume has actually fallen by 0.1% over FY2002. The increase in balance sheet assets is coming from increased rollovers and from higher cash advances, which have risen at a 46% CAGR since year-end 1997 and which are up 18% YTD.

Is this the beginning of a consumer credit crash, along the lines of Hong Kong or Korea, or is it a temporary result of reduced spending due to SARS and low consumer confidence?

We definitely believe that all evidence points to the latter. Our analysis follows:

Fig 3 Credit card transactions and receivables: 1995-2003

NT$m	1995	1996	1997	1998	1999	2000	2001	2002	5/2003
Total transaction value:									
Local	N/A	227,386	322,480	441,505	545,830	660,934	716,162	813,489	824,546
Overseas	N/A	45,001	51,945	49,592	51,956	58,836	55,700	60,107	48,250
Total	190,653	272,387	374,425	491,097	597,786	719,770	771,862	873,596	872,796
% Increase		42.9%	37.5%	31.2%	21.7%	20.4%	7.2%	13.2%	-0.1%
% Increase, local			41.8%	36.9%	23.6%	21.1%	8.4%	13.6%	1.4%
% Increase, overseas			15.4%	-4.5%	4.8%	13.2%	-5.3%	7.9%	-19.7%
Cash advances									
Local	N/A	13,453	24,456	38,172	49,682	77,820	101,601	130,376	154,894
Overseas	N/A	1,249	1,286	1,466	1,706	1,948	2,178	2,110	1,985
Total	N/A	14,702	25,742	39,638	51,388	79,768	103,779	132,486	156,878
% Increase			75.1%	54.0%	29.6%	55.2%	30.1%	27.7%	18.4%
% Increase, local			81.8%	56.1%	30.2%	56.6%	30.6%	28.3%	18.8%
% Increase, overseas			3.0%	14.0%	16.4%	14.2%	11.8%	-3.1%	-5.9%
Total receivables outstanding	N/A	N/A	88,420	124,908	152,768	205,656	259,875	316,328	337,829
% Increase, YoY				41.3%	22.3%	34.6%	26.4%	21.7%	21.7%

Source: Company data, ING estimates

Regional comparisons

Taiwan's credit card usage has expanded rapidly, increasing from 2.7% of GDP in 1995 to 8.6% YTD in 2003. Per-capita receivables have also expanded swiftly, from 1.1% of per-capita GDP in 1997 (the first year for which figures are available) to 3.3% currently.

Although Taiwan's per capita receivables are comparable to those of Singapore, card debt to GDP is considerably higher, largely because of Singapore's tough restrictions on unsecured consumer lending and higher GDP.

Taiwan's level of borrowing is more than 22% below that of Hong Kong's peak in terms of percentage of GDP—not an overly comfortable margin when one considers the overall rate of growth; however, we look to other factors which cause us to conclude that the Taiwanese consumer is more credit-worthy.

Fig 4 Credit cards: regional comparison

	Units	1995	1996	1997	1998	1999	2000	2001	2002	2003/5
Taiwan:										
Total Receivables Outstanding	TWD, m	N/A	N/A	88,420	124,908	152,768	205,656	259,875	316,328	337,829
Total Usage	TWD, m	190,653	272,387	374,425	491,097	597,786	719,770	771,862	873,596	872,796
Total Cards	000s	3,703	5,467	7,798	10,640	13,575	18,276	24,135	31,591	34,571
Per Cap GDP	USD	12,232	13,095	11,920	12,755	13,519	13,300	12,382	12,807	12,610
Per Cap Receivables	USD	N/A	N/A	126	177	220	279	332	406	418
% of GDP		N/A	N/A	1.06%	1.39%	1.63%	2.10%	2.68%	3.17%	3.32%
Total Usage/GDP		2.67%	3.54%	4.47%	5.45%	6.38%	7.34%	7.96%	8.75%	8.57%
Hong Kong:										
Total Receivables Outstanding	HK$m	20,216	23,707	30,573	34,846	37,344	48,602	54,829	51,361	46,786
Total Usage		N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Total Cards	000s	N/A	N/A	N/A	N/A	5,529	7,159	9,217	8,865	8,732
Per Cap GDP	USD	23,030	24,326	26,741	25,249	24,263	24,783	24,407	24,014	23,896
Per Cap Receivables	USD	425	476	608	687	727	935	1,046	970	880
% of GDP		1.84%	1.96%	2.27%	2.72%	3.00%	3.77%	4.29%	4.04%	3.68%
Total Usage/GDP		N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Singapore:										
Total Receivables Outstanding	SGD, m	826	894	1,035	1,113	1,371	1,724	2,100	2,426	2,478
Total Usage	SGD, m	6,153	6,986	7,915	7,689	8,948	10,557	11,069	11,959	11,361
Total Cards		N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Per Cap GDP	USD	23,828	25,321	22,272	21,190	20,958	22,630	19,945	21,563	21,442
Per Cap Receivables	USD	165	174	163	172	208	247	275	336	341
% of GDP		0.69%	0.69%	0.73%	0.81%	0.99%	1.09%	1.38%	1.56%	1.59%
Total Usage/GDP		5.17%	5.37%	5.59%	5.61%	6.49%	6.69%	7.28%	7.68%	7.30%

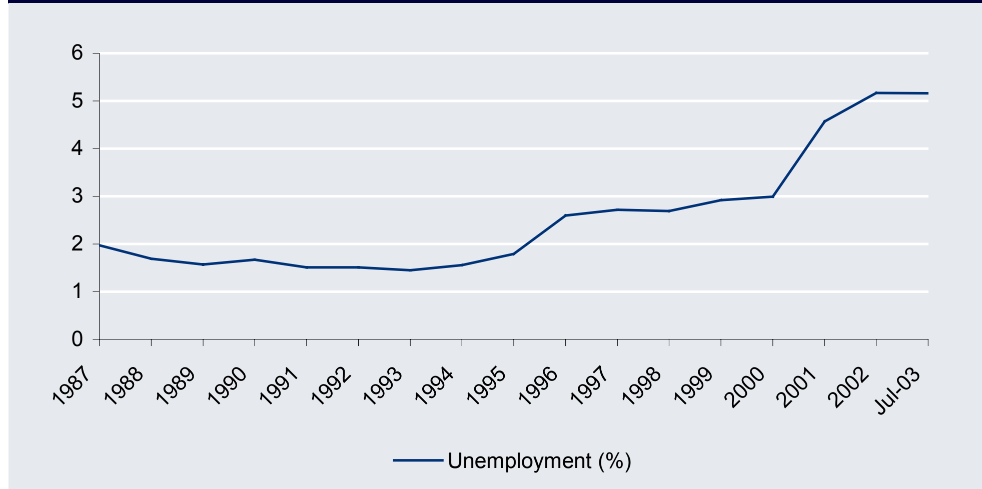
Source: Company data, ING estimates

Household credit quality

As in Hong Kong, Taiwan's unemployment rate has risen rapidly since the Asian Crisis to an historic high (currently 5.16%). However, there have been signs that the peak has passed, with joblessness still below its August 2002 level of 5.35%. As our experience is that unemployment has been closely associated with consumer credit card delinquency in Asia[4], this is a trend which bears careful watching.

[4] Although this does not necessarily hold true for other, developed markets—please refer to our report *HSBC goes sub-prime: Is this a Household accident?*, dated 30 June 2003 for additional discussion of this issue, under the heading "*What drives losses in US consumer finance?*" (p.26)

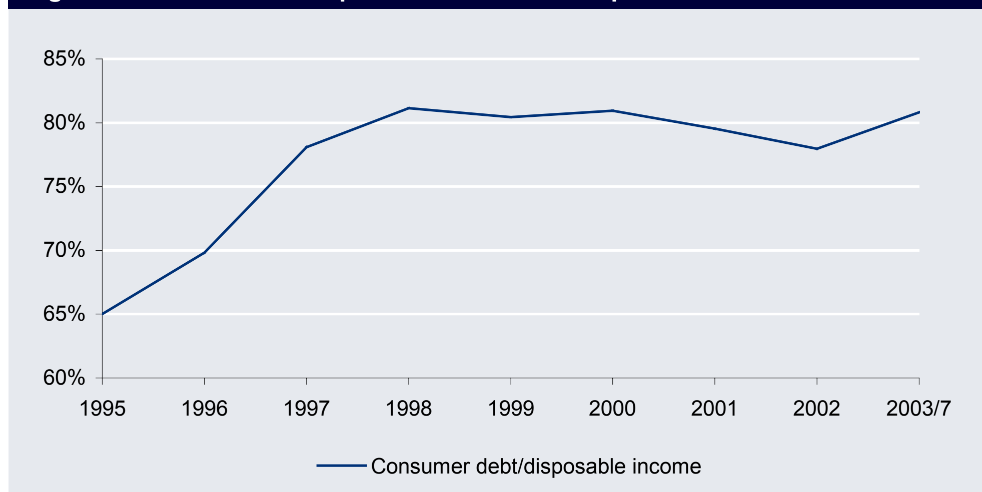
Fig 5 Taiwan unemployment: 1987-present



Source: Ministry of Economic Affairs

Note however that consumer debt as a percentage of disposable income actually peaked in 1998, and has declined somewhat since (mid-year 2003 figures are less representative due to seasonality of consumer income), indicating that borrowers are keeping up with their ability to pay.

Fig 6 Consumer debt/disposable income: 1995-present

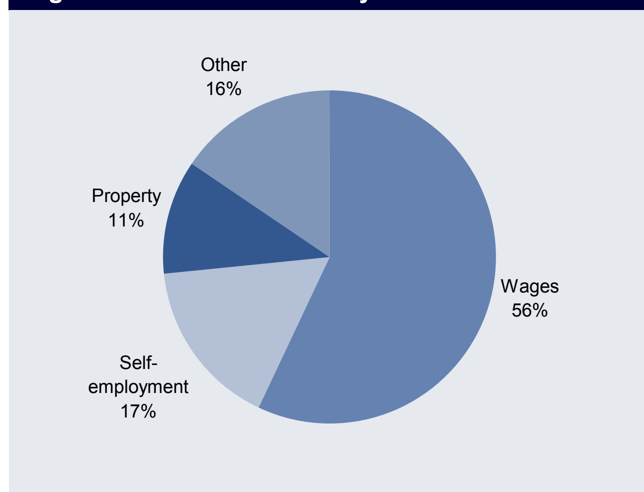


Source: CBC, Ministry of Economic Affairs

Household income and expense

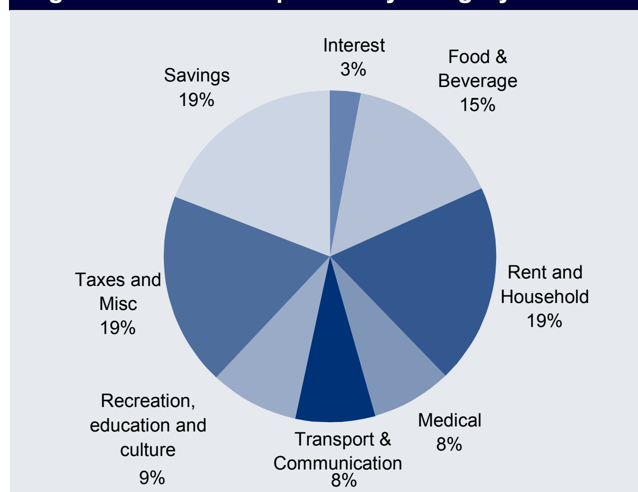
We can see further evidence of the creditworthiness of the Taiwanese consumer in the average statistics for household income and expense. As of 2002, these show that interest on debts accounted for only 3% of disposable income, versus net savings of 19%. By comparison, Federal Reserve data show that the US consumer pays a total of 14% of his/her disposable income in debt service, of which we estimate that 7.2% is interest.

Fig 7 Household income by source



Source: National Bureau of Statistics

Fig 8 Household expenses by category



Source: National Bureau of Statistics

Fig 9 Household income and expense: 2002 averages

	NT$	US$	% of total
Income:			
Wages	604,696	17,759	56.8%
Self-employment	177,074	5,200	16.6%
Property	54,279	1,594	5.1%
Imputed rent income	62,785	1,844	5.9%
Transfer receipts (pension, et cetera)	165,148	4,850	15.5%
Other	170	5	0.0%
Total Income	1,064,153	31,253	100.0%
Expenses:			
Interest	32,118	943	3.0%
Transfers (taxation, et cetera)	156,116	4,585	14.7%
Food	149,335	4,386	14.0%
Beverage	6,208	182	0.6%
Tobacco	6,213	182	0.6%
Clothing	23,958	704	2.3%
Rent	140,356	4,122	13.2%
Fuel and light	19,093	561	1.8%
Furniture	11,211	329	1.1%
Household	13,750	404	1.3%
Health care	82,627	2,427	7.8%
Transport/communications	82,248	2,415	7.7%
Recreation, education and culture	90,919	2,670	8.5%
Other	46,703	1,372	4.4%
Total expenses	860,853	25,282	80.9%
Net savings	203,300	5,971	19.1%

Source: National Bureau of Statistics data, ING estimates

Key players

The card business has historically been dominated by Citibank (the originator), Chinatrust (now the largest issuer), and Taishin (the purest play in the sector). Each of these banks has had consistently superior financial results which are due in no small part to the high-margin consumer credit business. As in all things, success attracts imitators, and top banks can no longer count on the rest of the sector being sleepy.

Virtually every institution we have talked with over the past year identifies credit cards as a key area for expansion—similar to the ill-advised feeding frenzy of Korean banks in 2001 or Hong Kong banks in 2002. We see this competitive dynamic as much more of a danger to the industry than household gearing, as margin competition and marketing costs could destroy the business in a way that credit problems alone can not.

Fig 10 Top credit card issuers in Taiwan

Bank	Cards outstanding (000)
Chinatrust	5,400
Taishin	3,900
Cathay	2,730
Union Bank	2,280
Fubon	2,270
Citibank	1,800
E.Sun	2,000
Chinfon Bank	1,200
The Chinese Bank	1,100
Far Eastern	960

Source: Company data, ING estimates

Winners take most

Our view of card issuance in Taiwan is that it is rapidly becoming a scale business, which is the dynamic in most mature markets. This final land rush for market share—most players are using expensive third-party card marketers and mass-market advertising to add customers—will not succeed in changing the position of most small issuers. The question is whether their attempt will impair the business of the winners to such an extent that overall profitability actually declines.

Our last two rounds of company visits, comprising virtually all the major listed banks and FHCs, have yielded a common theme: banks are planning a renewed emphasis on credit card marketing and promotion beginning in the fourth quarter.

Margin competition

We believe that much of this competition will take the form of discounting—a risk to still-fat margins. Note that all of the top issuers still have base revolving rates of 18.25-20%, very wide spreads for such a competitive market. Furthermore, rates have hardly budged even as funding costs have come down dramatically over the past 18 months. It seems like a market ripe for competition.

Fig 11 Revolving interest rate vs terms on cash advance

Top ten credit card issuers	Revolving interest rate	Cash advance
Chinatrust Bank	20.00%	At most 35% of credit line. Fee charged on 2.5% of cash advance plus NT$150
Taishin Bank	20.00%	50%-100% of credit line. Fee charged on 3.5% of cash advance or at least NT$100
Cathay Bank	18.89%	At most 40% of credit line. Fee charged on 3.5% plus NT$100
Fubon Bank	18.69%	At most 50% of credit line. Fee charged on 3.5% of cash advance plus NT$100
Union Bank	18.25%	At most 50% of credit line. Fee charged on 2.5% of cash advance plus NT$150, or at least NT$100
Citibank	20.00%	Fee charged on 3.5% of cash advance or at least NT$100
E.Sun Bank	19.71%	At most 100% of credit line. Fee charged on 3.5% of cash advance or at least NT$100
Chinfon Bank	19.71%	At most 50% of credit line. Fee charged on 2.5% of cash advance plus NT$150
Aetna SinoPac	18.90%	Fee charged on 3.5% of cash advance or at least NT$100
Far Eastern Bank	19.71%	Fee charged on 2.5% of cash advance plus NT$150

Source: Company data, ING estimates

Orthodox theory would suggest that the easiest and most effective competition would be to lower benchmark rates on revolving balances and cash advances; however, observed behavior in other markets, and the banks' own disclosed plans, do not support this theory.

Fig 12 Credit card market segments

% of population	Type	Avg Life (Mos)
25%	Balance transfer seeking	12
50%	Regular rate/benefit seekers	24
25%	Price insensitive	48
100%	Total	27

Source: ING estimates

Instead, we believe that banks will intensify competition on the rate side by use of balance transfer and "teaser" rate programs. This will help attract the segment of the population (which we estimate at 25%) which carries large balances and is very sensitive to rates without cannibalizing the less price-sensitive customers.

Although all price competition is bad for margins in general, it is the ability to avoid repricing the existing book that will keep profits high; it's also one of the reasons why we believe that those banks which are late to the party will be unsuccessful in the long run—they are disproportionally attracting the most rate-sensitive and least-loyal customers, meaning that what is intended to be a temporary rise in marketing expenditures and special offers turns into a never-ending campaign to retain and replace customers.

Fig 13 Balance transfer comparison

Major credit card issuers	Balance transfer rate	Fees
Far Eastern Bank	Annual rate of 11.68% for the first 12 months Zero rate for the first 15 months Annual rate of 5.99% for the first six months and 15.33% for the following six months	NT$200 per card, at maximum 3 cards 1% of approved balance for 15 months NT$150 per month for 12 months Balance transfer no less than NT$10,000
UWCCB	Zero rate for 24 months Annual rate of 11.66% for the first 12 months Annual rate of 6.4% for the first six months and 14.97% for the following 12 months	1.1% of monthly transferred balance, no penalty on early repayment NT$300 per card, no penalty on early repayment NT$110 per card per month for 12 months
Standard Chartered	Annual rate of 4.99% for the first six months and 14.98% for the following 12 months	NT$115 per month for 12 months
AIG	Annual rate of 9.5% for the first six months and 14.97% for the following six months Annual rate of 12% for the first 12 months	NT$100 per month for 12 months NT$100 per month for 12 months
Fubon Bank	Annual rate of 8.99% for the first six months and 14.99% for the following six months	NT$350 per card, at maximum 6 cards
Chinatrust Bank	Annual rate of 3.66% for the first six months, 12.66% for the following six months, and 20% starting the 2nd year	n.a.
Citibank	Annual rate of 4.88% for the first six months and 20% starting the 7th month	n.a.
HSBC	Annual rate of 12.25%	None
AnShin Card Services	Zero rate for the first 12 months and 18.9% afterwards Annual rate of 3.99% for the first six months and 15% for the following 12 months	1% of approved balance for 12 months NT$200 per month for 12 months
International Bank of Taipei	Annual rate of 2.88% for the first 3 months, 6.88% for 4th-6th month, and 14.88% for 7th-25th month	NT$188 per month for 12 months Balance transfer no less than NT$10,000

Source: Company data, ING Financial Markets

Cash cards

An additional reason we doubt that rate competition will be excessive is the growing presence of cash cards in the market.

The cash card product is a revolving line of credit which can be accessed via a special card through an ATM, but which generally can not be used to purchase merchandise. As such, it competes with the cash advance function of credit cards, but not with their more traditional purchase and convenience aspects. As cash card lines are generally quite low—as little as US$300—they are easy to qualify for, and generally used by younger workers who need funds for entertainment in between paychecks.

Cash cards have long been popular in Japan; they were brought to Taiwan by Cosmos Bank, which launched Taiwan's first cash card (the “George and Mary card,” a play on the similar-sounding Taiwanese words for “borrowing money and easy to access”) in mid-1999, and the bank still has half of the 2 million cards in issue.

Fig 14 Cash card leaders (at 3Q03)

Bank	Rank	# of cards (000s)	Balances (NT$m)
Cosmos Bank	1	1,200	70,000
Taishin Bank	2	600	17,000
Ta Chong Bank	3	320	9,000
Union Bank	4	300	7,100
The Chinese Bank	5	280	9,070

Source: Company data, ING estimates

Competition in cash cards acts to immunize the larger credit card industry from rate competition, as it allows segmentation of frequent cash advance borrowers without across-the-board rate cuts. Note that average rates on cash cards are only 16.7%, versus 19.4% on credit cards—we expect this disparity to widen, with a further 150bps in rate cuts over the next 18 months, versus only 125bps for banks.

Fig 15 Major cash card issuers and terms

Bank	Card name	Annual rate	Zero-rate period	Maximum credit	Annual fee	Processing fee	Service fee per transaction	No of cards issued	Balances (NT$m)
American Express	-	13.88% for the first six months, 16.00% from the 7th month	-	3 times monthly salary, or NT$600k at maximum	1% of credit	None	NT$200 for withdrawal from ATM. NT$500 for withdrawal via voice mail		
Cathay Bank	U-Life	13.75%	-	NT$150k-300k	None	NT$1,000	NT$100		
Central Trust of China	-	4.99% for military, government, and school employees, or 8.99% for ordinary customers	-	NT$600k	None	None	NT$100		
Chinatrust Bank	-	18.25% or 14.25% (for quality customers)	-	NT$200k-NT$500k	None	None	NT$100	193k as of Jul-03 (target 360k in FY03)	Target NT$15bn in FY03
Citibank	Ready Cash	9.99% for the first three months, and 18.00% afterwards	-	2-3 times monthly salary or NT$800k at maximum	NT$600 (free for the first year, or free on annual transaction of more than NT$50k)	None	NT$100 for withdrawal of less than NT$10k via ATM. No fee for withdrawal via voice mail		
Cosmos Bank	George & Mary	18.25%	-	NT$10k-600k	None	None	NT$100	1m (target 1.57m in FY03 and 2m in FY04)	NT$60bn as of mid May-03 (target NT$80bn in FY03 and NT$100bn in FY04)
E.Sun Bank	Take It	18.25%	-	NT$300k	None	None	NT$100	200k	NT$3.5bn as of Jun-03
Far Eastern Bank	Wishes	13.61% or 9.9% (for existing customers)	-	NT$1m at maximum	None	NT$2,000 for 1st year	None		
First Bank	Somebody	18.25%	-	NT$300k	None	None	NT$100		
Fuh Hwa Bank	Young Man Card (combo card)		-	NT$100k	None	None	NT$99 in the first 99 days		
Grand Commercial Bank	Grand Cash	16.80%	-	80% of annual salary or NT$300k at maximum	None	None	NT$100		
Hsinchu Bank	Dear Card	18.25%	6 months	NT$300k	None	None	NT$100		
International Bank of Taipei	All In One	15.00%	-	NT$300k	None	None	NT$100		

Fig 15 Major cash card issuers and terms – cont.

Bank	Card name	Annual rate	Zero-rate period	Maximum credit	Annual fee	Processing fee	Service fee per transaction	No of cards issued	Balances (NT$m)
Land Bank of Taiwan	Chunchiao & Chimin	12.99% or 9.99% (for existing customers)	99 days	NT$20k-300k	None	None	1% of transaction		
Macoto Bank	-	18.00%	3 months	NT$1m at maximum	None	NT$300 for credit analysis	2.5% of the maximum credit for three months, NT$100 each withdrawal afterwards	70k	1,000
Standard Chartered	Smart Cash	19.95%	-	NT$200k	None	NT$2,000	NT$150 for withdrawal from ATM. NT$180 for withdrawal via voice mail		
Ta Chong Bank	Much	18.25%	3 months	NT$300k	None	NT$100 for credit analysis	NT$100	250k as of mid Jul-03 (target 500k in FY03)	NT$7bn as of mid Jul-03 (target NT$12bn in FY03)
Taishin Bank	You-Be	18.25%, or 16.25% for balance of NT$150-200k, 14.5% for NT$200-250k, 12.5% for NT$250-300k	1 month (3 months for balance transfer)	NT$150k-300k	None	None	NT$100	450k as of May-03 (target 700k in FY03)	NT$13bn as of May-03 (target NT$30bn in FY03)
Taiwan Business Bank	-	14.99%	-	NT$500k	None	None	NT$100		
The Chinese Bank	Mike Card	18.25%	-	NT$500k	None	None	NT$100	200k as of Jul-03 (target 400k within in 1 year)	NT$4.5bn as of mid Jul-03 (target NT$14bn-NT$15bn in FY03)
Union Bank	3-in-1 (combo card)	18.25%	1 month	NT$20k-300k	None	None	NT$100	160k (target 600k in FY03)	NT$4bn (target NT$12.5bn in FY03)
UWCCB	-	18.25%	The first 29 days	3 times monthly salary, or NT$150k at maximum	None	None	2.5% of transaction		

Source: Company data, ING Financial Markets

Economic integration – The shape of things to come

Taiwan's major economic issue is the same as the country's major political issue—whether or not, and when, to move closer to the mainland. Although the current (DPP) government has spurned quick integration, we believe that there is the potential for positive changes in cross-straits relations following the March 2004 election.

Current polls show that the election is likely to bring a change of government, and with a KMT/PFP victory a change in policy, given that the KMT has an explicit policy of economic integration with China. KMT Chairman Lien Chan's March statement that his first priority in office would be to make a "trip of peace" with an eye towards establishing direct links reinforces this view.

What could this mean for the Taiwanese banks?

A second CEPA

Firstly, improved cross-straits relations would be likely to mean accelerated rights for Taiwanese banks in mainland China. We anticipate that Taiwan would receive preferential entry into the mainland financial system via an accord similar to the Closer Economic Partnership Arrangement ("CEPA") concluded with Hong Kong in June. To complement this, we would expect the Taiwanese government to loosen its restrictions on its domestic banks entering the China market and instead adopt a policy of encouraging stronger integration.

At a minimum, we would expect that Taiwan's banks would receive:

More expansion possibilities

Accelerated branching rights for Taiwanese banks, possibly with a minimum threshold for asset size of US$6bn (NT$204bn). This provision would apply to over 30 Taiwanese banks, including all of our coverage universe and other major listed banks such as Fubon, Cathay, Hua Nan, Chang Hwa, and IBT.

Faster RMB business license approval

Simply operating mainland branches does not mean that Taiwanese banks will have unrestricted freedom to enter all markets. RMB business requires a separate license, and a foreign bank without the ability to make RMB loans and take RMB deposits will have a poor platform.

Normally, the minimum waiting time for an RMB license (which must be applied for on a branch-by-branch basis) is three years after the commencement of business in that branch, which has been reduced under CEPA to two years for qualifying Hong Kong banks. We believe that it could be granted even more quickly to Taiwanese banks, with some credit given for their existing rep offices.

Potential offshore RMB deposit-taking

Mainland officials have become increasingly worried about the large volume of RMB circulating offshore, particularly in Hong Kong and Taiwan. More for this reason than out of any desire to provide benefit to the Hong Kong banks (although we believe that it will do so), the Beijing government has been discussing the idea of permitting offshore RMB deposit taking in Hong Kong by local banks.

We believe that the same structure would make sense in Taiwan, given the amount of cross-border business already going on. Of key importance will be the terms of implementation: will banks be permitted to funnel offshore RMB deposits back into their own mainland lending operations, or will they merely be allowed to pass RMB back through the interbank clearing market, leaving mainland branches to negotiate interbank lines with Chinese banks as a source of funding?

As we have said in the past, the potential for Taiwanese banks to acquire Hong Kong banks in order to gain RMB deposit-taking privileges is also worth considering—and no doubt a factor in Fubon's bid for IBA.

Recapture of Taiwanese businesses

The lack of loan growth in Taiwan has not been caused by a scarcity of growing Taiwanese businesses, but rather by a hollowing-out of the domestic economy as more and more businesses move critical operations to the mainland. We estimate that up to US$100 billion (NT$3.4tr) has been invested in China by Taiwanese companies, and that up to one million Taiwanese businessmen are now living and working on the mainland.

Of course, the Taiwan banks are still doing business with these companies, and an appreciable (but essentially indeterminate) amount of the lending to manufacturing and industry is to fund projects in China, even if it is (as is common) secured by property in Taiwan. However, much of the opportunity to follow and fund these (current, former, potential) customers is being lost.

If we assume that these investments will generate loan demand based on a debt/equity ratio of 1:2 (approximately that of Taiwanese capital goods companies under ING's coverage), this is a potential additional US$50bn (NT$1.7tr) in loan demand, with a further US$5bn (NT$170bn) every year. Even assuming that surreptitious financing or use of Taiwanese collateral has already filled half of this need, Taiwanese banks would still have a one-time increase in loans of 7.3% and a permanent increase in loan growth of 1.5% per year.

Competition

Mainland Chinese banks, especially those which are state-owned, should not be underestimated in their ability to resist any Taiwanese incursion. These state banks usually co-operate with foreign banks bidding for syndicated loans to Taiwanese corporates. For example, the Formosa Group initiated two syndicated loans in 2002. US$230m for investment in the Kunshan plant was led by ABN AMRO and co-led by China's top four banks (Bank of China, Agricultural Bank of China, China Construction Bank, Industrial & Commercial Bank of China), while US$211m for investment in the Ningbo Plant was led by Bank of China (Hong Kong) and Citibank. Both were priced at spreads of as low as 60-70bps above interbank.

Domestic reflation

Clearly there are broad positive implications for the economy in general of integration with the mainland which can not help but benefit the banks.

We think that a closer economic relationship with China and direct links would be an effective catalyst for increased consumer, business and investor confidence in Taiwan's long-term economic outlook. In short, it would be a trigger for reflation in Taiwan's economy.

M&A

Consolidation and M&A in the Taiwanese banking sector has three main components, all of which have been quite active over the past twelve months. The components are as follows:

- Formation of financial holding companies ("FHCs").
- Intra-market consolidation of banks.
- Cross-border M&A.

FHCs

The legitimization of the financial holding company (FHC) structure in 2H01 has kicked-off a reshaping of Taiwan's financial industry. Breaking down the boundaries between different financial institutions, the FHC model allows banks, securities houses, and insurance companies to share resources and cross-sell products with each other under a unified holding umbrella. Still lacking, however, is a coordinating regulatory body for the FHC and consolidated capital requirements, which would allow excess capital at subsidiaries to be effectively used.

Fourteen FHCs have been established to-date, with eight led by banks, three by insurance companies, one by securities finance, one by securities brokerage, and one by a bills finance company.

In-market consolidation

Taiwan's banking industry is still very fragmented, with the top five banks having only 38.7% aggregate market share versus over 71% for the top five Hong Kong banks.

Another way of looking at concentration is to use the Herfindahl-Herschmann index ("HHI"), which is calculated by summing the squares of the market shares of the 50 largest banks[5]. The US Department of Justice uses the HHI to look at mergers for antitrust purposes; according to the Department of Commerce, the DOJ considers HHI values between 1000 and 1800 to be moderately concentrated and indices above 1800 to be concentrated. Note that Taiwan's HHI is only 444, versus 2055 for the very concentrated Hong Kong market.

Fig 16 Bank concentration in Taiwan and Hong Kong

	Taiwan		Hong Kong	
Rank	Bank	Mkt share	Bank	Mkt share
1	Bank of Taiwan	11.2	HSBC	40.9
2	Taiwan Cooperative Bank	8.8	BOC Hong Kong	16.7
3	Land Bank of Taiwan	6.9	Standard Chartered	5.6
4	First Bank	6	BEA	3.9
5	Hua Nan Bank	5.8	Citibank	3.9
HH Index		444.3		2,054.7

Source: Company data, KPMG, ING estimates

[5] Hey—I spent a lot of money on grad school, I might as well use it.

Trend toward polarisation

The spirit of financial reform is accelerating the polarisation among banks. Over the next two to three years, the gap between the best and the rest will become much more pronounced. Financially-strong and well-run banks will continue to take market share and they will also gain most from the measures introduced to tackle the sector-wide problems. As in Korea, these good banks will be more attractive merger and acquisition targets, and this coupled with the FHC structure will allow them access to more products with which they can lock in their clients and book added fee income.

Any exit mechanism introduced as part of an NPL resolution program will also help speed up the trend toward polarisation. Around 40% of the last-proposed RTC fund was intended to close up the asset-liability gap for the financial institutions having negative net worth and eventually phase them out of the market. RTC or no, we do expect to see some large and historic names run afoul of new stricter regulations and be forced into mergers.

Slow consolidation so far—but accelerating

Over-banking has been an issue for Taiwan since the government issued 16 new bank licenses in the early 90's. For more than a decade we saw only one real bank merger: a "good" bank (Taishin) merging with a "bad" bank (Dah An). Then in 2002-3 we saw a flurry of merger announcements between Fubon Financial and Taipei Bank, Cathay Financial and UWCCB, Chinatrust and Grand Commercial, and Chiao Tung FHC and ICBC.

However, subsequent to these mergers the number of domestic banks remains essentially unchanged as the merged entities have all agreed to remain independent operations in the next three to five years. This is a major disappointment to investors as it means that cost savings will be difficult to come by—and the mergers are likely to be financial failures.

At the community level, 36 credit co-operatives and the credit departments of farmers and fishermen's associations were placed under MoF supervision and taken over by ten domestic banks (seven state-run, one privately-run, and two credit co-op-converted) in 3Q01, and another eight were taken over in 2Q02. This however hasn't really solved the over-banking problem. Banks that took over these community-level financial institutions increased their number of branches, as well as their bad assets.

Consequently, over the last eighteen months the number of domestic banks has dropped only from 53 to 52, meanwhile the number of branches has risen continuously from 2,700 to 3,300, with the top five banks accounting for a market share of less than 40%.

We'd like to see more mergers between good banks, between state banks, or even foreign banks acquiring domestic banks. However, usually it is difficult to reach price agreements – banks don't want to sell cheap. In addition, the upcoming presidential election makes the government somewhat reluctant to push forward M&As or allow banks to fail in the short term.

Cross-border M&A

Generally negative…

Taiwanese banks are also looking to spread out into the region, and the larger banks have reportedly kicked the tires in Korea, Thailand, and Indonesia. In general, we don't believe that this would be a good use of shareholders' funds, as we don't see

substantial cost savings which could be gained, and we don't normally believe in revenue synergy except within certain very narrowly-defined areas.

... but Hong Kong could offer attractive possibilities

However, an interesting development is the potential granting of RMB deposit-taking powers to the Hong Kong banks. If coupled with the Taiwanese banks' knowledge of corporate borrowers who are moving to the mainland, as well as the pending approval of branch licenses, this would be a strong argument for Taiwanese institutions to buy up the smaller Hong Kong banks.

RMB deposits from mainland citizens who wish to bank offshore could thus be recycled via mainland branches into RMB loans to Taiwanese corporates—a profitable triangle trade. Although we do not expect RMB deposits will be taken in Hong Kong within the next 18 months, it would not be surprising if Taiwanese institutions seek to position themselves for this eventuality by acquiring the minor HK banks (WHB, WLB, IBA, LCH).

Fubon has taken the first step by arranging to purchase Arab Bank's 55% stake in IBA, and if this acquisition is approved a general offer for remaining shares will follow. A caution is that in IBA Fubon will be acquiring a bank which lacks both a strong domestic franchise and any additional rights under CEPA due to its small asset size. We would prefer to see Taiwanese banks link up with slightly larger banks such as Wing Hang which could offer immediate access into China and RMB lending powers.

As a rule we are strongly negative on cross-border bank mergers; however, the case of Hong Kong and Taiwan may be a situation where a real strategic advantage can be gained via the combination of better access to RMB deposits in Hong Kong and an RMB-borrowing client base in Taiwan.

Valuation

Our valuations, target prices, and ratings are based on our standard regional cost of capital methodology. We use the bank's cost of capital (similar to a CAPM-driven model, but with the forward beta modified in certain cases to represent our assessment of the underlying volatility of the business rather than simply the historical volatility of the stock price) along with our estimate of sustainable core ROE to derive a fair multiple of book value. This fair multiple, applied against forecast YE2004 book value per share, is our twelve-month price target.

Fig 17 Taiwan bank valuation summary

NT$	ING Rating	Price 10/16/03	BVPS YE02	P/BV	EPS 2002A	2003E	2004E	PER 2002A	2003E	2004E	Trailing DPS	Yield
Chinatrust	**BUY**	32.30	17.35	1.9x	2.61	2.15	3.16	12.4x	15.0x	10.2x	0.90	2.8%
Taishin	**BUY**	21.80	15.36	1.4x	1.77	2.02	2.71	12.3x	10.8x	8.0x	1.00	4.6%
First FHC	**SELL**	21.70	14.99	1.4x	(6.47)	(1.45)	1.38	NM	NM	15.8x	-	0.0%
SinoPac	**HOLD**	17.90	11.95	1.5x	0.93	1.27	1.42	19.2x	14.1x	12.6x	0.65	3.6%
E.Sun	**BUY**	18.70	8.96	2.1x	(1.25)	1.75	1.53	NM	10.7x	12.2x	-	0.0%
Cosmos	**BUY**	15.50	10.49	1.5x	0.67	1.74	2.11	23.0x	8.9x	7.3x	-	0.0%
Cathay	**NR**	51.00	14.92	3.4x	2.23	2.68	2.91	22.9x	19.0x	17.5x	1.50	2.9%
Fubon	**NR**	34.60	18.47	1.9x	1.25	2.11	2.30	27.7x	16.4x	15.0x	1.20	3.5%
Chang Hwa	**NR**	16.80	14.71	1.1x	(7.23)	0.79	1.11	NM	21.2x	15.2x	-	0.0%
Mega	**NR**	19.70	14.50	1.4x	1.02	1.60	1.90	19.3x	12.3x	10.4x	0.38	2.0%
Hua Nan	**NR**	25.20	13.02	1.9x	(5.99)	1.72	2.02	NM	14.6x	12.5x	-	0.0%
AVG				1.8x				19.5x	14.3x	12.4x		1.8%

Non-rated companies earnings estimates are I/B/E/S consensus figures
Source: Company data, ING estimates

Chinatrust

Chinatrust has a 7.8% cost of capital, by our estimates, the lowest in the sector apart from SinoPac despite its mix of high-margin businesses which are frequently perceived as risky. Against this we believe that the bank will return a core ROE of 19% within the next three years—a sustainable level for Chinatrust given its business mix. On this basis, we peg fair value for CT at just under 2.5x book, or NT$50 per share.

Fig 18 Cost of capital valuation summary: Chinatrust

Risk-free rate (5yr Govts)	1.81%
Market risk premium	7.00%
Estimated forward Beta	0.85
Cost of capital	7.8%
Sustainable LT core ROE	19.2%
Implied PBV (x)	2.48
2004F BVPS (NT$)	20.19
Implied target price (NT$)	50.00
Current price (NT$)	32.30
Difference	17.70
Upside	54.8%

Source: Company data, ING estimates

Taishin

Although Taishin's business mix is similar to that of Chinatrust in many ways, its smaller size and less well-defensible positions in credit and cash cards lead to a higher underlying cost of capital—8.8% by our calculations. Against this we use a long-term sustainable ROE of 16%; again somewhat lower than that of Chinatrust as we do not see as strong a history of ROE generation from Taishin.

Our calculations yield a fair value of 1.8x forward BVPS, or NT$29.65, for upside from current prices of 36%.

Fig 19 Cost of capital valuation summary: Taishin

Risk-free rate (5yr Govts)	1.81%
Market risk premium	7.00%
Estimated forward Beta	1.00
Cost of capital	8.8%
Sustainable LT core ROE	16.0%
Implied PBV (x)	1.82
2004F BVPS (NT$)	16.32
Implied target price (NT$)	29.65
Current price (NT$)	21.80
Difference	7.85
Upside	36.0%

Source: Company data, ING estimates

First FHC

First FHC has a deservedly high cost of capital due to the high amount of impaired assets the bank is still carrying on its balance sheet. Even assuming a sustainable ROE of 12.5%—generous considering that the bank last reported a double-digit return in 1998, and that we expect the company to follow 2002's net loss with another one this year—FFHC's fair value is just 1.15x book, or NT$18.28 per share.

Fig 20 Cost of capital valuation summary: First FHC

Risk-free rate (5yr Govts)	1.81%
Market risk premium	7.00%
Estimated forward Beta	1.30
Cost of capital	10.9%
Sustainable LT core ROE	12.5%
Implied PBV (x)	1.15
2004F BVPS (NT$)	15.96
Implied target price (NT$)	18.28
Current price (NT$)	21.70
Difference	(3.42)
Upside	-15.7%

Source: Company data, ING estimates

SinoPac

SinoPac is a fundamentally low-spread and ROE business when compared to some of its competitors—but it is also relatively low risk. For this reason, we award SinoPac the lowest cost of capital among the members of our Taiwan bank universe, at 7.4% a full 40bp below that of quality leader Chinatrust. Using a sustainable core ROE of 10.7%, there is only modest upside to our target price of NT$19.36; however we would be remiss if we left our analysis at that.

We believe it overwhelmingly likely that SinoPac is taken over by a competitor or even a foreign player, meaning that the normal rules of valuation do not apply. Although it is our practice never to set price targets based on hypothetical M&A, we nevertheless point out that in our opinion SinoPac is worth NT$21-3 per share to a domestic acquisitor, and potentially even more to a foreign player.

Fig 21 Cost of capital valuation summary: SinoPac

Risk-free rate (5yr Govts)	1.81%
Market risk premium	7.00%
Estimated forward Beta	0.80
Cost of capital	7.4%
Sustainable LT core ROE	10.7%
Implied PBV (x)	1.44
2004F BVPS (NT$)	13.41
Implied target price (NT$)	19.36
Current price (NT$)	17.90
Difference	1.46
Upside	8.2%

Source: Company data, ING estimates

E.Sun

E.Sun is a good combination of low risk and high ROE, a pairing that merits a high fair value of 2.1x book, or NT$24.64 per share. Although E.Sun's trailing book multiple is already the highest in our Taiwan universe, bear in mind that the bank has already written off virtually all of its bad debts, so that its book value is much more solid by comparison than the book of an FFHC—or even a Chinatrust post GCB.

Fig 22 Cost of capital valuation summary: E.Sun

Risk-free rate (5yr Govts)	1.81%
Market risk premium	7.00%
Estimated forward Beta	0.85
Cost of capital	7.8%
Sustainable LT core ROE	16.5%
Implied PBV (x)	2.13
2004F BVPS (NT$)	11.59
Implied target price (NT$)	24.64
Current price (NT$)	18.70
Difference	5.94
Upside	31.8%

Source: Company data, ING estimates

Cosmos

Cosmos shows the highest upside under our methodology, due to its combination of low price, an already-clean book, and a concentration in high-margin, rapidly-growing consumer lending. Even while amortizing the remaining loss from NPL sales and write-offs, we believe that Cosmos can easily earn a 16% core ROE against its 10.4% cost of capital, yielding a fair value of 1.8x book, or NT$24.77 per share.

Fig 23 Cost of capital valuation summary: Cosmos

Risk-free rate (5yr Govts)	1.81%
Market risk premium	7.00%
Estimated forward Beta	1.00
Cost of capital	8.8%
Sustainable LT core ROE	16.0%
Implied PBV (x)	1.82
2004F BVPS (NT$)	13.64
Implied target price (NT$)	24.77
Current price (NT$)	15.50
Difference	9.27
Upside	59.8%

Source: Company data, ING estimates

Loan portfolios and growth

Industry performance and outlook

Taiwan's banking sector has returned to positive loan growth in 2003, with latest July figures showing a 2.8% increase over the prior year. Two key sectors—manufacturing and consumer lending—are both reversing earlier periods of decline to boost overall balances, and we believe that both will continue to lead.

Consumer balances will benefit both from a recovery in domestic spending and from a rebound in the property market, which accounts for some 65% of all loans to individuals.

On the corporate side, we see both a rise in domestic borrowing as corporates re-gear their balance sheets for growth and the post-election potential that Taiwanese banks will be able to recapture some of the customers which have moved their operations to the mainland.

This is an ideal time from the point of view of the Taiwanese banks to resume significant loan growth, as the added revenues will help pay off old losses and the new—and presumably better—loans will dilute old NPLs.

Fig 24 Loans by category (% growth YoY)

	1996	1997	1998	1999	2000	2001	2002	7/2003
Commercial and SOEs	(3.5)	15.5	16.7	12.2	4.8	(2.5)	(1.7)	0.4
Agricultural, Forestry, Fishing, and Animal Husbandry	(3.3)	2.4	33.3	(17.8)	7.7	(50.6)	8.2	30.3
Mining and Quarrying	12.5	22.8	0.4	15.7	6.5	(55.7)	(14.2)	(11.2)
Manufacturing	(2.5)	15.1	11.4	16.9	11.8	(1.7)	(2.1)	0.7
Electricity, Gas, and Water Supply	(3.3)	1.5	5.5	(6.6)	9.6	4.2	0.6	1.9
Construction	(13.4)	9.1	19.7	(5.8)	(12.1)	(22.2)	(9.0)	(4.6)
Trade	(6.2)	17.0	7.4	7.6	(0.2)	(11.3)	(3.0)	4.9
Accommodation and Eating-Drinking Places	2.0	(15.5)	54.4	(2.9)	19.5	71.2	(10.6)	(4.6)
Transport, Storage, and Communication	1.0	23.6	0.5	24.7	36.3	(1.1)	31.5	12.0
Finance and Insurance	52.2	24.3	73.7	28.4	(26.3)	83.7	4.7	(4.7)
Real Estate, Rental, and Leasing	(2.2)	18.6	23.9	18.5	9.5	10.9	(14.0)	(6.7)
Services	(6.8)	32.1	44.3	14.7	(1.1)	(37.9)	(8.6)	(3.0)
Government Agencies	22.0	19.9	11.0	12.3	18.5	2.4	(10.5)	(1.5)
Social Security Insurance, Pension Fund, and Non-profit Institutions	19.6	(27.2)	17.2	13.8	13.1	30.1	49.5	45.8
Individuals	12.7	20.8	8.0	3.5	3.4	(2.2)	0.4	6.3
Total Loans	6.5	18.2	12.0	8.5	6.3	(1.4)	(2.1)	2.8

Source:

Reported growth hindered by asset quality

Taiwanese loan growth has been anemic for most of the past four years, with balances over this period rising by only 3.4% since year-end 1999. This can be partially laid at the foot of asset quality issues which have persisted over the same time period, with two major effects impinging on growth:

First, poor asset quality and the government's increasingly-stringent loan classification and disclosure regulations, along with the general climate of unease stemming from the Asian Crisis, have caused managements to be more conservative when issuing loans—possibly erring on the side of caution. While we prefer quality to quantity, it is

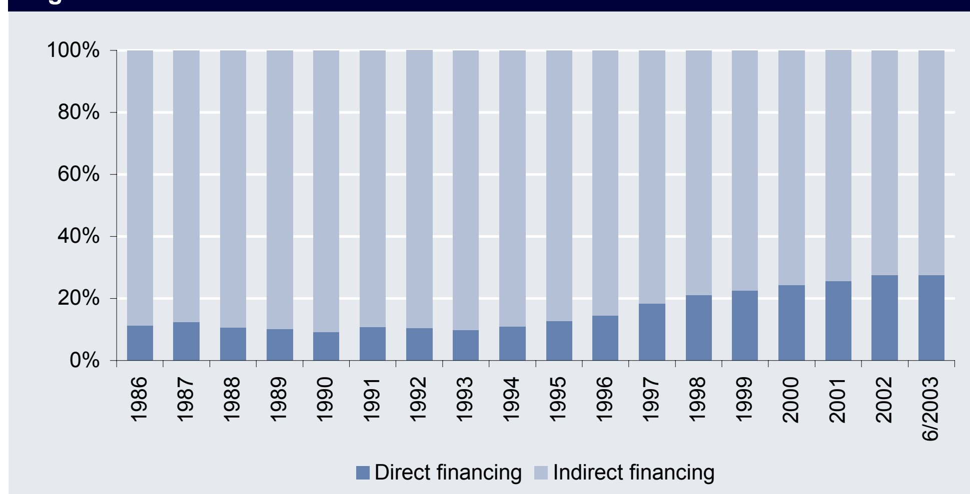
undeniable that the slowdown in loan growth is at least partially due to a change in standards.

Secondly, loans are reported net of charge-offs, which have been heavy throughout the period. Since the beginning of 1999, banks have written-off over NT$1 trillion in bad loans, reducing balances by approximately 9.6% of YE1998 loans and lowering the 1995-present loan growth CAGR from 7.4% to 6.2%.

Dis-intermediation

As in other Asia-Pacific markets, banks in Taiwan have been competing with a robust domestic fixed-income market for a shrinking loan pool—and losing more battles than they win; direct financing has become increasingly prevalent as opposed to bank borrowing. At the end of June 2003, NT$6,994bn (27.6%) of domestic funds were raised through issuing stocks or bonds; however, prior to 1995 the ratio was below 10%.

Fig 25 Trend of dis-intermediation



Source: Central Bank of China (CBC), ING Financial Markets

One key driver is government's encouragement of issuance, plus bull stock markets (in 1Q96-3Q97 and 1Q99-1Q00), where numerous financial products were developed that offered domestic enterprises more funding alternatives.

Banks' rigid lending rate structure is also responsible for the rapid growth in direct financing. Until recently, banks determined lending rates based on the rarely-adjusted prime lending rate, as opposed to securities houses and bills finance companies which offered issuers more flexible rates based on market supply/demand.

Note that the FHC structure is encouraging banks to follow the old maxim: "if you can't beat 'em, join 'em" by acquiring bills finance and securities subsidiaries and integrating their products into the banks' strategy for servicing customers. Remember also that straight corporate lending is at best marginally profitable for banks—one reason we are not so worried about them losing this loss-leader to the fixed-income market.

Eventually the demand for ancillary services (treasury, f/x, derivatives, *et al.*) may mean that banks should resume chasing these loans as a centerpiece of corporate relationships, but we are at least five years away from this point.

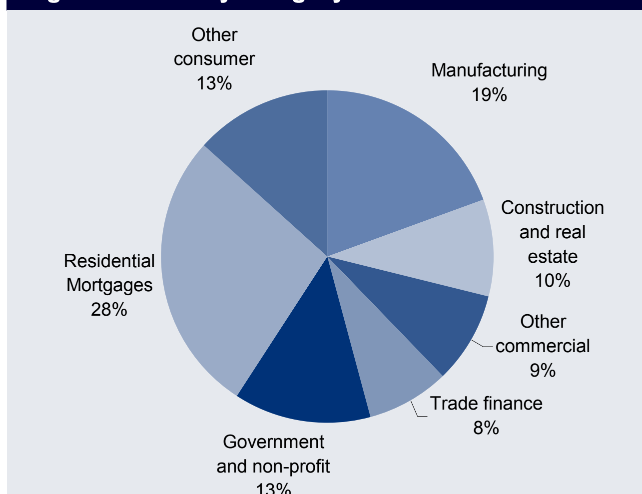
Fig 26 Corporate loan profitability - example

Base lending rate	**3.55%**
Less: 1-year time deposit rate	1.40%
Net lending spread (A)	2.15%
Cost of acquisition and servicing (B)	0.75%
Cost of credit (C)	0.75%
Net lending profit (D) = (A) - (B) - (C)	0.65%
Required capital (E)	8.00%
Implied ROE (D) / (E)	8.13%

Source: ING Financial Markets

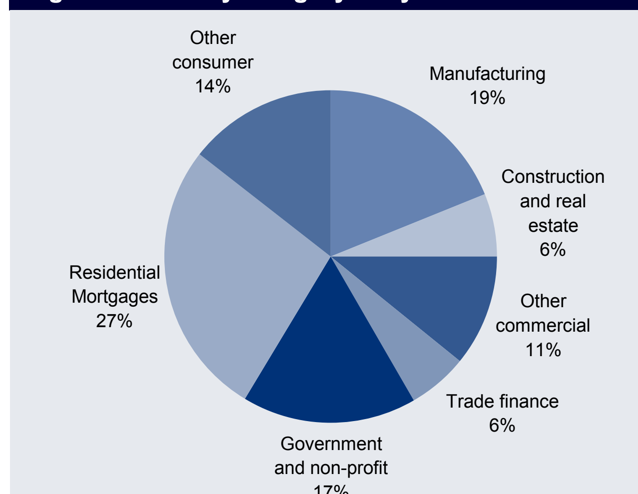
Loan composition

Fig 27 Loans by category: YE1995



Source: CBC

Fig 28 Loans by category: July 2003



Source: CBC

The structure of Taiwan's lending has not changed much since the mid-1990s. Residential mortgages and other consumer assets still account for 41% of all loans, with the manufacturing sector taking up another 19%. However, both construction lending and trade finance have shrunk in importance over the past eight years, the former because of declining credit quality and the latter due both to customers of Taiwanese exporters becoming more confident about their reliability (and hence demanding fewer safeguards) and to increased competition from foreign banks.

One additional segment which had been doing well until 2002 is loans to government agencies and public enterprises, hence their rise in share of balances over the past few years. The driving force behind this additional borrowing from banks was the government's desire to refund outstanding high-cost bonds while interest rates were falling.

However, after rising at a 14.2% CAGR from 1995 through 2001, government loans declined by almost 9%, mainly in 4Q02 and 2003. One potential boost to public-sector lending in the future is that the government has signalled that its expansion of the RTC fund to bail out troubled banks—assuming that some RTC measure is eventually passed—will be funded primarily through bank borrowings over its ten-year term. This could result in as much as NT$1 trillion in additional bank borrowings over its life.

While it was welcome in an otherwise parlous lending environment, all this government refinancing did not stimulate overall credit expansion in the economy, and at rates below 3%, it was and is a marginally-profitable business at best for banks.

Fig 29 Total loans (NT$m)

	1995	1996	1997	1998	1999	2000	2001	2002	7/2003
Commercial and SOEs	3,390,690	3,270,534	3,778,670	4,407,831	4,944,061	5,180,323	5,050,335	4,964,234	4,852,072
Agricultural, Forestry, Fishing, and Animal Husbandry	23,154	22,400	22,938	30,582	25,141	27,069	13,384	14,475	17,405
Mining and Quarrying	8,831	9,935	12,204	12,249	14,174	15,097	6,685	5,733	5,492
Manufacturing	1,435,636	1,399,614	1,610,308	1,793,809	2,097,744	2,345,005	2,305,171	2,256,434	2,217,393
Electricity, Gas, and Water Supply	186,263	180,195	182,987	193,098	180,390	197,744	206,011	207,283	219,059
Construction	471,119	408,057	445,070	532,617	501,586	440,982	342,961	312,249	295,403
Trade	599,693	562,406	658,022	707,014	761,079	759,672	673,999	653,757	666,739
Accommodation and Eating-Drinking Places	21,471	21,891	18,490	28,543	27,711	33,125	56,717	50,685	49,189
Transport, Storage, and Communication	132,295	133,657	165,142	165,931	206,847	281,946	278,741	366,583	368,607
Finance and Insurance	74,928	114,066	141,778	246,262	316,156	233,081	428,283	448,299	388,103
Real Estate, Rental, and Leasing	233,605	228,411	270,841	335,591	397,766	435,634	483,275	415,570	392,959
Services	203,695	189,902	250,890	362,135	415,467	410,968	255,108	233,166	231,723
Government Agencies	928,150	1,132,394	1,357,950	1,507,623	1,693,764	2,007,421	2,055,935	1,839,738	1,873,114
Social Security Insurance, Pension Fund, and Non-profit Institutions	42,073	50,326	36,654	42,945	48,850	55,264	71,917	107,481	113,304
Individuals	3,023,037	3,408,407	4,115,930	4,444,450	4,599,916	4,754,566	4,650,040	4,670,589	4,841,794
Total Loans	7,383,950	7,861,661	9,289,204	10,402,849	11,286,591	11,997,574	11,828,227	11,582,042	11,680,284

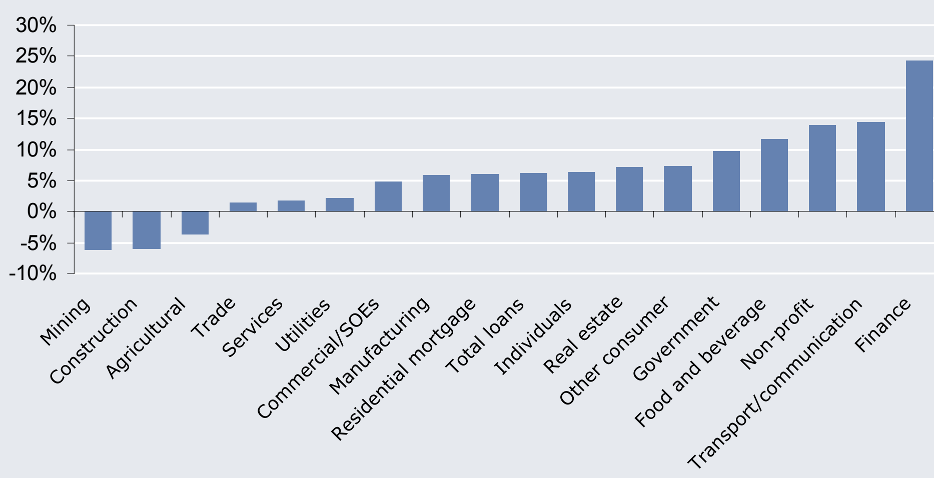
Source: CBC, ING estimates

Fig 30 Loans by category (% of total)

	1995	1996	1997	1998	1999	2000	2001	2002	7/2003
Commercial and SOEs	45.9	41.6	40.7	42.4	43.8	43.2	42.7	42.9	41.5
Agricultural, Forestry, Fishing, and Animal Husbandry	0.3	0.3	0.2	0.3	0.2	0.2	0.1	0.1	0.1
Mining and Quarrying	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0
Manufacturing	19.4	17.8	17.3	17.2	18.6	19.5	19.5	19.5	19.0
Electricity, Gas, and Water Supply	2.5	2.3	2.0	1.9	1.6	1.6	1.7	1.8	1.9
Construction	6.4	5.2	4.8	5.1	4.4	3.7	2.9	2.7	2.5
Trade	8.1	7.2	7.1	6.8	6.7	6.3	5.7	5.6	5.7
Accommodation and Eating-Drinking Places	0.3	0.3	0.2	0.3	0.2	0.3	0.5	0.4	0.4
Transport, Storage, and Communication	1.8	1.7	1.8	1.6	1.8	2.4	2.4	3.2	3.2
Finance and Insurance	1.0	1.5	1.5	2.4	2.8	1.9	3.6	3.9	3.3
Real Estate, Rental, and Leasing	3.2	2.9	2.9	3.2	3.5	3.6	4.1	3.6	3.4
Services	2.8	2.4	2.7	3.5	3.7	3.4	2.2	2.0	2.0
Government Agencies	12.6	14.4	14.6	14.5	15.0	16.7	17.4	15.9	16.0
Social Security Insurance, Pension Fund, and Non-profit Institutions	0.6	0.6	0.4	0.4	0.4	0.5	0.6	0.9	1.0
Individuals	40.9	43.4	44.3	42.7	40.8	39.6	39.3	40.3	41.5
Total Loans	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: CBC, ING estimates

Fig 31 Loan growth by category: CAGR 1997-July 2003



Source: Central Bank of China (CBC), ING Financial Markets

Loan growth projections

Our encouraging loan growth projections are driven by a recovery in two key sectors: manufacturing lending (which accounts for 46% of all corporate lending) and retail lending (primarily mortgages and credit cards). We see 2005 as the peak year for loan growth, with many projects and facilities arranged in 2004 post-election only being fully-disbursed in that year, and improved cross-strait relations leading to recapture of Taiwanese corporates on the mainland.

We forecast a 7% increase in manufacturing loans in 2004 (versus 2% in 2003) and an 8.5% increase in 2005. These are big numbers for growth, but by no means a return to the heyday of 1997-2000, when manufacturing loans grew at an average annual rate of 13.8%.

Loans to individuals are already up 6.3% YoY as of July; we project that this lending will strengthen to 9% by 2005, before falling back to 8% in 2006. With stronger economic growth and pressure off property prices, even this high rate of borrowing will not significantly increase the debt/income or debt/asset positions of Taiwanese households.

Fig 32 Total loans (NT$m)

	2002	7/2003	2003F	2004F	2005F	2006F
Commercial and SOEs	4,964,234	4,852,072	5,018,351	5,192,413	5,470,319	5,762,661
Agricultural, Forestry, Fishing, and Animal Husbandry	14,475	17,405	15,271	16,264	17,240	18,274
Mining and Quarrying	5,733	5,492	5,446	5,174	5,278	5,489
Manufacturing	2,256,434	2,217,393	2,301,563	2,462,672	2,671,999	2,859,039
Electricity, Gas, and Water Supply	207,283	219,059	214,745	223,550	236,963	248,811
Construction	312,249	295,403	302,882	296,824	302,760	310,329
Trade	653,757	666,739	692,982	738,026	785,998	825,298
Accommodation and Eating-Drinking Places	50,685	49,189	48,658	48,171	49,134	51,100
Transport, Storage, and Communication	366,583	368,607	406,907	423,183	444,343	464,338
Finance and Insurance	448,299	388,103	421,401	387,689	368,305	379,354
Real Estate, Rental, and Leasing	415,570	392,959	382,324	361,297	349,554	353,050
Services	233,166	231,723	226,171	229,564	238,746	247,580
Government Agencies	1,839,738	1,873,114	1,802,943	1,875,061	1,837,560	1,736,494
Social Security Insurance, Pension Fund, and Non-profit Institutions	107,481	113,304	155,847	171,432	180,004	189,004
Individuals	4,670,589	4,841,794	5,020,883	5,447,658	5,937,947	6,412,983
Total Loans	11,582,042	11,680,284	11,998,024	12,686,565	13,425,831	14,101,142

Source: CBC, ING estimates

Fig 33 Loans by category (% growth YoY)

	2002	7/2003	2003F	2004F	2005F	2006F
Commercial and SOEs	(1.7)	0.4	1.1	3.5	5.4	5.3
Agricultural, Forestry, Fishing, and Animal Husbandry	8.2	30.3	5.5	6.5	6.0	6.0
Mining and Quarrying	(14.2)	(11.2)	(5.0)	(5.0)	2.0	4.0
Manufacturing	(2.1)	0.7	2.0	7.0	8.5	7.0
Electricity, Gas, and Water Supply	0.6	1.9	3.6	4.1	6.0	5.0
Construction	(9.0)	(4.6)	(3.0)	(2.0)	2.0	2.5
Trade	(3.0)	4.9	6.0	6.5	6.5	5.0
Accommodation and Eating-Drinking Places	(10.6)	(4.6)	(4.0)	(1.0)	2.0	4.0
Transport, Storage, and Communication	31.5	12.0	11.0	4.0	5.0	4.5
Finance and Insurance	4.7	(4.7)	(6.0)	(8.0)	(5.0)	3.0
Real Estate, Rental, and Leasing	(14.0)	(6.7)	(8.0)	(5.5)	(3.3)	1.0
Services	(8.6)	(3.0)	(3.0)	1.5	4.0	3.7
Government Agencies	(10.5)	(1.5)	(2.0)	4.0	(2.0)	(5.5)
Social Security Insurance, Pension Fund, and Non-profit Institutions	49.5	45.8	45.0	10.0	5.0	5.0
Individuals	0.4	6.3	7.5	8.5	9.0	8.0
Total Loans	(2.1)	2.8	3.6	5.7	5.8	5.0

Source: CBC, ING research

Taiwan outperforms Hong Kong

Taiwan is our preferred reflation candidate within the Greater China region, despite the announcement of CEPA in Hong Kong and Hong Kong banks' historically-better access into China. We believe that Taiwan's higher economic growth and more competitive financial sector will combine with pre-WTO access to China to produce improved lending prospects.

Note that since 1997 Taiwan has outperformed Hong Kong in terms of loan growth; we believe that this will continue through 2006. Although we do not see the coming

reflation in Asia as a matter of loan growth alone, this is a particularly key metric for Taiwan as there is still much work to be done in reforming and reshaping the domestic financial sector, and this is much easier to accomplish in an environment of even minimal growth than it is in a shrinking industry.

Fig 34 Loan growth: Taiwan vs Hong Kong

Source: HKMA, CBC, ING estimates

Fig 35 Sectoral loan growth (YoY %chg): Hong Kong vs. Taiwan

		1996	1997	1998	1999	2000	2001	2002	7/2003
Manufacturing	Taiwan	(2.51)	15.05	11.40	16.94	11.79	(1.70)	(2.11)	0.66
	Hong Kong*	7.38	2.92	(14.52)	(15.26)	(8.04)	(3.39)	(0.78)	2.70
Construction and real estate	Taiwan	(9.69)	12.48	21.27	3.59	(2.53)	(5.75)	(11.91)	(5.80)
	Hong Kong*	27.01	32.21	(5.47)	(7.71)	3.71	(2.39)	(2.54)	(1.70)
Other commercial	Taiwan	3.29	18.21	30.76	14.16	1.11	3.83	6.53	1.47
	Hong Kong*	11.85	21.52	(10.06)	(15.15)	0.32	(13.33)	(4.79)	(2.60)
Trade finance	Taiwan	(6.22)	17.00	7.45	7.65	(0.18)	(11.28)	(3.00)	4.85
	Hong Kong	6.56	4.30	(22.66)	(23.87)	(8.60)	(14.65)	2.64	3.12
Government and non-profit	Taiwan	21.90	17.91	11.18	12.39	18.37	3.16	(8.49)	0.33
	Hong Kong	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Residential Mortgages	Taiwan	12.94	13.50	6.93	4.50	4.71	(1.78)	2.43	5.81
	Hong Kong*	20.81	28.19	9.03	3.21	2.93	3.28	(0.81)	(4.05)
Other consumer	Taiwan	12.36	35.77	9.81	1.81	1.04	(2.95)	(3.16)	7.09
	Hong Kong*	20.16	25.68	(2.27)	(0.59)	11.83	3.16	(3.89)	(9.63)
Total	Taiwan	6.47	18.16	11.99	8.50	6.30	(1.41)	(2.08)	2.75
	Hong Kong*	17.09	24.44	(3.77)	(7.17)	2.29	(3.83)	(2.64)	(3.26)

* YoY % change as of June, 2003.

Source: HKMA, CBC, ING estimates

Asset quality

Asset quality remains a critical issue

The balance sheets of Taiwanese banks remain in poor shape. In aggregate, we believe that the banking sector as a whole could potentially be insolvent if required to account for the full cost of legacy bad debts now. Although this is much more of an issue at the larger state-owned institutions and credit cooperatives, all Taiwanese banks have been affected by the burden of NPLs.

Remember that the smaller private banks, although in much healthier shape as a class, are in most traditional products still price-takers—and hence, any panicked or irrational pricing decisions made by the larger and more-distressed banks will impact their profitability as well.

Fig 36 Asset quality summary

2Q03A	NPAs/ loans	Weighted NPLs	Reserves/ NPAs	Reserves/ required
Chinatrust	2.4%	0.6%	60.8%	92.4%
Taishin	2.6%	0.6%	34.2%	56.0%
First FHC	4.8%	1.4%	20.1%	40.2%
SinoPac	2.0%	0.4%	32.6%	45.6%
E.Sun	1.2%	0.4%	71.0%	63.2%
Cosmos	10.2%	1.4%	10.0%	34.3%

Source: Company data, ING estimates

Although loss deferrals and the issuance of tier 2 debt were the primary means of meeting capital needs in 2001-2, banks (led by First and Mega) are back in the equity markets—a trend we believe will continue as our analysis shows that banks will require at least an additional NT$220 bn by year-end 2004 in order to fully meet MoF requirements. This, along with government divestitures, represents a substantial overhang for the sector, especially given the poor market environment.

NPL regulations grow stricter

The Ministry of Finance (MoF) is showing a willingness to confront the bank asset quality problem head-on; recently the MoF mandated that domestic banks lower NPL ratios to below 5% while raising capital adequacy ratios (CARs) above 8% by the end of FY03.

In addition, the MoF is moving towards international standards for reporting impaired loans at Taiwanese banks. Although Taiwan's definition of NPLs will remain more lax than that of most western regimes, the MoF has become considerably stricter. The new mandated 5% NPL ratio target includes loans under surveillance—a key change which we estimate will inflate currently-reported NPL numbers by 300–350bp for the industry as a whole.

The combination of stricter standards and more rigorous measurement of bad assets sets a high bar for the sector—we estimate that 75% of major institutions will be unable to meet the criteria without raising capital or taking advantage of loss deferrals.

Different levels of punishments—including branch closures and suspension of existing businesses—will be meted out to those who fail to achieve the required targets. This will force domestic banks to clean up balance sheets even more aggressively; in fact, this process is already under way.

Write-offs are clearing NPLs

Since YE1998, domestic banks together have written-off over NT$1tr in bad debt—NT$140.2bn in FY99, NT$163.5bn in FY00, NT$233bn in FY01, and NT$413.9bn in FY02, plus an additional NT$100bn in FY03 YTD—and the pace has only quickened this year.

These write-offs have helped reduce reported NPLs (under the new standard) from an estimated 10.5% to 7.9% over the past twelve months. In fact, both reported overdue loans and loans under surveillance have been declining since 1Q02. Loans under surveillance include (1) mid- to long-term loans on which instalments are past due 3 to 6 months, (2) loans on which principal is past due less than 3 months while interest repayments are past due 3-6 months, and (3) overdue loans which are exempt from reporting—*e.g.*, loans under restructuring agreements.

Without being overly pessimistic, it does bear keeping in mind that the NPL's which have already been resolved are in large part the most sound loans—typically those backed by real estate or easily-restructured corporate loans. The remaining NPLs are more resistant to sale or workout, and we expect that the recoveries on these remaining pools could be lower than those experienced already (10–50% recoveries on book value).

More provisions to come …

Going forward we expect banks' earnings streams to be further undermined given the mandate by the Ministry of Finance (MoF) that requires domestic banks adopt a new definition of bad loans that is more in keeping with internationally accepted standards.

Since April 2003, NPLs in Taiwan have included both reported NPLs under the former definition and loans under surveillance, which were previously undisclosed.

Can AMCs solve the NPL problem?

Instead of charging huge provisions, banks that do not have sufficient earnings stream to fund them may sell their bad assets to asset management companies (AMCs), as the MoF allows any loss resulting from an asset sale to be amortised over five years. However, this method will eventually have a similar equity erosion effect, given that the asset sale usually results in a huge discount of 60%-75%.

Most domestic banks will adopt both provisioning and asset sale to write off their bad debt. From a cost-return perspective, selling bad assets to asset management companies (AMCs) is more efficient than charge-off on provisioning thanks to the legally allowed five-year amortisation method. As opposed to the provisioning method, asset sale will clean up banks' balance sheets quickly meanwhile having limited immediate impact on earnings.

Large, old (especially state controlled) banks can accept amortizing AMC charges as they can use the huge equity bases accumulated over past years to offset the loss in earnings, but smaller bad banks may be disproportionately hurt as their annual profits are too small to even cover the amortised loss.

Essentially, the five-year amortisation policy only puts off the problem. Although we do not necessarily disdain regulatory forbearance as a means of incentivizing banks to clear their bad assets, it is critical that banks be able to quantify the losses incurred and earn their way out of their negative capital positions over a reasonable time frame.

Asset resolution is what counts

Merely forming AMCs is just a way of moving banks' bad assets from left pocket to right, at least on a short-term horizon. Of major concern is that we do not know where and how these AMCs are going to deal with the assets they have acquired. Outside of Taiwan, asset securitisation is widely accepted. However, given the immaturity of the Taiwanese securitisation market (only one transaction has even been completed) as well as an incomplete regulatory framework, selling the raw NPLs to the market may be the quickest way to obtain immediate return.

Real estate slump inhibits quick sales

The easiest loans to sell are those backed by real estate. Unfortunately, we see no sign of a recovery in the domestic real estate market, and this will make it difficult to sell assets. Taiwan's property prices peaked in 1993, and since then have declined continuously due mainly to oversupply. Although capacity has remained stagnant since 1996, the imbalance has not been corrected on the buy side due to a slowdown in domestic economy and correction in the local bourse.

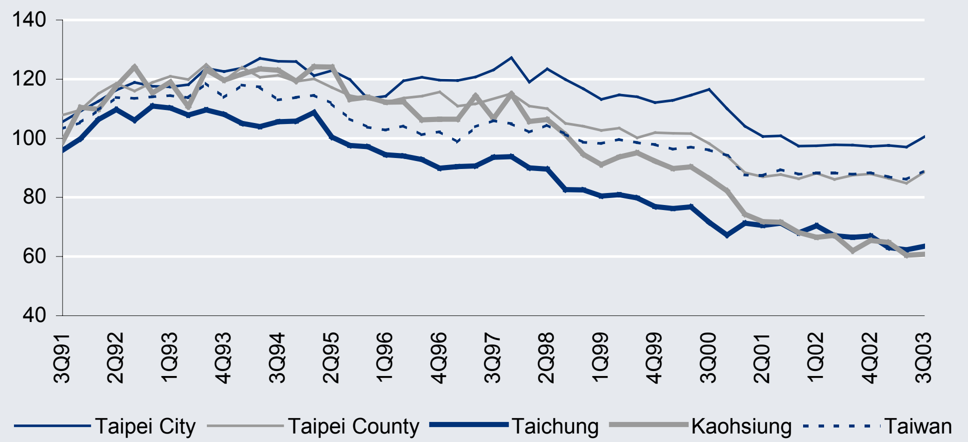
Between 1991 and 2002, residential price indices dropped between 23% and 50%, dependent on the district, from their respective peaks. The metropolitan Taipei area suffered less (property prices down 23% in Taipei City and 30% in Taipei County) given their locations, less severe over-capacity and the outstanding performance in the luxury residential segment in 1998–2000. On the other hand, Taichung and Kaohsiung, located in the central and southern Taiwan respectively, have seen 40% and 50% price declines, and there seems to be less support for the property prices in Kaohsiung given the MRT system and underground railway currently under construction.

We believe that the downturn has bottomed—especially in Taipei—but we expect the market will continue be less-than-robust at least for the next 12 months, for two key reasons. The first is the termination of the 50% cut in the land incremental tax. The government has since January 2002 halved the land incremental tax rate for a two-year period, ie from Jan-02 to Dec-03, in efforts to boost transactions in the real estate market. In that case, property prices may weaken again as we approach the end of FY03, as property owners may sell their properties to take full advantage of the tax benefit before it is expired.

The second is that Taiwan's auctioning system may aggravate the property price declines. As mentioned above, AMCs are most likely to sell the assets they have acquired back to the market. Besides the existing court auctions, now there are two other venues—"Golden auctioned house " and "Silver auctioned house " where these acquired assets can be liquidated. We believe that the increasing prevalence of large amounts of AMC property at auction is a further risk for property prices.

Note that this is not analogous to the RTC experience in the US, as it is still largely the banks selling property for their own accounts, rather than the government clearing out its holdings after first recapitalizing or closing the affected banks.

Fig 37 Taiwan housing indexes in major cities



Source: Sinyi Realty, ING Financial Markets

Reserve adequacy

Taiwanese banks remain under-reserved, despite asset quality improvements and massive provisions over the past three years. The tide is starting to turn, however—a key factor for investors who do not wish to pay for mistakes already made in the past.

Fig 38 Reserve adequacy summary

2Q03	Reserves/ loans	Required reserves	Actual/ required	Shortfall (NT$m)	Shortfall/ equity
Chinatrust	1.48%	9,196	92.43%	696	0.83%
Taishin	0.90%	5,764	55.97%	2,538	4.92%
First FHC	0.96%	20,918	40.21%	12,507	20.41%
SinoPac	0.65%	3,692	45.63%	2,007	4.56%
E.Sun	0.86%	2,558	63.69%	929	3.78%
Cosmos	1.02%	4,592	34.33%	3,016	15.20%

Source: Company data, ING estimates

Calculation methodology

We calculate the required reserves and shortfall as follows:

We divide the Taiwanese banks' loan portfolios into the international standard categories of Pass (performing), Special Mention, Substandard, Doubtful, and Loss, with Special Mention equivalent to the MoF's "Loans under surveillance" classification. Note that this analysis accepts each bank's internal classification of their own loans, which we believe to be considerably more lenient than the standards applied outside of Taiwan.

We apply reserve weightings as follows to determine the appropriate minimum level of required reserves: 1% on Pass; 5% on Special Mention; 20% on Substandard; 50% on Doubtful; and 100% on Loss loans. In addition, where not included in banks' internal classifications, we classify all excess (above 1.25%) accrued interest receivables and Other Real Estate (ORE, or foreclosed property) as Substandard. All assets are classified on a gross of collateral basis.

This is more stringent than even the new MoF methodology, but is directly in line with the standards applied by the BIS and major regulators in the U.S. and the UK.

Full details of the calculation for each bank are contained in the relevant company section following.

Rates and margins

Continued spread deterioration …

We expect banks' underlying profitability on specific products to continue deteriorating until the interest rate cycle really kicks into gear in late 2004. The Central Bank of China (CBC) will maintain a loose monetary policy, with a rate rise unlikely in the near term, although we think that rates are at least near the bottom and we will not see further cuts.

Mortgage books will continue to reprice somewhat as homeowners shift to the ARM structure; but banks are already fighting back with offset products and other ways of regaining margin. Finally, high-spread credit and cash cards will inevitably come under pressure (see below).

… but mix and gearing will improve margins

The negative factors described above will start to be offset in 2H03 by changes in mix towards higher-spread (even if declining-spread) products and by a badly-needed increase in loan-to-deposit ratios for the sector. These will pull up overall margins even as spreads on many products remain on a downward slope.

Also bear in mind the potential of securitization (newly approved this year in Taiwan) to raise margins and improve utilization of capital. Although low gearing makes the advent of widespread shifts in loans off-balance-sheet something other than a near-term event, securitization has potential to extend the improvement in ROE past 2005.

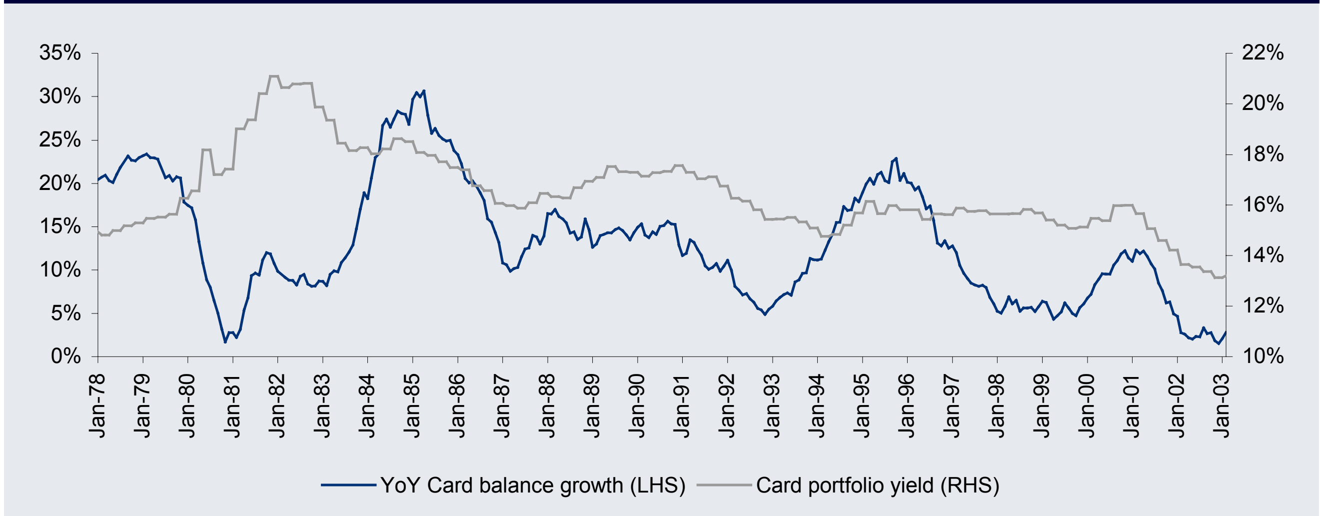
Credit and cash cards

Although credit card balance growth continues apace (see our full analysis beginning at page 8), rising penetration means that the easy growth in accounts is near an end, and the battle for usage will now begin. Although rates have held up quite well so far, and all major players swear with hats in hand that cutting the benchmark rates is to them anathema, we firmly believe that it is inevitable that rates (still in the 19-20% range) will come down.

Looking at the development of the US market (see following chart), we can see that since the end of hyperinflation in the early 1980s, declines in balance growth have been generally associated with falling yields—and vice-versa. We believe that the same will hold true for Taiwan.

Specifically, we project that credit card balances will lose on average 125bp of gross yield over the next 18 months, and that cash card balances (which we see being used as a price competitor in a more aggressive way) will lose 150bp in the next 12 months. Note that three of our four BUY rated banks, and both of our top picks, are leaders in credit and cash cards—falling spreads will play to the advantage of scale players by discouraging new entrants and banks will small or low-quality portfolios.

Fig 39 US credit card yields versus growth



Source: Federal Reserve BOG, ING estimates

Company section

Chinatrust: Local hero

Chinatrust is Taiwan's most profitable major bank, with trailing ROE of over 15% despite heavy write-downs and the poor economic environment. The bank took an early lead in consumer banking, and remains the #1 issuer of credit cards, having surpassed early originator Citibank.

Nevertheless, the company trades at a sizeable discount to its peers, with a 2004 PER of 10.2x versus our Taiwan bank average of 13.1x. We believe that this discount is due to unwarranted concerns about Chinatrust's business prospects, especially in consumer banking and credit cards.

We are thus initiating coverage of Chinatrust with a BUY rating and NT$50 price target, based on our cost of capital methodology which yields a fair price/book multiple of 2.48x.

We see key issues for Chinatrust as follows:

Credit card risk

Credit cards account for 9% of Chinatrust's assets but 30% of the company's net profits. We further estimate that the card portfolio (and associated products such as cash cards) will generate over 50% of the institution's credit risk going forward. Although Chinatrust has demonstrated excellent risk management to date, clearly any general decline in individual credit quality will hit the FHC hard.

Our analysis of the credit card market (please see "***Credit cards: impending doom or continued boom?***" starting at page 8) shows that the Taiwanese consumer is not under strain, with debt to disposable income actually lower than the 1998 level despite the poor economy and higher unemployment. In addition, the burden of interest payments on debt—the key issue for high-rate unsecured consumer credit—stands at only 3% of aggregate household disposable income, with net savings at 19% of same. This is not an overgeared consumer.

Furthermore, the rise in unemployment has already been seen and joblessness peaked over 1 year ago. Although we remain concerned about the still-high level of unemployment and its very slow decline, any spike in defaults due to this factor should already have been seen based on our previous experience—the critical period is 6 months after the peak of unemployment.

Acquisitions

Chinatrust agreed to buy smaller competitor Grand Commercial in July, and we believe that this may not be the last acquisition by the group.

It is no secret that we don't like most bank mergers; yet, it has been inevitable (and clearly marked by management) that Chinatrust would participate in M&A. For one thing, the bank—although admittedly of very high quality—was too small versus its large competitors, a dangerous position in a fragmented but consolidating market.

Fig 40 Leading banks' market share (deposits) at 1H02

Bank	Branches	Market share (%)
Bank of Taiwan	130	11.2
Taiwan Cooperative Bank	170	8.8
Land Bank of Taiwan	121	6.9
First Bank	173	6
Hua Nan Bank	159	5.8
Chang Hwa Bank	165	5.4
Taiwan Business Bank	124	3.8
Chinatrust Bank	56	3.8

Note: domestic branches only.

Source: MoF, Company data, ING estimates

Secondly, Chinatrust does not have the comprehensive branch network in Taipei that is deemed necessary to succeed in this critical market, and the regulatory authorities have cannily promoted consolidation by making it essentially impossible to open new branches in desirable areas except by buying other institutions. So, we have expected—and still do expect—Chinatrust to keep extending its network by acquisition.

Although we appreciate that CT's strategic imperative is to acquire other banks so as to get larger and better positioned, that doesn't mean it fits with our financial strategy as investors.

Even taking management's assessment of cost savings at face value, we believe that the Grand Commercial merger will be dilutive to returns at CT, with a return on investment of under 9% versus the group's cost of capital of 9.5% and ROE of 15%. Note that in our analysis we include the estimated NT$10bn in NPL write-offs (estimated to hit the P&L in 4Q03-1Q04) that Chinatrust will make on the Grand Commercial book as part of the acquisition expense, rather than as a "floating extraordinary" item.

Competition

Chinatrust has been extraordinarily successful in credit cards in part because its large competitors were sleepy state banks without the initiative or the systems to properly manage consumer credit risk and transaction processing. These banks are sleepy no longer (although First FHC's embarrassing recent missteps in cash card issuance indicate that not everything has changed), and they are all anxious for a share of Chinatrust's franchise.

We believe that they will be successful in driving down pricing and increasing competition for new customers, but the relentless economics of consumer banking are driven by scale—and so far it does not seem that state banks will easily attain the scale to profitably challenge CT.

We do project a significant erosion of spreads, but this is only to be expected as the market matures. In the interim, Chinatrust's expanded network and service offerings will enable the company to mine its existing customer base and sell clients new products.

Introduction

Chinatrust FHC was established in May of 2002 by the conversion of Chinatrust Bank, which was one of the crop of private banks licensed in 1991-2. Through further acquisitions, Chinatrust FHC now has five non-banking subsidiaries—Chinatrust Securities, Chinatrust Insurance Brokerage, Chinatrust Bills Finance, Chinatrust Asset

Management (the bank's AMC), and Chinatrust Venture Capital, along with the recently-acquired Grand Commercial Bank.

Returns

Return to shareholders at Chinatrust FHC (and Chinatrust Bank previously) improved steadily from 1998-2002 due to continued improvement in underlying profitability, and especially the interest spread book – note that net interest margin rose from 2.67% to 4.58% over the same period. The company generated ROE of 15.6% in 2002 on strong ROA of 1.44%, again tops in our universe.

As with most other banks, the peak year for CT's provisioning was 2001, when the industry began to get serious about its bad debt problems. In that year Chinatrust Bank booked loan loss provisions alone of NT$10.8bn (the group total was NT$14.1bn when other asset quality charges are included) and charged off NT$8.7bn in bad debt, which resulted in a 119bp decline in ROE—though net income actually rose slightly. However, the bank has remained reasonably clean since then, even with a declining economy. We expect a similar cleanup to take place for Grand Commercial's book now that the bank has been acquired.

Cost efficiency also started improving in 2001, due to (1) the economy of scale that has resulted from years of retail segment development and (2) completion of a company-wide reengineering program, which effectively streamlined Chinatrust Bank's back-office operation and brought about greater IT system integration. Currently, Chinatrust Bank's cost-to-income ratio stands at around 45%; this ratio is quite good for a bank that focuses on consumer banking (and especially the credit card business), which is known for expensive marketing and servicing costs.

Fig 41 Key earnings components: 1998-2004F (NT$m)

Yr to Dec	1998	1999	2000	2001	2002	2003F	2004F
Net Interest Income	12,158	16,033	20,367	23,708	30,173	27,934	31,364
Non-Interest Income	7,713	7,301	11,481	17,333	12,751	18,686	24,959
Non-Interest Expenses	9,521	11,471	16,574	17,959	18,795	21,799	26,614
Loan Loss Provisions	5,036	8,077	6,599	14,089	9,177	10,301	7,336
Core Income	3,809	2,520	6,874	7,525	11,873	11,710	18,202
Net Income	4,151	4,861	7,220	7,663	12,032	11,373	16,682
EPS (NT$)	1.42	1.43	1.83	1.66	2.61	2.15	3.16

Note: Consolidated since 2003, bank data available only for 1998-2002

Source: Chinatrust FHC, ING Financial Markets

Fig 42 Key earnings components: 4Q01-2Q03 (NT$m)

Yr to Dec	4Q01	1Q02	2Q02	3Q02	4Q02	1Q03	2Q03
Net Interest Income	6,441	7,216	7,660	7,740	7,556	7,441	6,813
Non-Interest Income	5,867	3,778	2,627	3,357	2,988	3,692	4,373
Non-Interest Expenses	4,664	4,613	4,381	4,803	4,997	4,996	5,047
Loan Loss Provisions	4,943	2,098	1,982	2,543	2,554	1,652	1,789
Core Income	2,117	3,339	2,977	2,975	2,582	3,568	3,519
Net Income	2,099	3,339	3,128	2,984	2,581	3,529	3,600
EPS (NT$)	0.46	0.73	0.68	0.65	0.56	0.77	0.71

Note: Consolidated since 1Q03, bank data available only for 4Q01-4Q02

Source: Chinatrust FHC, ING Financial Markets

Fig 43 Key earnings ratios: 1998-2004F

Yr to Dec	1998	1999	2000	2001	2002	2003F	2004F
ROA	0.74%	0.80%	1.07%	1.00%	1.44%	1.20%	1.55%
Core ROA	0.68%	0.42%	1.02%	0.98%	1.43%	1.24%	1.70%
ROE	10.08%	9.70%	11.97%	10.78%	15.64%	13.39%	17.27%
Core ROE	9.25%	5.03%	11.39%	10.59%	15.44%	13.79%	18.85%
NIM	2.67%	3.31%	3.75%	3.89%	4.58%	3.57%	3.44%
Cost/Income	47.91%	49.16%	52.04%	43.76%	43.79%	46.76%	47.25%
Overhead	2.09%	2.37%	3.05%	2.95%	2.85%	2.79%	2.92%
Effective Tax Rate	28.32%	33.45%	20.76%	16.31%	20.59%	19.35%	18.64%

Note: Consolidated since 2000, bank data available only for 1998-2001

Source: Chinatrust FHC, ING Financial Markets

Fig 44 Key earnings ratios: 4Q01-2Q03

Yr to Dec	4Q01	1Q02	2Q02	3Q02	4Q02	1Q03	2Q03
ROA	1.04%	1.64%	1.54%	1.45%	1.23%	1.67%	1.67%
Core ROA	1.05%	1.64%	1.46%	1.44%	1.23%	1.69%	1.64%
ROE	11.41%	18.24%	17.10%	15.80%	13.14%	17.67%	17.62%
Core ROE	11.51%	18.24%	16.28%	15.76%	13.14%	17.86%	17.22%
NIM	4.07%	4.55%	4.78%	4.71%	4.48%	4.35%	3.93%
Cost/Income	37.89%	41.96%	42.59%	43.28%	47.40%	44.87%	45.12%
Overhead	2.95%	2.91%	2.74%	2.92%	2.97%	2.92%	2.91%
Effective Tax Rate	21.63%	22.06%	24.13%	20.70%	13.71%	20.46%	19.10%

Note: Consolidated since 1Q03, bank data available only for 4Q01-4Q02

Source: Chinatrust FHC, ING Financial Markets

Loan portfolio

Chinatrust's loan portfolio is primarily retail-driven and has been for some time. Corporate lending accounts for only 44% of the book, with the remainder apportioned amongst mortgages (30%), credit cards (9%), and other consumer credit (17%).

Even more so than the raw balance statistics would indicate, credit cards and consumer lending are a driving force for profits, with credit cards alone producing 30% of net profits. We project that credit card balances will resume strong accretion, at a CAGR of 30% through YE2005 (in part due to the inclusion of GCB) and then at a CAGR of 12% from 2005-2009.

Non-card consumer lending will grow almost as strongly for Chinatrust, with a 24% CAGR through 2005. Bear in mind that this is the reverse of the dynamic we see for the industry as a whole, where other consumer loans will grow faster than credit card receivables; this is a) a consequence of Chinatrust's scale advantage in mass-marketed credit cards; and b) a reflection of the bank's reluctance to cannibalize its existing credit card portfolio with aggressive marketing of cash cards and other alternative products with lower spreads.

Coupled with an uptick in corporate lending growth to the 8-9% range over the next three years, this will leave Chinatrust with total loan growth of 8% in 2004 and 10% in 2005.

Fig 45 Loan breakdown: 1998-2004F

Yr to Dec	1998	1999	2000	2001	2002	2003F	2004F
Total loans	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Corporate	51.2%	52.5%	51.6%	47.3%	48.0%	49.0%	49.5%
Consumer	48.8%	47.5%	48.4%	52.7%	52.0%	51.0%	50.5%
Mortgage	32.7%	32.1%	31.6%	33.2%	33.0%	33.0%	32.0%
% of consumer loans	67.1%	67.7%	65.3%	63.0%	63.5%	64.7%	63.4%
Unsecured personal loans (excluding credit card revolving)	16.0%	15.4%	16.8%	19.5%	19.0%	18.0%	18.5%
% of consumer loans	32.9%	32.3%	34.7%	37.0%	36.5%	35.3%	36.6%

Note: Loan breakdown available for Chinatrust Bank in 1998-2002; combined Chinatrust and Grand Commercial Bank starting 2003

Source: Ministry of Finance, Chinatrust FHC, ING Financial Markets

Fig 46 Loan growth: 1998-2004F

Yr to Dec	1998	1999	2000	2001	2002	2003F	2004F
Total loans	11.5%	11.4%	18.0%	5.0%	6.9%	30.2%	8.0%
Corporate	8.7%	14.2%	16.0%	-3.8%	8.5%	32.9%	9.1%
Consumer	19.2%	9.4%	16.1%	10.2%	6.3%	30.2%	4.7%
Mortgage	6.0%	6.7%	28.8%	22.0%	4.2%	23.3%	11.0%
Unsecured personal loans	37.6%	18.9%	15.7%	9.4%	1.6%	8.8%	35.0%

Note: Loan growth available for Chinatrust Bank in 1998-2002; combined Chinatrust and Grand Commercial Bank starting 2003

Source: Ministry of Finance, Chinatrust FHC, Grand Commercial Bank, ING Financial Markets

Asset quality

Chinatrust's asset quality is better than that of its large competitors, and is among the best in Taiwan overall—but this has come at a high price. We believe that asset quality has now stabilized on an organic basis due to CT's prudential provisioning and charge-off policies, and to the large investments in credit risk management made over the past three years.

The group's reported NPL ratio was 2.2% as of June 2003, or 2.5% if loans under surveillance[6] are included, as we strongly believe they should be. This is still somewhat high by global standards, but in the Asian context it puts Chinatrust in the top tier of banks.

The key issue going forward for Chinatrust will be identifying and resolving the bad assets in the Grand Commercial book—and its clear that GCB has more than its fair share of troubled lending relationships. From an investment standpoint, we want to see this cleanup done as expeditiously as possible; we are not afraid to see a large one-time loss on sale or write-off as long as we can quantify the damage and believe in management's ability to prevent its recurrence.

How has Chinatrust cleaned up its book?

Since the early 1990s, Chinatrust has restricted its mortgage lending in central and southern Taiwan due to the continued deterioration in property prices in those areas. Over the last three to four years, the bank has also deliberately reduced its corporate exposure in light of the weakening domestic economy and the poor risk/reward tradeoff on these loans.

In addition, the bank has been aggressive in its write-offs and provisioning over the last several years. Its net bad debt write-offs totaled more than NT$39bn during the 1998-2002 period—a whopping 10.5% of total loans at the beginning of the period.

[6] Loans under surveillance consist of loans with interest overdue for three months but less than six months, as well as certain restructured loans.

Loan loss provisions have been consistently elevated, running at 1%-2% of loans per annum, even though current regulations only allow up to 1% of such provisions to be tax deductible. Provisions and charge-offs together have turned the tide, and the coverage ratio has improved from 52% at YE2001 to 71.4% as of June 2003; this suggests lower provisioning expense in the years ahead, at least once GCB is taken care of.

As for the rapidly growing credit card business, the underlying delinquencies are well controlled - under 3% on a 90+ day basis, with annualised charge-offs of less than 4%. Chinatrust Bank usually writes off delinquent credit card receivable accounts fully at 180 days – somewhat later than some of its major competitors (eg Taishin writes off post 150 days) but still in line with global standards.

Concern over GCB's asset quality

As of June 2003, GCB reported overdue loans of NT$5,712m, translating into an NPL ratio of 4.1%. This rises to a whopping 8% if loans under surveillance are included—more than 3x the rate for Chinatrust Bank. The large amount of surveillance loans compared with statutory NPLs indicates that the bank may be under-reporting problems, and in fact asset quality is probably worse than it appears.

Our calculation shows that, assuming no further charge-offs, the acquisition of GCB would raise Chinatrust Bank's reported NPL ratio to 2.6% from 2.2%, or to 3.6% from 2.5% when including loans under surveillance. NPL coverage will drop from 69.0% to 54.9%, while CAR will also fall from 12.3% to 12.1%.

Fig 47 Change in asset quality

	Before merger	Post merger
Reported NPL ratio	2.2%	2.6%
Observed loan ratio	0.3%	1.0%
Coverage ratio - MoF definition	69.0%	54.9%
Coverage ratio - broad definition	60.8%	39.3%
CAR	12.3%	12.1%

Source: Chinatrust Bank, Grand Commercial Bank, ING

Reserve adequacy

By applying our standard regional reserve methodology to Chinatrust Bank's currently-reported loan portfolio to gauge its reserve levels, we found that Chinatrust Bank unlike most of its competitors is close to our required level of reserves, with the 1H03 outstanding amount at over 92% of our required level.

Fig 48 Chinatrust reserve adequacy: 1H03

NT$m	Gross amount	Reserve percentage	Required reserve
Pass	560,328	1%	5,603
Special Mention	1,677	5%	84
Substandard	9,849	20%	1,970
Doubtful	1,847	50%	923
Loss	616	100%	616
ORE	0	20%	0
Excess AIR	0	20%	0
Total	574,316		9,196
Actual Reserves			8,500
Shortfall			696
Actual/Required			92%
Shortfall/Capital			1%

Source: Company data, ING estimates

Do bear in mind, however, that accounting for GCB assets which were merged into the FHC after the close of the quarter would add massively to our estimates of expected loss and hence required reserves. We expect Chinatrust to take approximately NT$10bn in incremental charge-offs in 4Q03-1Q04 to address this and bring GCB into line with the group's current level of asset quality; this will keep actual reserves at above 80% of our theoretical required level at year-end, with any deficiency being immaterial at under 3% of total equity.

Fund raising plan to pay for GCB write-offs

The board has recently approved an NT$9bn issue of financial debentures by Chinatrust Bank. The fund-raising plan is aimed at enhancing capital adequacy subsequent to the expected write-off of NT$10bn in GCB's non-performing loans (including both reported NPLs and loans under surveillance), which we believe will take place by 1Q04. As of June, Chinatrust's capital adequacy ratio (CAR) was 12.3%, vs 11.3% in the same period of last year.

Rates and margins

Compared to most other local peers, Chinatrust (and specifically its lead bank) is in a better position in terms of profitability because of its robust interest margin, which stood at 3.93% in the most recent quarter and which was 4.58% for all of FY2002. This high margin is mainly due to the credit card business, but other retail lending is also a boost, with average spreads of 7.5%.

Margins peaked in 2Q02 at 4.78% and have since then reversed, mainly due to the kick-off of the adjustable-rate mortgage (ARM) program. ARMs have helped advance Chinatrust's market position in residential mortgages, but have eroded its overall profitability.

The margin compression started in 3Q03 given relatively high mortgage refinancing (as of August more than 70% of Chinatrust Bank's existing mortgage customers have refinanced into ARMs). Like most other domestic banks Chinatrust intends to bolster its profitability by offering a full suite of new high-yield products such as cash cards. However, contribution from this segment is extremely limited in the short run given late entry and minor market presence.

While management foresees little spread compression on credit cards given that they betray no intention of cutting card rates, we project that balances of both credit card

and cash card loans will lose 125-150bps of gross yield over the next 24 months. This yield compression will contribute to a reduction of Chinatrust Bank's consumer loan spread by a total of 140bps and spread on credit card revolving by 200bps in FY04-05.

Fig 49 Key net interest margin components: 1998-2003F (%)

Yr to Dec	1998	1999	2000	2001	2002	2003F
Yield on Earning Assets	9.04%	8.70%	10.22%	9.69%	6.58%	4.26%
Cost of Interest-bearing Liabilities	6.05%	5.25%	6.62%	5.63%	2.00%	1.17%
Interest Spread	2.99%	3.44%	3.60%	4.06%	4.57%	3.09%
Net Interest Margin	2.67%	3.31%	3.75%	3.89%	4.58%	3.57%

Note: Consolidated since 2003, bank data available only for 1998-2002
Source: Chinatrust FHC, ING Financial Markets

Fig 50 Key net interest margin components: 1Q02-2Q03F (%)

Yr to Dec	1Q02	2Q02	3Q02	4Q02	1Q03	2Q03
Yield on Earning Assets	7.35%	7.04%	6.67%	6.27%	5.92%	5.30%
Cost of Interest-bearing Liabilities	2.49%	2.10%	1.86%	1.70%	1.47%	1.31%
Interest Spread	4.86%	4.93%	4.81%	4.57%	4.45%	3.99%
Net Interest Margin	4.55%	4.78%	4.71%	4.48%	4.35%	3.93%

Note: Consolidated since 1Q03, bank data available only for 1Q02-4Q02
Source: Chinatrust FHC, ING Financial Markets

Continued growth in fee income across all major segments

As Taiwan's No. 1 credit card issuer, Chinatrust has a market share of 16% in terms of cards in circulation, 18% in terms of credit card consumption and 17% in terms of revolving balance. After more than a decade of development, earnings from the credit card business (including interest revenue from revolving loans) currently accounts for over 30% of the company's total bottom line.

In addition to its brand franchise in the credit card business, Chinatrust has exposure to a wide range of financial products, where it is usually a front runner. The company is ranked number one in the factoring business (with market share of 30%), in mutual fund sales (market share of 13%), in consumer lending ex-credit cards (13%), and in stock agency business (17%). As a result, fee-based income accounts for nearly 20% of total operating revenue.

In 2002, fees and commissions at the bank level grew by 16%; meanwhile, the number of circulating cards rose 19%, factoring grew by 43%, mutual fund sales were up 74.7% YoY and bancassurance revenues increased by 162% (these sales are booked through Chinatrust Insurance Brokerage).

We see continued growth momentum for CT from a variety of areas. The growth of its core businesses is consistently above the industry average, and even less-profitable business segments continue to outperform due to the bank's innovative product design and marketing acumen.

Quality management

Chinatrust FHC is known for its high quality management, but the group has made two steps recently which reinforce this point.

The first is the recruitment of a brand new top management team subsequent to the forming of the holding company, with members coming from global banks, consulting firms, and internal promotion. In March 2003, Chinatrust recruited Eric Chen,

previously the country head for Citibank Taiwan, to take over from Jeffrey Koo Jr., as president of Chinatrust. Mr. Chen arrived with a team of 20 key staff also poached from his former employer.

Note that these staff are properly incentivized to get the stock price moving: Chinatrust Bank was the first domestic bank to offer stock options as incentives for mid- and above-level employees, through a share buyback program.

We expect the top management reshuffle to have positive impact on Chinatrust FHC. The company has since FY03 been focusing more on both wealth management business and corporate banking, particularly transaction-based lending to middle-level domestic enterprises in efforts to generating more fee-based income. Citibank happens to be the expert in these fields, thus the recruitment of Mr. Chen will help Chinatrust enhance know-how and new product offerings etc. More importantly, this recruitment helps minimise the company's strong "family-run" image and so enhance its corporate governance.

Further to that point, the second key action was the separation of the Koo family's interests into two distinct groups: one, led by Koo's Group Chairman Koo Chen-fu, which includes Taiwan Cement, China Synthetic Rubber, and KG Telecommunications, and a second led by Jeffrey Koo Sr. which is mainly formed around Chinatrust.

In conjunction with Chinatrust's relative transparency in terms of financial disclosure, this move sends a clear signal that the bank will be managed on a professional basis and will not be called upon to support other group companies.

Grand Commercial

Acquisition and Integration

In early July 2003, Chinatrust announced that it would acquire Grand Commercial Bank (GCB) in a half-cash, half-equity transaction. It must be said that GCB's main asset was its size and branch network; the bank had a 0.18% ROA in 2002 (after a large loss in 2001), and even in its best year (1999) earned less than its cost of capital, with a 9.8% ROE. In addition, as described above the bank remains significantly distressed.

GCB shareholders received a combination of 0.254 Chinatrust FHC common shares and 0.633 Chinatrust short-term preferred shares for each GCB share held. This valued GCB at NT$19.6bn in total, or NT$13.55 per share. To acquire Grand Commercial Bank shares, Chinatrust issued 1,015m preferred shares and 407m common shares.

The deal was concluded on September 30 when Chinatrust FHC officially included 100% of GCB under its holding company umbrella and GCB common shares were converted into Chinatrust FHC common shares. Chinatrust FHC's total capital then increased to NT$52.8bn. GCB shareholders will be able to exchange Chinatrust FHC preferred shares into cash within six months subsequent to the acquisition.

Now, the fun part

Chinatrust is scheduled to merge GCB into Chinatrust Bank on November 17. GCB will become part of CTB's branch network and systems and the GCB name will disappear. This is a key benefit for investors, because the financial success of the acquisition is in large part dependent on quick integration and elimination of duplicated functions.

Note that this stands in stark contrast to the Fubon/Taipei Bank combination, which still retains both banks as distinct entities. It should be said in Fubon's defense however that Taipei Bank does have significantly more brand equity than does GCB.

Bigger, stronger

Subsequent to the acquisition of GCB, Chinatrust Bank has become Taiwan's largest privately-owned bank in terms of total assets, deposits and client base. Its domestic market share will increase to 5% from 4% for both loans and deposits. Corporate loans account for over 70% of GCB's total loan book—exactly the sector in which CT has been looking to add balances. GCB also has more than 700 thousand retail clients–potential buyers for Chinatrust's various financial service products.

The merger with GCB will help strengthen Chinatrust Bank's trust business. Specialised in corporate banking-related trust services—*e.g.* real estate trusts, debt trust custodianship of bills/bonds—GCB had total funds of NT$19.6bn under trusteeship at June 2003, with a market share of 1.3%. Together with Chinatrust, which has trust funds of NT$134.6bn and a market share of 9.1%, the combined entity could challenge First Bank (market share of 10.6%) for the second place ranking (behind #1-ranked Citibank, with 11.1% share) in this field

In addition, GCB ranks among the top five in terms of FX trading and is #1 in terms of FX premium trading, with a domestic market share of more than 50%. This is also a plus for Chinatrust Bank, given its efforts to switch into the fee-generating corporate banking business.

More credit card scale

This acquisition will also benefit Chinatrust Bank on the credit card front. GCB has signed contracts with Takashimaya Department Store and President Dream Park (a grand-sized, Kaohsiung-based shopping centre) to issue co-branded credit cards when Takashimaya opens its new branch in the 101-floor Taipei Financial Centre in November and President Dream Park commences operation in 2H03. Acquisition of GCB will help enhance Chinatrust Bank's co-branded credit card business.

More M&A?

Given its mid- to long-term goal of catching a 10% market share, management does not rule out the possibility of continued acquisition. SinoPac Holdings is one of the potential targets, given its foreign bank background and well-established overseas operations.

Growing distribution power

Network: branches

The acquisition of GCB raises the number of Chinatrust Bank's domestic branches from 58 to 102—a not inconsiderable benefit as we stated above. The location of these branches is also important: keen to develop its wealth management business, Chinatrust has been making efforts to strengthen its exposure to the metropolitan areas in which reside most of the coveted high-net-worth customers.

GCB's existing branch network is highly complementary with that of Chinatrust Bank. Chinatrust Bank was seeking to add 13 branches in Taipei City and 9 in Taipei County. GCB happens to have 12 branches located in Taipei City and nine in Taipei County. Out of Taipei, GCB has seven branches located in Taoyuan, Hsinchu and Miaoli, and

four in Kaohsiung. This helps make up for Chinatrust Bank, which currently needs ten branches altogether in these areas.

Fig 51 Branch network - give & take

Region	No of branches to be added by Chinatrust	No of branches operated by GCB
Taipei City	13	12
Taipei County	9	9
Taoyuan, Hsinchu, Miaoli	4	7
Kaohsiung	6	4

Source: Chinatrust FHC, ING Financial Markets

Network: 7-11s

GCB's network value has been substantially enhanced by its tie-up with affiliate President Chain Stores (PCS), which has the 7-11 franchise for Taiwan and is the largest retailer in the country. Both Chinatrust and GCB had agreements to put ATMs in PCS' 7-11 convenience stores—roughly splitting the network between them. The merger of the two banks will thus give CT control over ATM locations in all 7-11s.

Chinatrust currently has 1,500 ATM islandwide, and approximately 1,077 out of them are located in 7-11s. There are more than 3,000 PCS locations in Taiwan, and GCB has already installed its ATMs in 717. Chinatrust management expects the acquisition of GCB to increase the total number of ATMs installed at President Chain Stores to 1,800 units by the end of 2003 and to 2,500 units by June 2004.

This is a key benefit in terms of enhancing convenience to depositors and cash card borrowers; we believe that they will pay for the perceived value by being less rate-sensitive. The enlargement of ATM network will also benefit Chinatrust in terms of mutual fund sales, which is one of the key functions designed into GCB's ATMs.

Fig 52 Immediate post-merger effect

	Chinatrust	Grand Commercial	Combined
Distribution network			
Domestic branches	58	44	102
ATMs - whole bank	1,500	735	2,235
ATMs - installed at President Chain Stores	1,077	717	1,794
Main business (NT$m)			
Total loans	541,426	131,205	672,631
Market share	*4.05%*	*0.98%*	*5.03%*
Consumer loans	244,791	37,400	282,191
% of total loans	*45.21%*	*28.51%*	*41.95%*
Total deposits	667,918	146,115	814,033
Market share	*4.08%*	*0.89%*	*4.97%*
Total assets	876,297	191,583	1,067,880
Net worth	83,585	16,917	100,502

Note: Data as of Jun-03

Source: Ministry of Finance, company data, ING Financial Markets

Synergy promised starting FY04

While Chinatrust has promised no involuntary headcount reduction at GCB for two years subsequent to the merger (grrrrrr), some extent of organisational restructuring and branch reallocation is likely as 4-5 of Grand Commercial Bank's Taipei-based branches (mostly in Taipei County) are located very nearby those of Chinatrust Bank. In addition, Chinatrust FHC also offers an early retirement program and expects 300-400 GCB employees to retire by the end of 2003.

Management estimates that the merger will cut operating expenses by approximately 20%, or NT$700m annually—quite a good show if achieved considering that the purpose of the merger is not to close overlapping branches.

Factoring in reduced provisions (post the NT$10bn mega-write-off), GCB could generate NT$2.6bn per year without any additional revenue growth from new products. Note that management is looking for NT$5bn-NT$7bn additional revenue from GCB per annum within three years. If so, the acquisition will be financially justified, but we think it more likely that CT's ROI is around 9%.

Fig 53 Grand Commercial return on investment

	NT$bn
Purchase price	19.6
Additional NPL write-offs	10.0
Merger costs	1.0
Total investment	30.6
Standalone net income:	
2002 Actual	0.36
Plus: reduced provisions	1.57
Plus: cost savings	0.70
2002 Adjusted	2.63
ROI	8.6%

Source: Company data, ING estimates

Driving productivity gains

Concerns remain at the mentality level. Most of GCB's existing employees came from First Bank and still believe in "life-time employment." Aside from the early retirement program, time and effort will be needed to bring GCB's employees up to the Chinatrust standard of work. Note that each Chinatrust Bank branch contributes approximately NT$200m in revenue per year, which is almost four times that of the average GCB branch. Going forward, enhancing GCB's productivity will become a key task for Chinatrust management.

A move across the strait

Aside from a Hong Kong branch established in 1997 (which has since gained a full banking license), Chinatrust's first foray into China came in March, when the bank set up a representative office in Beijing. CT was the first private Taiwanese bank that obtained China government approval for the rep office application; subsequently four banks followed: Chang Hwa Bank (rep office based in Kunshan), UWCCB (based in Shanghai), Taiwan Co-op Bank (based in Beijing), and Hua Nan Bank (based in Shenzhen).

Chinatrust Bank plans to upgrade the Beijing rep office into a formal branch as soon as approved by both Taiwan and China government. As opposed to Fubon Bank that has recently acquired International Bank of Asia (IBA), Chinatrust has no intention to acquire a Hong Kong bank to gain benefits under CEPA (Closer Economic Partnership Arrangement). The bank is instead considering acquiring a controlling stake in a Chinese local bank to obtain immediate channels, once the Taiwanese government lifts relevant restrictions. Potential targets include city banks or small-sized banks having local licenses.

The acquisition of GCB could aid Chinatrust's eventual cross-strait expansion, given that Tainan Group, GCB's major shareholder, has engaged in the mainland market for more than ten years. Through GCB, Chinatrust might be able to leverage Tainan Group's strong channels and sales forces to have an immediate local presence for selling financial products.

Fig 54 Chinatrust financial summary

Income statement	2001A	2002A	2003F	2004F	2005F
(NT$m) Yr ended Dec					
Interest income	61,581	44,830	37,641	43,092	50,486
Interest expense	37,873	14,658	9,707	11,728	16,134
Net interest income	**23,708**	**30,173**	**27,934**	**31,364**	**34,352**
Ave. int. earning assets	*608,856*	*658,786*	*782,680*	*910,489*	*983,869*
NIM	**3.89%**	**4.58%**	**3.57%**	**3.44%**	**3.49%**
Non-interest income	17,333	12,751	18,686	24,959	30,875
Total operating income	**41,040**	**42,923**	**46,620**	**56,323**	**65,227**
Non-interest expense	17,959	18,795	21,799	26,614	29,018
Pre provision profit	**23,081**	**24,129**	**24,822**	**29,709**	**36,210**
Loan loss provisions	14,089	9,177	10,301	7,336	7,991
Non-operating income	138	159	-337	-1,520	-1,520
Pre tax profit	**9,130**	**15,111**	**14,183**	**20,852**	**26,699**
Tax	1,467	3,079	2,810	4,170	5,340
Net profit	**7,663**	**12,032**	**11,373**	**16,682**	**21,359**
Core earnings	**7,525**	**11,873**	**11,710**	**18,202**	**22,879**
Per share data (NT$)					
EPS	1.66	2.61	2.15	3.16	4.05
DPS	0.87	0.95	0.65	0.95	1.21
Effective payout ratio	*52.2%*	*36.5%*	*30.0%*	*30.0%*	*30.0%*
BVPS	16.05	17.35	17.03	19.55	22.64
ABVPS	15.84	17.31	17.03	19.55	22.64
Valuation					
Price to book value	2.0x	1.9x	1.9x	1.7x	1.4x
Price to adjusted book value	2.0x	1.9x	1.9x	1.7x	1.4x
Price to earnings	19.4x	12.4x	15.0x	10.2x	8.0x
Profitability ratios					
Net interest margin	3.9%	4.6%	3.6%	3.4%	3.5%
Yield on interest earning assets	9.7%	6.6%	4.3%	4.6%	4.9%
Cost on interest bearing liabilities	5.6%	2.0%	1.2%	1.3%	1.6%
Net interest spread	4.1%	4.6%	3.1%	3.3%	3.3%
Non-int. income (% Op income)	42.2%	29.7%	40.1%	44.3%	47.3%
Cost to income	43.8%	43.8%	46.8%	47.3%	44.5%
Overhead ratio	2.9%	2.9%	2.8%	2.9%	2.9%
Cost coverage	228.5%	228.4%	213.9%	211.6%	224.8%
ROA	1.0%	1.4%	1.2%	1.6%	1.9%
ROE	10.8%	15.6%	13.4%	17.3%	19.2%
Oroa analysis					
Net interest margin	3.9%	4.6%	3.6%	3.4%	3.5%
Non-interest inc./gross inc.	42.2%	29.7%	40.1%	44.3%	47.3%
Efficiency ratio	43.8%	43.8%	46.8%	47.3%	44.5%
Provision/assets	1.7%	1.1%	1.0%	0.7%	0.7%
Operating return on assets	**2.1%**	**2.6%**	**2.2%**	**2.6%**	**3.0%**
Equity/assets	9.0%	9.4%	8.7%	9.3%	10.0%
Operating return on equity	**22.8%**	**27.4%**	**25.2%**	**27.9%**	**30.2%**

Source: Chinatrust FHC, ING Financial Markets

Fig 55 Chinatrust financial summary (cont)

Balance sheet	2001A	2002A	2003F	2004F	2005F
(NT$m) As at Dec					
Gross loans	515,632	559,901	738,766	797,149	875,926
Loan loss reserves	*7,334*	*8,619*	*9,151*	*5,882*	*6,357*
Net loans	504,651	547,990	725,364	786,701	864,546
Total earning assets	635,789	681,784	883,577	937,401	1,030,337
Other assets	181,136	167,472	154,961	171,386	169,440
Total Assets	**816,926**	**849,255**	**1,038,538**	**1,108,787**	**1,199,777**
Deposits	695,806	716,919	881,170	934,311	1,004,309
Customer deposits	610,252	677,423	848,360	903,503	975,783
Other deposits	85,554	39,496	32,810	30,808	28,526
Other paying liabilities	21,241	21,920	29,279	29,778	30,436
Other liabilities	25,419	30,522	38,148	41,495	45,476
Total Liabilities	**743,000**	**769,361**	**948,597**	**1,005,585**	**1,080,221**
Equity with revaluation	**73,925**	**79,894**	**89,941**	**103,202**	**119,556**
Adjusted equity	**72,937**	**79,704**	**89,941**	**103,202**	**119,556**
Balance sheet ratios					
Loan-to-deposit	73.6%	77.6%	83.4%	84.8%	86.7%
Equity to assets	9.0%	9.4%	8.7%	9.3%	10.0%
Total loan loss reserves to assets	0.9%	1.0%	0.9%	0.5%	0.5%
Asset quality					
Nonperforming assets	16,629	15,700	14,773	12,666	12,950
Special mention	4,405	2,972	0	0	0
Substandard	11,935	10,809	9,835	8,306	8,686
Doubtful	2,238	2,027	1,844	1,557	1,629
Loss	746	676	615	519	543
ORE	1,710	2,189	2,479	2,283	2,093
NPAs/total loans	3.2%	2.8%	2.0%	1.6%	1.5%
Reserve coverage of NPAs	44.1%	54.9%	61.9%	46.4%	49.1%
Required reserves	9,741	9,838	11,222	11,238	12,113
Actual reserves	7,334	8,619	9,151	5,882	6,357
Shortfall (surplus)	2,407	1,219	2,071	5,356	5,756
Actual to required reserves	75.3%	87.6%	81.5%	52.3%	52.5%
Shortfall to capital	3.3%	1.5%	2.3%	5.2%	4.8%
Growth rates (YoY)					
Income statement					
Net interest income	16.4%	27.3%	-7.4%	12.3%	9.5%
Non-interest income	51.0%	-26.4%	46.6%	33.6%	23.7%
Non-interest expenses	8.4%	4.7%	16.0%	22.1%	9.0%
Pre-provision earnings	51.1%	4.5%	2.9%	19.7%	21.9%
Loan loss provisions	113.5%	-34.9%	12.3%	-28.8%	8.9%
Core earnings	9.5%	57.8%	-1.4%	55.4%	25.7%
Net profit	6.1%	57.0%	-5.5%	46.7%	28.0%
Balance sheet					
Loan growth	4.2%	8.7%	32.0%	7.9%	9.9%
Interest earning assets	9.3%	7.2%	29.6%	6.1%	9.9%
Asset growth	13.2%	4.0%	22.3%	6.8%	8.2%
Deposit growth	12.3%	3.0%	22.9%	6.0%	7.5%
Shareholders' funds	8.3%	8.1%	12.6%	14.7%	15.8%

Source: Chinatrust FHC, ING Financial Markets

Taishin[b]: #2 tries harder

We are initiating coverage of Taishin FHC with a BUY rating and a price target of NT$29.65, representing 36% upside from the current market price. Taishin is a strong contender in consumer finance, holding the #2 slots in both credit and cash cards. However, the biggest distinguishing factor about the bank is that it is not a mono-line player, but rather fields a full suite of retail financial products and is demonstrably good at cross-selling—an effort that among bankers could well be the subject of the old saw: "everybody talks about the weather, but nobody ever *does* anything about it."

Taishin is rapidly improving both its asset quality and shareholder returns; we forecast that both will continue.

The bank's biggest problem is strategic: how to cope with being a small bank in a scale business. One way is to get bigger; the 2002 purchase of Dah An Bank was well-executed despite our usual fears about bank M&A. However, Taishin is still only the #13 bank in Taiwan, and doesn't want to be left behind. Any further acquisitions (IBT and SinoPac are the obvious targets) will have to be done cheaply and quickly to avoid dilution of returns.

Introduction

Taishin Bank[e][f] was founded as part of the "Class of 1992" private banks, and converted to an FHC in February 2002 at a share swap ratio of 1:1. The holding umbrella was then expanded by including four other group affiliates—Taiwan Securities, Taishin Bills Finance, Taishin Marketing Consulting Co., and Taishin Asset Management Corp—at the end of 2002, at a share swap ratio of 1:1.2 between Taishin FHC and Taiwan Securities and 1:1.3 between Taishin FHC and Taishin Bills Finance. Taishin FHC owns 100% of these subsidiaries, with combined assets of NT$586bn and net worth of NT$51.6bn as of June 2003.

Taishin Bank is the key earnings driver for the company, contributing more than 85% of Taishin FHC's bottom line, with most of the remainder from Taiwan Securities and Taishin Bills Finance. Taishin Bank also has a more stable earnings stream than the other two subsidiaries—earnings from the securities arm move in-line with stock market volume while the bills finance business is fairly sensitive to interest rates.

Market share

Currently, Taishin Bank has market share of 2.1% in deposits and 2.6% in loans, ranking as 13th among domestic banks—a relatively untenable position in a rapidly-consolidating market. However, within its specialty product areas Taishin does have significant heft, ranking as the #2 credit card issuer (behind Chinatrust) and the #2 cash card issuer (behind Cosmos). In this way Taishin is very similar to Hong Kong 's Dah Sing Financial, another small banks with outsize share of consumer assets.

Taiwan Securities ranks #5 among domestic brokers in terms of trading value, operating 53 branches islandwide with a market share of approximately 4.5%, while Taishin Bills Finance currently ranks first or second in terms of profit and is #2 in asset size.

Network

At the holding company level Taishin's distribution network comprises 136 branches, 667 ATMs, and 213 mini branches, as well as 1,405 salespeople and 1,122 financial planners.

Returns

Return to shareholders at Taishin FHC (and at Taishin Bank previously) has not been very impressive despite the company's position in the high-margin consumer lending business. The nadir came in 2001, when the bank posted ROA of 0.36% and ROE of 3.7%, due to NT$6.2bn in loan loss provisions, mainly ascribed to exposure to the financially stressed Hung Kuo Group.

Both ROA and ROE then improved dramatically in FY2002 (to 1.01% and 12.87%, respectively) on the back of extremely strong growth in the credit card business, with the bank's revolving balances growing more than 75% YoY. In addition to credit cards, Taishin has also made strong strides in mail loans, auto finance, second mortgages, and cash cards, further increasing the bank's overall exposure to high-yield consumer products.

Fig 56 Key earnings components: 1997-2005F (NT$m)

Yr to Dec	1997	1998	1999	2000	2001	2002	2003F	2004F	2005F
Net Interest Income	4,397	5,925	8,253	9,799	10,683	18,833	21,893	24,362	27,934
Non-Interest Income	1,174	1,027	1,646	1,375	3,003	3,405	8,172	7,944	7,945
Non-Interest Expenses	3,082	4,375	4,904	5,688	6,536	10,099	13,879	14,127	16,493
Loan Loss Provisions	983	905	2,820	3,186	6,232	7,208	7,497	6,536	6,536
Core Income	1,267	1,347	1,739	1,707	697	4,184	7,376	9,897	10,923
Net Income	1,383	1,485	1,816	1,916	1,035	4,077	7,376	9,897	10,923
EPS	1.28	1.09	1.19	1.14	0.58	1.77	2.02	2.71	3.00

Note: Consolidated since 2003

Source: Taishin FHC, ING Financial Markets

Fig 57 Key earnings ratios: 1997-2005F

Yr to Dec	1997	1998	1999	2000	2001	2002	2003F	2004F	2005F
ROA	0.92%	0.72%	0.76%	0.74%	0.36%	1.01%	1.32%	1.45%	1.30%
Core ROA	0.84%	0.65%	0.73%	0.66%	0.24%	1.04%	1.32%	1.45%	1.30%
ROE	11.20%	9.68%	9.10%	7.63%	3.70%	12.87%	16.31%	17.27%	17.55%
Core ROE	10.26%	8.78%	8.71%	6.80%	2.49%	13.21%	16.31%	17.27%	17.55%
NIM	3.27%	3.21%	3.98%	4.47%	4.52%	6.04%	5.01%	4.61%	4.61%
Cost/Income	55.33%	62.93%	49.54%	50.90%	47.76%	45.41%	46.16%	43.73%	45.97%
Overhead	9.16%	9.49%	9.46%	10.39%	11.06%	12.95%	12.70%	10.70%	10.89%
Effective Tax Rate	15.83%	19.47%	20.06%	25.75%	24.00%	15.16%	15.11%	15.00%	15.00%

Note: Consolidated since 2003

Source: Taishin FHC, ING Financial Markets

Including credit cards, high-yield products together accounted for 43% of total consumer loans (26% of total loans) at YE2002, up from 35% of total consumer loans (22% of total loans) at YE2001. Along with continued interest rate cuts, this change in asset mix has boosted Taishin Bank's net interest margin to 4.85% in 2Q03 from 4.37% in 4Q00.

Dah An Merger

Taishin acquired Dah An Bank in February 2002 and merged it into Taishin Bank, almost doubling the lead bank's scale of business. The merger with Dah An Bank has been reasonably well-executed, and has improved both profitability and cost efficiency for Taishin Bank. Subsequent to the merger, Taishin Bank's customer accounts increased by 47%, and the enlarged sales force has had good success selling high-yield products to former Dah An customers.

The merger also achieved a headcount reduction of more than 5% and cut down on redundant back-office IT systems and hardware, lowering the cost-to-income ratio to around 45% currently from nearly 50% in 1Q02. This is evidence that there are still economies of scale to be had in the Taiwanese banking sector, which should mean that we will see increased overall profitability as the industry consolidates.

Fee income and cross-selling

As with Chinatrust, Taishin is increasingly dependent on fee income for overall returns. In 1H03, gross fee income soared nearly 50% YoY and accounted for 16% of total operating revenue (vs 12% in FY02). We see this as a result of strong performance in credit and cash card lending, increased emphasis on cross-selling activities among group entities post the Dah An merger and FHC integration, and the company's focus on the wealth management business.

Given the Dah An experience, we expect the addition of new group members to create more cross-selling opportunities. The inclusion of Taiwan Securities and Taishin Bills Finance at year-end 2002 enhanced Taishin's distribution channels and customer base, along with filling out the group's product offerings. Currently, the cross-selling ratio for Taishin FHC is 2.1 (*i.e.,* on average every customer buys 2.1 products from various Taishin Group entities).

Adding these two subsidiaries will help improve Taishin FHC's cross-selling capabilities, given the strong positions that Taiwan Securities and Taishin Bills Finance respectively hold in their own segments. So far we are able to see some evidence that cross-selling results are accelerating (see table below); while it is almost impossible to evaluate these on a *ceteris paribus* basis it seems reasonable to attribute at least some of the effect to the FHC consolidation and coordination of selling efforts.

Fig 58 1H03 Cross-selling activities at Taishin FHC

Third party products	1Q03	1H03	FY03 target	Achievement rate
Bancassurance (first-year premium)	NT$1.3bn	NT$3.9bn	NT$7.5bn	52%
Sales of mutual funds and structured notes (volume)	NT$13.8bn	NT$31.7bn	NT$68.2bn	47%
Sales of mutual funds and structured notes (fee income)	NT$156m	NT$403m	NT$602m	67%
Self-developed products				
Cash card (new issuance)	**5.70%**	**26.20%**	**48%**	**55%**
Credit card (new issuance)	2.60%	4.90%	5.70%	86%
Fee income from treasury management units (TMU)	NT$89m	NT$193m	NT$360m	54%

Source: Taishin FHC, ING Financial Markets

Wealth management

Currently, Taishin Bank has approximately 20 thousand wealth management customers with a total of NT$100bn in assets under management. Compared to the bank's existing base of 50-60 thousand affluent customers (each having total assets of NT$3m or above), as well as the client referral potential of other FHC subsidiaries, this implies significant growth potential for the business segment.

No doubt the low interest rate environment is a factor in stimulating people to start moving money from slim-yielding deposits into other products; recall that this is a key positive for banks as a migration of excess liquidity into non-deposit investment products will improve the loan-to-deposit ratio and take pressure off of lending spreads.

In 1Q03, Taishin Bank upgraded its VIP centre into a "flagship store" that provides customised one-on-one wealth management services. With more than six years of experience in this field and over 200 senior financial planners all set, management expects to increase its total assets under management to NT$150bn by YE2003 from the current NT$100bn.

We are big believers in the universal banking and wealth management models, but are very cautious in assigning any near-term profit potential to these activities in Taiwan given that all banks seem to have gotten the same idea at the same time. So far, Taishin's results indicate that we should give management the benefit of the doubt, however.

Loan portfolio and growth

Taishin Bank was one of the first domestic banks to position itself as a consumer-oriented bank, and built a well-established distribution network with this goal in mind. Currently, 65% of Taishin Bank's total loan portfolio are consumer loans, while 45% of that total (or 28% of total loans) represent high-yield products.

Representing around one third of Taishin Bank's total loan portfolio, (first) mortgages are less important as an earnings contributor, given the low spreads this product now produces under the ARM system. Taishin views this segment more as an information-rich product that helps to broaden the bank's client base and maintain existing relationships. This attitude means that Taishin escaped relatively unscathed from the price-cutting war which resulted from the introduction of adjustable-rate mortgages.

Going forward, we expect growth momentum to continue in high-yield consumer products (including credit cards), at 15%-20% on average in the next two to three years. In the meantime, (primary) mortgages will inch up given the strategic position that this product holds for Taishin, as well as a moderate recovery in the property market.

We forecast that corporate lending will also trend upward, but at a much slower pace than that of the total loan portfolio. Although Taishin is focusing more on SME loans in an attempt to generate additional transaction-based fee income, these loans are in general fragmented and of low dollar volume per account—which means that they will bring limited help to the growth of this segment.

Fig 59 Loan breakdown: 1998-2004F

Yr to Dec	1998	1999	2000	2001	2002	2003F	2004F
Total loans	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
Corporate	33.42%	37.30%	37.00%	36.74%	38.50%	35.50%	35.00%
Consumer	66.58%	62.70%	63.00%	63.26%	61.50%	64.50%	65.00%
Mortgage	42.38%	37.50%	38.00%	38.10%	34.75%	34.00%	32.00%
% to consumer loans	63.65%	59.81%	60.32%	60.23%	56.50%	52.71%	49.23%
Unsecured personal loans	16.06%	15.34%	14.93%	13.57%	14.98%	16.33%	17.42%
% to consumer loans	24.13%	24.46%	23.70%	21.45%	24.36%	25.32%	26.80%
Credit card revolving	8.14%	9.86%	10.07%	11.59%	11.77%	14.17%	15.58%
% to consumer loans	12.22%	15.73%	15.98%	18.32%	19.13%	21.96%	23.97%

Note: Loan breakdown for Taishin Bank only

Source: Ministry of Finance, Taishin FHC, ING Financial Markets

Fig 60 Loan growth: 1998-2004F

Yr to Dec	1998	1999	2000	2001	2002	2003F	2004F
Total loans	25.51%	7.77%	5.43%	4.41%	72.77%	6.20%	9.10%
Corporate	16.97%	20.28%	4.58%	3.68%	81.05%	-2.08%	7.56%
Consumer	30.29%	1.49%	5.93%	4.84%	67.96%	11.38%	9.95%
Mortgage	28.02%	-4.64%	6.83%	4.69%	57.58%	3.91%	2.68%
Unsecured personal loans	19.56%	2.88%	2.63%	-5.11%	90.79%	15.77%	16.34%
Credit card revolving	78.35%	30.66%	7.64%	20.19%	75.37%	27.86%	20.00%

Note: Loan growth for Taishin Bank only
Double-digit loan growth in FY02 due to merger with Dah An Bank
Source: Ministry of Finance, Taishin FHC, ING Financial Markets

Rates and margins

High-yield product line-up

Compared to most domestic banks, Taishin Bank is in a much better position in terms of profitability given its disproportionate exposure to high-yield consumer products. From FY98-FY02, Taishin Bank's net interest margin ranged between 3.2%-6.0%, vs 2.7%-3.3% on average among domestic banks in the same period—a very powerful differential.

Fig 61 Key net interest margin components: 1998-2003F (%)

Yr to Dec	1998	1999	2000	2001	2002	2003F
Yield on Earning Assets	8.53%	9.35%	9.06%	8.75%	7.81%	6.15%
Cost of Interest-bearing Liabilities	8.11%	7.50%	6.99%	6.11%	4.33%	1.81%
Interest Spread	0.42%	1.85%	2.08%	2.64%	3.48%	4.34%
Net Interest Margin	3.21%	3.98%	4.47%	4.52%	6.04%	5.01%

Note: Consolidated since 2003, bank data available only for 1998-2002
Source: Taishin FHC, ING Financial Markets

Fig 62 Key net interest margin components: 1Q02-2Q03F (%)

Yr to Dec	1Q02	2Q02	3Q02	4Q02	1Q03	2Q03
Yield on Earning Assets	6.29%	7.64%	7.87%	8.15%	7.00%	6.58%
Cost of Interest-bearing Liabilities	4.39%	4.83%	4.42%	3.57%	2.00%	1.78%
Interest Spread	1.90%	2.80%	3.44%	4.58%	4.99%	4.80%
Net Interest Margin	4.46%	4.53%	5.01%	5.65%	5.37%	4.85%

Note: Consolidated since 1Q03, bank data available only for 1Q02-4Q02
Source: Taishin FHC, ING Financial Markets

As the second largest credit card issuer in Taiwan, Taishin Bank currently has 3.9m cards in circulation with an underlying market share of around 11%. Compared to Chinatrust, the #1 credit card issuer (with 5.3m cards in force and market share of 15%), Taishin is less vulnerable to margin compression resulting from slowing growth in revolving balance.

This is thanks to Taishin's diversified high-margin product line-up, that contains not only credit cards but also secondary mortgage, automobile loans, unsecured personal loans, and cash cards—all carrying relatively high gross yields, ranging from 8%-18%. Including credit cards, these high-margin products accounted for 28.7% of Taishin Bank's total loan book, vs. 22% for Chinatrust and single-digit on average among other peers.

As mentioned earlier, Taishin Bank is less impacted by the prevalence of the adjustable-rate mortgage. Aside from the aforementioned diversified product offering, other key reasons include (1) its swift adjustment in deposit structure that helps

maintain low cost of funds and (2) nearly 70% of existing mortgage customers have already refinanced into the ARM program.

Low cost of funds

Low cost of funds is the other factor driving up profitability. Taishin has taken steps to promote a better deposit mix, increasing demand deposits as a percentage of total deposits subsequent to the introduction of its off-set (see below) and adjustable-rate mortgages. As of June 2003, demand deposits at Taishin Bank represented 34% of total deposits, vs 30% at year-end 2002.

Potential price war

We expect the credit card division to contribute around 30% of Taishin Bank's pre-tax profit in FY03. On the other hand, management also admits that this field is getting crowded, especially from new threats (*e.g.*: Fubon and Cathay). In face of intensifying competition, management does not rule out the possibility of partaking the price war—perhaps launching tiered pricing as other local peers have done on both credit and cash cards.

This, if realised, will cause margin compression at Taishin. Our base case forecast is that both credit and cash cards loans will lose 125-150bps (depending on product) of gross yield over the next 24 months. This along with higher deposit rates will help reduce Taishin Bank's consumer loan spread by 75bps and spread on credit card revolvings by 165bps in FY04-05.

Product focus: Off-set mortgages

Taishin Bank was the first domestic bank to launch an off-set mortgage product. This product offers mortgage borrowers a linked demand deposit account, with interest being charged only on the net borrowing amount. In other words, customers only need to pay interest on their current level of mortgage principal minus outstanding demand deposits.

Note that this gives customers the flexibility to lower their interest payments by offsetting balances when they have excess cash while keeping the money available for easy withdrawal without requiring mortgage refinancing. This type of mortgage has long been popular in Australia and the UK, and has been introduced with great success by Standard Chartered in Hong Kong and Singapore.

The off-set mortgage charges on a floating rate basis – ARM rate plus 10bps, aimed at approaching those who want to leverage on the low-interest-rate environment while keeping a certain level of cash in hand. Currently, the off-set rate is as low as 3.43%, calculated as follows:

1.43% (ARM benchmark index) + 1.9% (lowest risk premium, rising depending on credit spread) + 10bps(off-set premium).

Since its introduction in April 2003, the off-set mortgage has attracted more than 2,000 new clients, with more than NT$10bn in outstanding loans as of July and new takedown of 40%. Management is looking for NT$30bn in outstanding loans by the end of FY03.

Asset quality

The merger with Dah An Bank boosted Taishin Bank's NPL ratio to 4.67% in February 2002 from 3.61% as of year-end 2001. Nevertheless, aggressive charge-offs brought it down to below 3.96% by June 2002. In FY02, Taishin Bank wrote off approximately NT$21.6bn in bad debt (net), including NT$7.5bn sold to Taishin AMC; this helped reduce the bank's reported NPL ratio to 2.45% (3.03% including loans under surveillance) at year end.

In 1H03, Taishin Bank charged off another NT$5.2bn in bad debt, leading reported NPL ratio down to 2.24% (2.66% by the international standard). This is far below the industry average of 5.68% (7.97% in broad definition). In 2H03, we believe that management will look to write off another NT$4bn to bring down the bank's broadly-defined NPL ratio to below 2.5%. Going forward, limited NPL influx together with consistent charge-offs will help maintain Taishin Bank's NPL ratio at the current low level.

The NPL coverage ratio declined to 41.8% in June 2003 due to aggressive charge-offs but has improved to 46.9% in September. Bear in mind that as write-offs are made, looking at the coverage ratio in isolation becomes less and less relevant, as experience tells us that most loans which are written-off come from the most severely delinquent categories, rather than from Special Mention or Substandard. As the remaining categories have a much lower expected loss (that of Loss loans is 20x that of Special Mention loans in our methodology), it stands to reason that coverage should decline in absolute terms, even if it is actually rising on a weighted basis.

By applying our standard regional reserve methodology (which is weighted) to Taishin Bank's currently-reported loan portfolio to gauge its reserve levels, we found that Taishin Bank like most other Taiwanese banks falls short of our theoretical required amount, with 1H03 actual reserves at 56% of our required level. However, the difference, at under 5% of total equity, is no longer material.

Fig 63 2Q03 reserve adequacy

	Gross amount	Reserve percentage	Required reserve
Pass	349,745	1%	3,497
Special Mention	1,500	5%	75
Substandard	5,699	20%	1,140
Doubtful	1,069	50%	534
Loss	356	100%	356
ORE	805	20%	161
Excess AIR	-	20%	-
Total	359,175		5,764
Actual Reserves			3,226
Shortfall			2,538
Actual/Required			56%
Shortfall/Capital			5%

Source: Taishin FHC, ING Financial Markets

China exposure

Taishin has had branches of its securities and finance company (Taishin International Finance) businesses in Hong Kong for some time; in addition Taishin Bank established a full-license Hong Kong branch in June 2003. However, compared to those domestic

banks which have already set up China rep offices, Taishin is somewhat late to the party as regards mainland operations.

Given that they are behind, management does not rule out the possibility of acquiring a Hong Kong bank, as Fubon is doing with International Bank of Asia (IBA), to take advantage of the favourable treatments offered by CEPA. As discussed in the themes section of this report, we believe that Taishin's planning will be overtaken by events as we expect to see a second CEPA for Taiwanese banks sometime next year.

In the meantime, a China-based task team was founded in July to explore potential business opportunities in Southeast China, especially the Pearl River Delta. Management plans to target Taiwanese (consumer goods) manufacturers, who have had a significant operating presence in this region for years, considering their solid financial status and underlying lower risk when compared with domestic Chinese borrowers.

M&A

Taishin FHC's banking platform is small compared to those of other major FHCs (especially Chinatrust, Fubon, and Cathay among the private banks). This makes further acquisition increasingly important—especially subsequent to the mergers between Fubon and Taipei Bank, Cathay and UWCCB, and Chinatrust and Grand Commercial.

SinoPac Holdings is one potential take-over target; another which would make sense is International Bank of Taipei (IBT), in which Taishin Group (directly and indirectly) already holds a 9% stake, or approximately 20% including the stake owned by Shinkong Group. IBT's other major shareholder—the paper maker Yuen Foong Yu Group—owns a stake of more than 30% in the bank.

IBT is a Taipei-based SME bank with 83 domestic offices—76 of which are located in Taipei. This makes IBT attractive from an M&A perspective given that most FHCs now are keen to develop their wealth management business—a business which targets high net worth customers who mainly reside in metropolitan areas.

In addition, IBT has been focusing on small- and medium-sized enterprises for years, which could complement Taishin's high end consumer-oriented business model as there is substantial cross-over between the owners of SMEs and target customers for wealth management services.

Fig 64 Taishin financial summary

Income statement	2001A	2002A	2003F	2004F	2005F
(NT$m) Yr ended Dec					
Interest income	21,132	29,866	30,242	33,605	41,849
Interest expense	10,449	11,033	8,349	9,243	13,914
Net interest income	**10,683**	**18,833**	**21,893**	**24,362**	**27,934**
Ave. int. earning assets	*236,469*	*312,040*	*437,142*	*528,043*	*605,941*
NIM	**4.5%**	**6.0%**	**5.0%**	**4.6%**	**4.6%**
Non-interest income	3,003	3,405	8,172	7,944	7,945
Total operating income	**13,686**	**22,238**	**30,066**	**32,306**	**35,879**
Non-interest expense	6,536	10,099	13,879	14,127	16,493
Pre provision profit	**7,150**	**12,139**	**16,187**	**18,179**	**19,386**
Loan loss provisions	6,232	7,208	7,497	6,536	6,536
Non-operating income	338	-107	0	0	0
Pre tax profit	**1,255**	**4,825**	**8,690**	**11,643**	**12,850**
Tax	220	748	1,313	1,746	1,928
Net profit	**1,035**	**4,077**	**7,376**	**9,897**	**10,923**
Core earnings	**697**	**4,184**	**7,376**	**9,897**	**10,923**
Per share data (NT$)					
EPS	0.58	1.77	2.02	2.71	3.00
DPS	0.32	1.52	1.50	1.50	1.50
Effective payout ratio	*55.5%*	*85.8%*	*74.2%*	*55.3%*	*50.1%*
BVPS	15.66	15.36	15.11	16.32	17.82
ABVPS	15.66	15.36	15.11	16.32	17.82
Valuation					
Price to book value	1.4x	1.4x	1.4x	1.3x	1.2x
Price to adjusted book value	1.4x	1.4x	1.4x	1.3x	1.2x
Price to earnings	37.7x	12.3x	10.8x	8.0x	7.3x
Profitability ratios					
Net interest margin	4.5%	6.0%	5.0%	4.6%	4.6%
Yield on interest earning assets	8.7%	7.8%	6.1%	6.0%	6.5%
Cost on interest bearing liabilities	6.1%	4.3%	1.8%	1.8%	2.5%
Net interest spread	2.6%	3.5%	4.3%	4.2%	4.0%
Non-int. income (% Op income)	21.9%	15.3%	27.2%	24.6%	22.1%
Cost to income	47.8%	45.4%	46.2%	43.7%	46.0%
Overhead ratio	2.8%	3.2%	3.2%	2.7%	2.7%
Cost coverage	209.4%	220.2%	216.6%	228.7%	217.5%
ROA	0.4%	1.0%	1.3%	1.5%	1.3%
ROE	3.7%	12.9%	16.3%	17.3%	17.5%
Oroa analysis					
Net interest margin	4.5%	6.0%	5.0%	4.6%	4.6%
Non-interest inc./gross inc.	21.9%	15.3%	27.2%	24.6%	22.1%
Efficiency ratio	47.8%	45.4%	46.2%	43.7%	46.0%
Provision/assets	2.0%	1.4%	1.2%	0.9%	0.7%
Operating return on assets	**1.0%**	**2.4%**	**2.5%**	**2.6%**	**2.5%**
Equity/assets	9.1%	7.1%	8.9%	8.0%	7.0%
Operating return on equity	**10.8%**	**34.4%**	**28.0%**	**32.0%**	**35.9%**

Source: Taishin FHC, ING Financial Markets

Fig 64 Taishin financial summary – cont.

Balance sheet	2001A	2002A	2003F	2004F	2005F
(NT$m) As at Dec					
Gross loans	195,728	344,043	374,466	413,858	455,150
Loan loss reserves	*2,105*	*4,195*	*2,975*	*2,933*	*2,933*
Net loans	192,296	337,632	368,471	407,574	448,563
Total earning assets	241,565	382,514	491,769	564,317	647,566
Other assets	65,004	115,188	127,869	179,352	286,658
Total Assets	**306,569**	**497,702**	**619,638**	**743,669**	**934,224**
Deposits	252,538	410,470	438,347	474,481	513,593
Customer deposits	234,929	383,279	393,178	425,588	460,671
Other deposits	17,608	27,191	45,169	48,892	52,923
Other paying liabilities	5,000	15,000	14,750	14,750	14,750
Other liabilities	21,021	36,892	111,441	194,912	340,902
Total Liabilities	**278,559**	**462,363**	**564,538**	**684,143**	**869,245**
Equity with revaluation	**28,010**	**35,339**	**55,099**	**59,526**	**64,979**
Adjusted equity	**28,010**	**35,339**	**55,099**	**59,526**	**64,979**
Balance sheet ratio					
Loan-to-deposit	77.0%	83.3%	84.8%	86.6%	88.0%
Equity to assets	9.1%	7.1%	8.9%	8.0%	7.0%
Total loan loss reserves to assets	0.7%	0.8%	0.5%	0.4%	0.3%
Asset quality					
Nonperforming assets	10,932	10,302	10,188	10,193	10,190
Special mention	3,832	2,004	1,106	1,389	1,532
Substandard	5,327	5,640	6,800	6,800	6,800
Doubtful	999	1,058	1,275	1,275	1,275
Loss	333	353	425	425	425
ORE	440	1,247	582	304	158
NPAs/total loans	5.6%	3.0%	2.7%	2.5%	2.3%
Reserve coverage of NPAs	19.3%	40.7%	29.2%	28.8%	28.8%
Required reserves	4,017	5,687	6,215	6,562	6,949
Actual reserves	2,105	4,195	2,975	2,933	2,933
Shortfall (surplus)	1,912	1,492	3,240	3,630	4,016
Actual to required reserves	52.4%	73.8%	47.9%	44.7%	42.2%
Shortfall to capital	6.8%	4.2%	5.9%	6.1%	6.2%
Growth rates					
(YoY)					
Income statement					
Net interest income	9%	76%	16%	11%	15%
Non-interest income	118.5%	13.4%	140.0%	-2.8%	0.0%
Non-interest expenses	14.9%	54.5%	37.4%	1.8%	16.7%
Pre-provision earnings	30.3%	69.8%	33.3%	12.3%	6.6%
Loan loss provisions	95.6%	15.7%	4.0%	-12.8%	0.0%
Core earnings	-59.2%	500.0%	76.3%	34.2%	10.4%
Net profit	-46.0%	293.8%	80.9%	34.2%	10.4%
Balance sheet					
Loan growth	1.0%	75.8%	8.7%	10.5%	10.0%
Interest earning assets	4.4%	58.3%	28.6%	14.8%	14.8%
Asset growth	11.1%	62.3%	24.5%	20.0%	25.6%
Deposit growth	7.3%	62.5%	6.8%	8.2%	8.2%
Shareholders' funds	0.0%	26.2%	55.9%	8.0%	9.2%

Source: Taishin FHC, ING Financial Markets

First FHC: Still Distressed

We are initiating coverage of First Financial Holding Company (FFHC) with a SELL rating. FFHC is the holding company for First Commercial Bank (FCB), Taiwan's largest non wholly government-owned bank. FCB is larger than Taishin Bank, Fubon Bank, and Bank SinoPac combined, and is slightly larger than Hua Nan Bank or Chang Hwa Bank. With an approximately 6.1% asset share in a very fragmented market, FFHC is a significant player in Taiwan banking.

FFHC's strengths are its unparalleled network of 190 branches and 654 ATMs and its large customer base—very significant assets, as we find that the lion's share of value that selling retail financial products creates flows to the distributor.

FFHC's Achilles' heel is its bad loans. Even going strictly by reported figures, FFHC's asset quality and reserve adequacy are poor. An additional concern is that our analysis indicates that reported asset quality has continuously understated bad assets.

The company has either earned a mid-single digit ROE or made a loss in each of the past four years. Although 1Q03 results are encouraging, our conviction that there are further asset quality costs that have yet to be incurred makes us less positive about the near future. Further, modernisation of the bank's IT continues, and integration of all four subsidiary companies into a cross-selling FHC will be expensive but without major offsetting cost savings.

However, FFHC does have significant operating leverage, and any broad-based recovery in the Taiwanese financial sector would buoy the group. We do think that the state banks in general are a late-cycle play rather than a leading group for the financials.

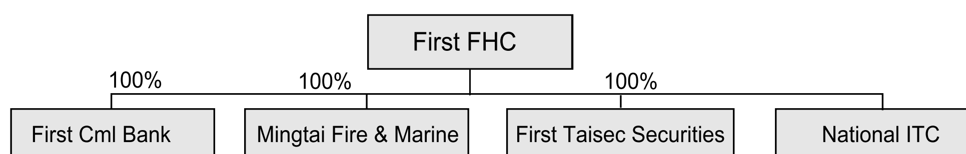
We place a fair value on FFHC shares of NT$18.28, representing a PBV of 1.15x forward (YE2004) BVPS of NT$15.96. On a PER basis, our fair value is equivalent to 13.3x forward 2004 EPS (both 2002 and 2003F EPS are negative). This valuation is based on a cost of capital of 10.9% and sustainable ROE of 12.5%.

Structure and business lines

Forming the FHC

First Financial Holding Company (FFHC) was first formed to hold 100% of First Commercial Bank in January 2003. FFCH incorporated First Taisec Securities, Mingtai Fire & Marine Insurance and National Investment Trust Co (NITC) on 31 July, 2003, through share exchanges with these companies. At that time First Taisec, Mingtai and NITC became 100%-owned by FFHC.

Fig 65 First FHC holding structure



Source: Company data

First Commercial Bank

Through its 190 domestic units and 18 overseas offices, First Commercial Bank provides a wide range of banking services and financial service products to its more than 4.1m retail and corporate customers. These customers include 60,000 VIP customers—those with deposit account balances of NT$3m or above—and 130,000 high net-worth customers—those with deposit account balances of NT$1m-NT$3m.

Among the 52 domestic banks, First Commercial Bank ranks No 4 in loans and deposits and No 1 as a lead manager of syndicated loans. In addition, First Commercial Bank leads in mutual fund sales and trust/custodial services. It also has the second largest international banking business and ranks No 3 in terms of foreign exchange transactions.

Mingtai

Mingtai has been the second largest property and casualty (P&C) insurer in Taiwan for the past two decades, with a market share of around 9%. The company has five main product lines: auto, fire, marine, engineering, and casualty insurance. Currently, Mingtai serves 790 thousand individual customers and 89 thousand corporate customers through 17 branches and 49 liaison offices.

First Taisec

First Taisec is a full-service securities firm, operating in four main businesses: brokerage, proprietary trading, underwriting and financial product offering, with the underwriting business growing most rapidly.

First Taisec currently serves 41,000 customers through nine sales offices with 106 brokers across Taiwan. Subsequent to the merger, First Taisec is to consolidate its operations with First Commercial Bank's existing 16 branches, 90,000 customers, and 179,000 brokers.

The combination will boost First Taisec's market share by trading volume to 1.1% from current 0.7%; the combined company will rank No 4 in the domestic market.

Fig 66 Profile of FFHC subsidiaries

	First Commercial Bank	Mingtai	Taisec	NITC
Date of foundation	1899	1961	1988	1986
Main product lines	Commercial banking: corporate (67%), consumer (33%)	Automobile (54.2%), fire (20.6%), marine (7.8%), engineering (5.8%), others (10.7%)	Brokerage, proprietary trading, underwriting, financial products	19 open-end funds: fixed-income funds (86.8%), equity funds (13.2%)
Market position	No.1 (mutual fund sales/trust/custodianship/syndicated loans), No.2 (int'l banking), No.3 (FX transactions), No.4 (total assets/loans/deposits/ATM transactions)	No.2 (direct written premium)	No.20 after combining with First Commercial Bank's 16 branches operating brokerage services	No.9 (assets under management)
Distribution network	190 domestic branches (including branches, sub-branches, rep offices and headquarters), 18 overseas offices, 654 ATMs	80 independent agents, 650 in-house sales/service staff, 17 branches, 49 liaison offices, 15 domestic banks, rep offices in HK, Shanghai, Indonesia, Malaysia, Thailand and Vietnam	9 sales offices plus 16 branches from First Commercial Bank, 106 brokers plus 179 brokers from First Commercial Bank	24 sales agents, 3 domestic offices, 2 int'l affiliates, 2 strategic alliances with Chinese asset management companies
Clientele	4.2m retail and corporate customers, including 60k VIP customers and 130k high net-wroth customers	790k individual customers and 89k corporate customers	41,533 customers plus 90,629 customers from First Commercial Bank	More than 71k customers, more than 90k beneficial accounts

Source: First Financial Holding Co., ING Financial Markets

The integration process

FFHC's strategy appears to be to harness its long track record, millions of loyal customers, and extensive distribution platform to create synergy amongst these businesses. FFHC management believes that by leveraging on these advantages the group will be able to cross-sell within different group entities, with the ultimate goal of being one of the top three financial service providers in Taiwan and Greater China.

We, however, do not expect significant synergy to be created for some time to come—if ever. Time and efforts to integrate different businesses will inevitably incur additional expenses. Despite a huge combined distribution network and client base, it will be fairly time- and money-consuming to identify customer needs fully and explore potential revenue opportunities.

Although there has already been some cross-selling within the group in terms of mutual fund sales and referral of securities brokerage clients among First Commercial Bank, NITC and First Taisec, it is still too early to see material revenue synergy.

We are particularly concerned about the integration of IT systems among banking, non-life insurance and securities brokerage businesses, as these are totally different by nature and were originally acquired from different suppliers. In addition, we foresee extra training cost incurred given management's plan to reallocate First Commercial Bank's back-office employees to front-end service staff or even wealth management specialist posts. As heartless as it may sound, our preference would be for additional redundancies rather than the transfer strategy.

Limited cross-selling in practice

While legally the holding entity is not consolidated yet, there has already been some extent of cross-selling activities. Currently, First Taisec has a presence at 16 of First Commercial Bank's securities brokerage branches. First Commercial Bank sold more than NT$11bn of NITC's mutual funds in FY02 and expects to increase this amount going forward given that most of its branches have been seeded with NITC's product specialists.

Returns

Return to shareholders at FFHC has been consistently poor in the past, with the company's best performance a 13.8% ROE in 1997. Even this was achieved due to a slim equity base (6.6% Tier 1) rather than outstanding return on assets (0.67% in FY98); the addition of additional capital in 1998 dropped returns down below 10% even as ROA rose slightly. The 2000–02 period was even worse for FFHC (and its Taiwanese state bank counterparts), with returns on equity in the low single digits or negative, and ROAs of below 0.4%.

Fig 67 Key earnings components:1997-2005F

NT$m	1997	1998	1999	2000	2001	2002F	2003F	2004F	2005F
Net Interest Income	16,244	18,889	20,227	21,975	22,477	24,134	21,027	20,130	21,374
Non-Interest Income	9,136	10,145	14,428	12,127	10,097	3,741	10,174	11,194	11,945
Non-Interest Expenses	13,743	14,653	13,820	13,313	13,531	12,698	12,943	12,872	11,005
Loan Loss Provisions	3,270	4,218	12,740	14,387	13,812	12,192	28,721	10,438	9,757
Core Income	6,800	8,901	7,520	5,547	4,814	10,762	(8,875)	6,667	10,817
Net Income	6,552	7,223	6,124	4,162	3,151	(24,724)	(8,061)	7,634	11,793
EPS	2.00	2.02	1.62	1.10	0.83	(6.47)	(1.45)	1.38	2.12

Source: Company data, ING estimates

Fig 68 Key earnings ratios: 1997-2005F

	1997	1998	1999	2000	2001	2002F	2003F	2004F	2005F
ROA	0.67%	0.68%	0.54%	0.35%	0.25%	-1.91%	-0.59%	0.53%	0.77%
Core ROA	0.70%	0.84%	0.66%	0.46%	0.38%	0.83%	-0.65%	0.46%	0.70%
ROE	14.57%	11.66%	7.72%	5.04%	3.77%	-34.96%	-11.66%	9.00%	12.61%
Core ROE	15.12%	14.37%	9.49%	6.72%	5.77%	15.22%	-12.84%	7.86%	11.57%
NIM	1.93%	2.10%	2.10%	2.18%	2.16%	2.21%	1.78%	1.59%	1.58%
Cost/Income	54.15%	50.47%	39.88%	39.04%	41.54%	45.55%	41.48%	41.09%	33.03%
Overhead	1.64%	1.63%	1.44%	1.32%	1.30%	1.16%	1.10%	1.02%	0.81%
Effective Tax Rate	18.73%	12.42%	7.10%	13.36%	7.97%	-260.49%	15.17%	16.81%	13.85%

Source: Company data, ING estimates

Fig 69 Key earnings ratios: 4Q01-4Q03

	4Q01	1Q02	2Q02	3Q02	4Q02	1Q03	2Q03	3Q03F	4Q03F
ROA	0.13%	-1.52%	-6.83%	0.17%	0.52%	0.62%	0.59%	0.51%	-3.92%
Core ROA	0.28%	1.09%	-5.62%	7.23%	0.70%	0.62%	0.48%	0.46%	-3.99%
ROE	1.96%	-23.16%	-124.02%	3.84%	12.04%	13.94%	13.19%	9.12%	-63.08%
Core ROE	4.27%	16.69%	-102.17%	164.13%	16.17%	14.06%	10.71%	8.20%	-64.34%
NIM	2.32%	2.20%	2.20%	2.35%	2.14%	1.92%	1.79%	1.69%	1.63%
Cost/Income	33.07%	46.92%	42.95%	52.51%	41.39%	42.23%	40.63%	41.63%	41.52%
Overhead	1.22%	1.19%	1.18%	1.16%	1.14%	1.10%	1.12%	1.06%	1.05%
Effective Tax Rate	19.18%	-114.39%	24.68%	0.50%	-2.32%	6.81%	19.67%	16.40%	14.75%

Source: Company data, ING estimates

What has driven FFHC's losses? Net interest margins—although somewhat low by regional standards—have actually risen during the period, from 2.18% to 2.21%. Net loans are some 2% higher than at FY00, not a stellar performance but one which is certainly better than average across Asia.

The driving factor has been huge charges for bad assets, expressed on the company's financial statements both as provisions and as extraordinary losses on the sale of impaired assets. These have aggregated 600bp on average assets over the past three years, versus net income of -132bp.

Rates and margins

First Commercial Bank's net interest margin rose in FY01-FY02, due mainly to continued interest rate cuts starting in late FY2000. However, this trend has reversed since 1Q03 due to low interest rates. One major reason is that starting in 3Q02, domestic banks have increasingly adopted a new, index-oriented lending rate structure, which uses either deposit rates or commercial paper rates as benchmarks. In other words, lending rates now move proportionally in line with deposit rate cuts, eliminating the ability to lag rate rises and falls to cushion margins.

Along with a long average contractual maturity of deposits of 6-12 months in Taiwan, this new lending rate scheme has caused bank assets to be re-priced more quickly than liabilities, thus undermining bank profitability in an environment of falling rates. This is in contrast to the salad days of banking in Taiwan, when lending rates were determined based on an infrequently revised prime lending rate. Under this scheme, banks were able to cut their deposit rates more quickly and on a larger scale than their lending rates in a falling rate environment – and were also able to make large profits.

Fig 70 Key net interest margin components: 1998-2003

	1998	1999	2000	2001	2002	2003F
Yield on Earning Assets	7.19%	6.63%	6.71%	5.94%	4.23%	3.07%
Cost of Interest-bearing Liabilities	5.16%	4.59%	4.47%	3.67%	2.06%	1.40%
Interest Spread	2.03%	2.04%	2.24%	2.27%	2.17%	1.67%
Net Interest Margin	2.10%	2.10%	2.18%	2.16%	2.21%	1.78%

Source: Company data, ING estimates

Fig 71 Key net interest margin components: 4Q01-2Q03

	4Q01	1Q02	2Q02	3Q02	4Q02	1Q03	2Q03
Yield on Earning Assets	5.25%	4.72%	4.48%	4.32%	3.90%	3.47%	3.07%
Cost of Interest-bearing Liabilities	2.82%	2.44%	2.14%	1.92%	1.76%	1.53%	1.39%
Interest Spread	2.43%	2.27%	2.34%	2.39%	2.14%	1.93%	1.68%
Net Interest Margin	2.32%	2.20%	2.20%	2.35%	2.14%	1.92%	1.79%

Source: Company data, ING estimates

The other key factor that drove down First Commercial Bank's profitability is lack of diversification—First Commercial Bank relies too much on interest income. Over the last five years, interest income on average contributed to 70% of First Commercial Bank's total operating revenue, while fees and commissions accounted for less than 10%. Management has expressed confidence that they will be able to raise the fee income ratio to over 10% of top line by the end of 2003, as over 60k of the bank's accounts each hold deposits of more than NT$3m—and thus are prime candidates for personal wealth management products.

However, we consider the bank's target to be too aggressive given the intensifying competition in the retail segment and First Commercial Bank's lack of distinguishing products and marketing strategies.

Compared with its peers, First Commercial Bank is in a better position in terms of both interest spread and net interest margin. However, looking closely one can see that the difference is getting smaller over the years. This is attributable to intensified competition, especially from privately-run banks that have increasingly focused on high-yield consumer banking business.

Loan portfolio

Like most of its local peers, First Commercial Bank has experienced slowing loan growth since 1999. Total loans remained flat in FY02 while dropping slightly in 1Q03. The key driver is corporate loans, especially loans to state-owned/public enterprises (SOEs) and loans to small- and medium-sized enterprises (SMEs), which both exhibited double-digit declines in FY02 and 1Q03.

Although consumer loans grew year over year throughout 1999-2Q03, growth in this segment came mainly from residential mortgages and it has been pacing down. Meanwhile, other consumer loans, for example unsecured personal loans, have been declining since 1999. In all, consumer loan growth has been insignificant in helping First Commercial Bank's credit expansion, since corporate loans account for more than 70% of First Commercial Bank's total loan book.

Despite First Commercial Bank's tremendous efforts over the last several years to create a balanced loan portfolio, limited progress has been made. Consumer loans

accounted for 29% of total loans at 2Q03 vs 28% at the end of FY98. As opposed to some private banks which have focused on unsecured personal lending (including credit and cash cards), First Commercial Bank has devoted most of its resources to pursuing additional mortgage business, which accounts for more than 60% of the bank's total consumer loans.

Currently, First Commercial Bank ranks as Taiwan's No 3 in terms of private corporate loans, No 4 in total loans / mortgage / SME loans, and No 5 in terms of SOE loans. However, from now on the bank should have to work harder to maintain its market position. On the corporate side, market share declined over the last 15 months in all different loan categories, especially loans to SOEs and SMEs. This is due mainly to competition from private banks, which are looking for new sources of growth as corporate funding demand remains weak in the private sector and the retail segment is becoming increasingly competitive.

Consumer loan market share grew steadily over the last three years. However, this was attributable to mortgages, a segment that has become less and less profitable due to fierce competition (from both state-controlled and private banks), and implementation of the new lending rate scheme. In the meantime, the bank's market share of unsecured personal loans has declined steadily since 1999.

Geographic breakdown

By geography, Taipei City and Taipei County together contributed to over 50% of First Commercial Bank's total outstanding loans, while 15% came from southern Taiwan. This is in line with First Commercial Bank's allocation of its domestic branch network, of which 41% is in the greater Taipei area. We also find it notable that southern Taiwan, particularly Kaohsiung, is gaining in importance as a loan origination centre.

However, management has indicated that the bank will close some of its southern Taiwan branches in order to add to its base in the north. Under current regulations, banks are generally given permission to open new branches only if they close a like number of old ones. This is meant in part to stimulate consolidation, as smaller banks can be attractive acquisition candidates for their branch networks alone.

Fig 72 First Bank's loan breakdown: 2000-1Q03, by region (%)

Yr to Dec	2000	2001	2002	1Q03
Taipei City	45.10	46.35	47.13	45.4
Taipei County	8.58	8.71	9.03	9.6
Greater Taipei	**53.68**	**55.06**	**56.16**	**55.0**
Taoyuan	4.01	4.02	4.23	4.5
Hsinchu	2.75	2.96	2.95	3.1
Northern Taiwan	**6.76**	**6.98**	**7.2**	**7.6**
Taichung	7.45	8.23	7.2	7.4
Changhwa	2.40	2.00	2.1	1.8
Middle Taiwan	**9.85**	**10.23**	**9.3**	**9.2**
Tainan	7.85	7.76	7.7	7.8
Kaohsiung	9.74	8.48	9.2	9.9
Southern Taiwan	**17.59**	**16.24**	**16.9**	**17.7**
Others	12.12	11.49	10.6	10.5

Note: Great Taipei includes Taipei City and Taipei County.
Northern Taiwan includes Taoyuan and Hsinchu.
Middle Taiwan includes Taichung and Changhwa.
Southern Taiwan includes Tainan and Kaohsiung.
Source: First Financial Holding Co., ING Financial Markets

Credit cards

As a late comer to the credit card business, First Commercial Bank has a long way to go. As of March 2003, 760,000 credit cards were in force at the bank, while card consumption was NT$3.7bn and revolving balances NT$2.7bn. These figures translate into a domestic market share of 2.3% in terms of cards under circulation, 1.6% in card consumption and only 0.8% in revolving balance. Compared with the top ten credit card issuers, which together took up more than 60% of the market, First Commercial Bank is far behind the leaders.

The card business is, however, growing quickly: Over the last two years, fee and interest income generated from credit cards have grown at a CAGR of 34.8% and 13.4%, respectively. Cards in force are up by more than 30% YoY, credit card consumption by 18.3% YoY, and revolving balances have increased 42.8% YoY.

Nevertheless, the contribution from this segment is not material for First Commercial Bank's earnings. Interest and fee income on cards together accounted for a mere 3% of First Commercial Bank's total operating revenue; in terms of bottom-line profits credit cards have yet to reach the break-even point.

FFHC currently sells its credit cards mainly through its existing banking platform. First Commercial Bank now has 250 employees engaged in credit card operations in an effort to enhance card consumption. The bank has also launched a number of affinity card programs with retailers and other organisations, both to increase brand awareness and to capture new cardholders.

Going forward, FFHC expects the inclusion of other non-bank subsidiaries as well as the resulting cross-selling among group entities to improve the credit card business. Enhancement of card usage through tackling different customer segments is likely to be the key strategy. On the other hand, risk management becomes increasingly important given First Commercial Bank's continuously rising delinquency ratio.

Fig 73 First Bank's credit card information: 2000-1Q03

Yr to Dec	2000	2001	2002	1Q03
Profile (NT$m)				
Cards in force (unit)	360,715	549,934	724,295	759,575
Card consumption	12,978	12,214	14,450	3,719
Consumption per card (NT$'000)	35.98	26.82	22.68	5.01
Revolving balance	1,172	1,823	2,604	2,686
Credit card revenue	470	563	788	222
Interest income	204	285	434	125
Credit card fees	266	278	354	97
Credit card revenue / total opt revenue	1.46	1.76	2.73	3.03
Market share (%)				
Cards in force	1.98	2.28	2.29	2.30
Card consumption	1.80	1.58	1.65	1.63
Revolving balance	0.58	0.70	0.82	0.82
YoY/ YTD growth (%)				
Cards in force		52.46	31.71	4.87
Card consumption		-5.89	18.31	2.95
Revolving balance		55.55	42.84	3.15
Credit card revenue		19.79	39.96	12.69
Interest income		39.71	52.28	15.21
Credit card fees		4.51	27.34	9.60
Asset quality				
90-day delinquency rate (%)	5.86	10.84	12.45	12.65
(Net) charge-off (NT$m)	–	–	32	45
(Net) charge-off ratio (%)	4.94	3.37	0.94	1.30

Note: 1Q03 YTD growth rates for credit card consumption and revenue are calculated on annualised basis.
Source: First Financial Holding Co., ING Financial Markets

Asset quality

FFHC's asset quality has improved substantially over the past two years, but remains a source of serious concern. In particular, we see continuing evidence that management's reporting of potential problem loans is inaccurate or incomplete, and a steady stream of new impaired loans is still hitting the books. These should, in our view, have very material P&L impact over the next three years.

Fig 74 First Bank's loans by classification: 2001-2Q03 (NT$m)

	Gross amount			
	2Q2003	1Q2003	YE2002	YE2001
Pass	823,359	762,869	785,384	767,545
Special Mention	15,639	15,251	17,518	24,694
Substandard	33,159	42,594	43,711	87,913
Doubtful	6,217	5,414	5,462	13,320
Loss	2,072	2,810	3,254	4,153
Total Loans	880,446	828,938	855,329	897,625
ORE	449	754	946	1,356
Classified Assets (SS+D+L)	41,448	50,818	52,427	105,386
% of total loans	4.7%	6.1%	6.1%	11.7%
Criticized Assets (SM+SS+D+L+ORE)	57,536	66,823	70,891	131,436
% of total loans + ORE	6.5%	8.1%	8.3%	14.6%

Source: Company data, ING estimates

FFHC's total criticised assets (comprised of loans graded Special Mention—equivalent in our methodology to loans reported as "under surveillance" —through Loss, as well as foreclosed property, or ORE) fell 46% during 2002 and a further 18% during 1H03. However, we note that most of the improvement came from sales and write-offs, rather than from collections, restructurings, or upgrades to performing status. Criticised assets to total loans plus ORE remains high at 6.5%.

Fig 75 First Bank's criticised assets vs effective risk pool: 1Q03-2Q03

	1Q03	2Q03
Total Loans	828,938	880,446
Less: risk-free government and SOE	90,305	92,111
Total Risk Loans	738,633	788,335
Criticized Assets	66,823	57,536
% of total risk loans + ORE	9.0%	7.3%

Source: Company data, ING estimates

We note further that almost 11% of FFHC's loan book, some NT$92bn, is to government entities and SOEs. This portfolio is essentially risk-free and has an NPL ratio of zero. Deducting these loans from the pool of risk assets means that over 7% of FFHC's loan book is impaired according to the bank's internal classifications.

NPL sales

One of the methods FFHC has used to rid itself of poor-quality loans is to sell them on to private investors or AMCs. We applaud this method in general, as we believe that management can not devote sufficient time to both managing existing bad loans and preparing the bank to be competitive in the future. In addition, the sale methodology fixes a transparent price for bad assets and generally improves valuation due to investors' reticence to take on the uncertainty of valuing distressed assets within the bank.

Fig 76 First Bank's NPL sales (NT$m)

Transaction	Date	Face amount	Associated reserves	Book value	Sale price	% of face
Lone Star 1	7/30/02	17,849	15,463	2,386	NA	NA
Lone Star 2	7/30/02	15,013	2,149	12,864	NA	NA
GE Capital	7/30/02	15,786	2,365	13,421	NA	NA
Taiwan AMC	7/30/02	7,173	513	6,660	NA	NA
Cerberus	3/27/02	13,421	2,483	10,938	NA	NA
Lehman Brothers	4/26/02	4,823	765	4,058	NA	NA
Total		74,065	23,738	50,327	16,700	22.5%

Source: First Financial Holding Co., ING Financial Markets

FFHC has so far sold six NPL tranches to various groups as described in the table above, for a total return on original face value of 22%, or a loss of 78%. It is disturbing to us that the bank has prior to sale provisioned and written-down only 32% of the value of these loans—well below the actual market estimate of loss.

In general, foreign investors tend to buy "high quality" NPLs; not an oxymoron but a recognition that the most easily-managed assets are those secured by valuable real estate or subject to immediate corporate restructuring and settlement at a haircut. Although foreign investors are of course far from infallible about the value of these assets, this would suggest that the return on the remainder of FFHC's bad loans may be lower.

National service?

We are concerned despite management's consistent contrary indications that FFHC may still be looked-to by the government to help bail out troubled financial institutions, as it did in 3Q01 when it took over the credit departments of five farmers' associations—Kaohsiung Tzekuan, Tainan Chiku, Tainan Nanhsi, Pingtung Changchi, and Pingtung Wuanluan.

From a shareholder perspective we prefer not to see acquisitions of this type, as they add no scale and additional impaired assets.

Reserve adequacy

We have applied our standard regional reserve methodology to FFHC's currently-reported loan portfolio to gauge the institution's reserve levels. On our methodology, FFHC falls far short at only 40% of our required level. The shortfall of NT$12.5bn at 1Q03 amounts to some 20% of the bank's gross equity.

Fig 77 2Q03 reserve adequacy (NT$m)

	Gross amount	Reserve percentage	Required reserve
Pass	823,359	1%	8,234
Special Mention	15,639	5%	782
Substandard	33,159	20%	6,632
Doubtful	6,217	50%	3,109
Loss	2,072	100%	2,072
ORE	449	20%	90
Excess AIR	-	20%	-
Total	880,896		20,918
Actual Reserves			8,411
Shortfall			12,507
Actual/Required			40%
Shortfall/Capital			20%

Source: Company data, ING estimates

Methodology

Our reserve adequacy methodology accepts the bank's internal classifications according to MoF guidelines. We consider Category 1 loans as Pass (or performing), Category 2 loans as Substandard, Category 3 as Doubtful, and Category 4 as Loss. In addition, we map loans under surveillance (generally either restructured loans or those delinquent 90-180 days) to our Special Mention category.

We then assess required provisions against these loans at rates of 1% for Pass, 5% for Special Mention, 20% for Substandard, 50% for Doubtful, and 100% for Loss. This assessment is made on the gross balance of the loan, and is not affected by collateral valuation. In addition, we take a 20% reserve against ORE and excess accrued interest receivables.

This method is intended to calculate the expected actual loss on the bank's loan portfolio over a period of time; we believe that reserve levels should be equivalent to this expected loss. More importantly, it attempts to cover losses on both currently identified impaired assets as well as those which—although currently unidentified—can be statistically expected to become non-performing in the future.

On this basis, FFHC has reserve needs of NT$20.9bn, as against actual reserves of NT$8.4bn at 2Q03. The shortfall of NT$12.5bn will have to be either provided in future years or taken as a loss on a sale or restructuring similar to that incurred in 2002.

Is our methodology too harsh?

Clearly, our reserve methodology is much stricter than that of the Taiwanese authorities, or FFHC would be under severe supervisory restrictions. Does this mean that we are too conservative—or alternatively, just plain wrong?

Possible as always, but our analysis of FFHC shows that we are more likely *underestimating* the amount of loss which will be incurred. Note that Figure 78, below, shows changes in the required reserve amount over the past ten quarters (full calculations are below).

Fig 78 NPL migration and the effect of charge-offs: 2001-2Q03 (NT$m)

1Q03 reserve shortfall	15,442
Less: 2Q03 provisions	2,852
Estimated 2Q03 reserve shortfall	12,590
Actual 2Q03 reserve shortfall	12,507
Difference	83
YE2002 reserve shortfall	16,610
Less: 1Q03 provisions	2,078
Estimated 1Q03 reserve shortfall	14,533
Actual 1Q03 reserve shortfall	15,442
Difference	(909)
YE2001 reserve shortfall	23,590
Less: FY2002 provisions	47,679
Less: Loss on sale of bad assets	33,580
Estimated YE2002 reserve shortfall	(57,669)
Actual YE2002 reserve shortfall	16,610
Difference	(74,279)

Source: Company data, ING estimates

An example of our analysis: The above shows reserve shortfall based on our methodology at year-end 2002 of NT$16.6bn. During 1Q03, the company added NT$2.1bn to the reserve via provisioning. This should mean that the reserve shortfall drops by a like amount, even if assets have been written-off in the meantime (as long as their proportional losses do not exceed our 20%/50%/100% estimate of loss).

Instead, we find that reserve shortfall fell by only NT$1.2bn during the quarter—a difference of NT$909m. In simple terms, this means that the bank increased its expected loss by NT$909m during the quarter, either by inflow of new NPLs or because the existing ones were classified too leniently and are now considered more severely distressed.

Note that the same effect can be observed in FY02, where reserve shortfall decreased by only NT$7.0bn despite additional provisions (including loss on sale of bad loans) of NT$45.7bn—a whopping difference of NT$38.8bn that represents additional expected loss added during the year.

In 2Q03, we do not see this effect, but the fact that actual migration tracks so closely with our estimates of loss validates the conclusion that over NT$12bn in additional provisioning is needed. One quarter is not enough for us to conclude that the entry of new NPLs has stopped.

This consistent upward revision to expected loss calculations indicates to us that FFHC does not yet have its asset quality problems under control, and that internal classification data (which are period of delinquency-based and do not use forward-looking criteria) can not be relied upon.

The mere fact that the bank raised capital tacitly recognises that this is the case, as the bank would not be likely to require additional capital unless it were to make additional provisions or realise a loss in some other area. The only other potential use, in our view, would be an acquisition. But we are wary of FFHC's ability to assimilate another significant institution, given that its own problems have not yet come to an end.

We believe that the issue of new NPL inflows or inaccurate classifications raises the risk to investors of owning the company and should be reflected in a higher cost of capital than simple use of historic beta and country premium would indicate.

Fig 79 First Bank's reserve adequacy: FY02 (NT$m)

	Gross amount	Reserve percentage	Required reserve
Pass	785,384	1%	7,854
Special Mention	17,518	5%	876
Substandard	43,711	20%	8,742
Doubtful	5,462	50%	2,731
Loss	3,254	100%	3,254
ORE	946	20%	189
Excess AIR		20%	-
Total	856,275		23,646
Actual Reserves			7,036
Shortfall			16,610
Actual/Required			30%
Shortfall/Capital			29%

Source: ING Financial Markets

Fig 80 First Bank's reserve adequacy: FY01 (NT$m)

	Gross amount	Reserve percentage	Required reserve
Pass	767,545	1%	7,675
Special Mention	24,694	5%	1,235
Substandard	87,913	20%	17,583
Doubtful	13,320	50%	6,660
Loss	4,153	100%	4,153
ORE	1,356	20%	271
Excess AIR		20%	-
Total	898,981		37,577
Actual Reserves			13,987
Shortfall			23,590
Actual/Required			37%
Shortfall/Capital			28%

Source: ING Financial Markets

Deposits and funding

With a market share of 6.4% in total deposits, First Commercial Bank currently ranks No 4 among domestic banks, and No 1 among all non-wholly state-owned banks. Like most of its local peers, First Commercial Bank relies heavily upon deposits as one of its major funding sources. Customer deposits in general account for 90% of total

sources of funds, far higher than inter-bank borrowings (7%-8%) and long-term liabilities (2%-3%).

By product type, time deposit remains the biggest component of total deposits; its significance however has been diminishing, due to First Commercial Bank's efforts to increase demand deposits that carry lower interest rates. Demand deposits as a percentage of total deposits has been rising, from 31.5% in FY00 to 36.6% in March 2003. This helps First Commercial Bank enjoy low cost of funds at 2.0% compared with the industry average of 2.5%. This is also an industry trend in which domestic banks are forced to readjust their deposit structure for cost reduction amid continued margin deterioration.

The other area where banks can find ways to control funding cost is to restrain deposit growth. Over the last five years, average deposit growth among domestic banks declined continuously from double-digit year-over-year before FY00 to less than 2% YoY (or -0.3% YTD) in Mar-03. During the same period, First Commercial Bank also intentionally decelerated its deposit growth, from 8.3% YoY in FY98 to 2.2% YoY in 1Q03, before a rise to 5.2% in 2Q03. By product, time deposits played a key factor holding back deposit expansion, at a cumulative average growth rate (CAGR) of 1.1% vs 7.9% from demand deposits.

It is also notable that government deposits have been growing as a part of First Commercial Bank's funding base, increasing by a CAGR of 8.4% in FY01-1Q03 vs industry average of -2.9%. We believe this is a trade-off that First Commercial Bank offered to its SOE loan customers in return for the business they have contributed. Compared with ordinary deposits, government deposits are usually more costly as they are given more favourable interest rates. Nevertheless, the resulting impact should be limited, as this segment represents less than 2% of First Commercial Bank's total deposits.

Currently, First Commercial Bank has 4.5m depositors (including 4.2m retail deposit customers). Out of them around 60k have deposit account balances exceeding NT$3m, and another 130k have deposits between NT$1m and NT$3m. By depositor type, individual depositors contributed to 62% of total deposits (as of 1Q03), and over 35% of these individual deposits came from the metropolitan Taipei area (including Taipei City and Taipei County). These high net-worth customers constitute a base for developing the wealth management business.

Wealth management

Like most of its local peers, FFHC also has turned its eyes to the retail segment, in which wealth management is an area of particular focus. FFHC's advantages in this business line are as follows:

- A large distribution network, comprising 190 domestic branches of which 71 are located in Taipei City and Taipei County—home to over 50% of Taiwan's richest people.
- First Commercial Bank has around 60k VIP customers with deposit account balances exceeding NT$3m, and another 130k high net-worth customers with deposits of between NT$1m and NT$3m.
- On the corporate banking side, First Commercial Bank has more than 223k SME deposit accounts, most of which can be treated as personal banking accounts.

Overall, First Commercial Bank estimates that it has around a 12.5% market share of the most lucrative VIP customer base in Taiwan.

To serve these VIP and high net-worth customers, First Commercial Bank currently has 51 dedicated and highly trained specialists in charge and expects to expand this team to more than 100 specialists by the end of FY03. These VIP sales have so far demonstrated impressive added value in terms of mutual fund sales. In FY00-02, sales of mutual funds generated from wealth management specialists grew at a CAGR of 65.4% and contributed to 22.4% of First Commercial Bank's total mutual fund sales in Apr-03.

Looking ahead, FFHC expects the acquisition and integration of Mingtai, NITC and First Taisec—and their combined 1.1m additional customers—to enhance revenue generated from this segment further, in particular in terms of more cross-selling of insurance products.

We are neutral on this move due to concerns over the underlying competition – which is intensifying due to the limited size of the market. According to a Citibank survey, some 400k families in Taiwan have investable assets of NT$3m or more, but only 100k of them are willing to have a third party manage these assets. Thus, price competition is foreseeable as all banks are competing for a small piece of the market.

Compared with privately-run names such as Chinatrust, Taishin and Fubon, which have devoted years of efforts to this segment, FFHC is without a doubt a latecomer. Aside from "being big", ie, having a huge distribution network and clientele, FFHC will have to think more about its product design and marketing strategies.

Fig 81 First FHC financial summary

Income statement	2001A	2002A	2003F	2004F	2005F
(NT$m) Yr ended Dec					
Interest income	62,706	47,648	37,691	35,162	42,372
Interest expense	40,229	23,514	16,664	15,032	20,998
Net interest income	**22,477**	**24,134**	**21,027**	**20,130**	**21,374**
Ave. int. earning assets	*1,040,812*	*1,091,616*	*1,178,085*	*1,267,280*	*1,354,235*
NIM	**2.16%**	**2.21%**	**1.78%**	**1.59%**	**1.58%**
Non-interest income	10,097	3,741	10,174	11,194	11,945
Total operating income	**32,573**	**27,875**	**31,201**	**31,324**	**33,318**
Non-interest expense	13,531	12,698	12,943	12,872	12,942
Pre provision profit	**19,043**	**15,178**	**18,259**	**18,452**	**20,376**
Loan loss provisions	13,812	12,192	28,721	10,438	9,757
Non-operating income	-1,663	-35,486	814	967	976
Pre tax profit	**3,567**	**-32,501**	**-9,649**	**8,981**	**11,595**
Tax	417	-7,777	-1,587	1,347	1,739
Net profit	**3,151**	**-24,724**	**-8,061**	**7,634**	**9,856**
Core earnings	**4,814**	**10,762**	**-8,875**	**6,667**	**8,880**
Per share data (NT$)					
EPS	0.83	-6.47	-1.45	1.38	1.78
DPS	0.50	0.00	0.00	0.60	1.00
Effective payout ratio	*60.6%*	*0.0%*	*0.0%*	*43.6%*	*56.3%*
BVPS	22.05	14.99	14.58	15.96	17.73
ABVPS	21.53	12.39	12.86	14.23	16.00
Valuation					
Price to book value	1.0x	1.4x	1.5x	1.4x	1.2x
Price to adjusted book value	1.0x	1.8x	1.7x	1.5x	1.4x
Price to earnings	26.3x	-3.4x	-14.9x	15.8x	12.2x
Profitability ratios					
Net interest margin	2.2%	2.2%	1.8%	1.6%	1.6%
Yield on interest earning assets	5.9%	4.2%	3.1%	2.7%	3.0%
Cost on interest bearing liabilities	3.7%	2.1%	1.4%	1.2%	1.6%
Net interest spread	2.3%	2.2%	1.7%	1.5%	1.4%
Non-int. income (% Op income)	31.0%	13.4%	32.6%	35.7%	35.8%
Cost to income	41.5%	45.6%	41.5%	41.1%	38.8%
Overhead ratio	1.3%	1.2%	1.1%	1.0%	1.0%
Cost coverage	240.7%	219.5%	241.1%	243.4%	257.4%
ROA	0.3%	-1.9%	-0.6%	0.5%	0.6%
ROE	3.8%	-35.0%	-11.7%	9.0%	10.5%
Oroa analysis					
Net interest margin	2.2%	2.2%	1.8%	1.6%	1.6%
Non-interest inc./gross inc.	31.0%	13.4%	32.6%	35.7%	35.8%
Efficiency ratio	41.5%	45.6%	41.5%	41.1%	38.8%
Provision/assets	1.1%	0.9%	2.0%	0.7%	0.6%
Operating return on assets	**0.7%**	**0.5%**	**-0.5%**	**0.8%**	**0.9%**
Equity/assets	6.6%	4.4%	5.8%	6.0%	6.2%
Operating return on equity	**11.3%**	**10.5%**	**-8.5%**	**12.5%**	**14.5%**

Source: First FHC, ING Financial Markets

Fig 82 First FHC financial summary

Balance sheet	2001A	2002A	2003F	2004F	2005F
(NT$m) As at Dec					
Gross loans	819,121	821,637	880,566	939,527	1,010,713
Loan loss reserves	*13,987*	*7,036*	*4,005*	*5,990*	*7,161*
Net loans	798,429	809,440	876,561	933,537	1,003,552
Total earning assets	1,055,813	1,127,419	1,228,752	1,305,807	1,402,663
Other assets	220,330	182,447	178,012	173,455	195,579
Total Assets	**1,276,143**	**1,309,866**	**1,406,764**	**1,479,262**	**1,598,243**
Deposits	1,121,403	1,162,451	1,220,680	1,285,357	1,382,005
Customer deposits	1,046,124	1,082,496	1,098,734	1,153,670	1,240,196
Other deposits	75,279	79,955	121,946	131,687	141,809
Other paying liabilities	85,279	110,455	162,946	172,687	182,809
Other liabilities	60,597	59,631	64,122	64,309	76,785
Total Liabilities	1,192,000	1,252,581	1,325,801	1,390,666	1,499,790
Equity with revaluation	**84,143**	**57,285**	**80,963**	**88,596**	**98,453**
Adjusted equity	**82,141**	**47,353**	**71,387**	**78,983**	**88,837**
Balance sheet ratios					
Loan-to-deposit	72.4%	70.2%	72.1%	73.1%	73.1%
Equity to assets	6.6%	4.4%	5.8%	6.0%	6.2%
Total loan loss reserves to assets	1.10%	0.54%	0.28%	0.40%	0.45%
Asset quality					
Nonperforming assets	131,436	70,891	30,851	31,520	32,207
Special mention	24,694	17,518	13,208	14,093	15,161
Substandard	87,913	43,711	13,784	13,605	13,293
Doubtful	13,320	5,462	2,585	2,551	2,492
Loss	4,153	3,254	862	850	831
ORE	1,356	946	412	421	430
NPAs/total loans	16.2%	8.7%	3.5%	3.4%	3.2%
Reserve coverage of NPAs	10.6%	9.9%	13.0%	19.0%	22.2%
Required reserves	37,577	23,646	14,155	14,720	15,369
Actual reserves	13,987	7,036	4,005	5,990	7,161
Shortfall (surplus)	23,590	16,610	10,149	8,730	8,208
Actual to required reserves	37.2%	29.8%	28.3%	40.7%	46.6%
Shortfall to capital	28.0%	29.0%	12.5%	9.9%	8.3%
Growth rates (YoY)					
Income statement					
Net interest income	2.3%	7.4%	-12.9%	-4.3%	6.2%
Non-interest income	-16.7%	-62.9%	172.0%	10.0%	6.7%
Non-interest expenses	1.6%	-6.2%	1.9%	-0.5%	0.5%
Pre-provision earnings	-8.4%	-20.3%	20.3%	1.1%	10.4%
Loan loss provisions	-4.0%	-11.7%	135.6%	-63.7%	-6.5%
Core earnings	-13.2%	123.6%	-182.5%	N.M.	33.2%
Net profit	-24.3%	-884.7%	-67.4%	N.M.	29.1%
Balance sheet					
Loan growth	0.6%	0.5%	7.8%	6.7%	7.6%
Interest earning assets	2.9%	6.8%	9.0%	6.3%	7.4%
Asset growth	3.7%	2.6%	7.4%	5.2%	8.0%
Deposit growth	4.6%	3.7%	5.0%	5.3%	7.5%
Shareholders' funds	1.6%	-31.9%	41.3%	9.4%	11.1%

Source: First FHC, ING Financial Markets

SinoPac: Waiting for love

SinoPac is an interesting hybrid of low-risk mortgage bank and volatile securities broker. This could potentially be a platform on which to build universal consumer banking—as indeed SinoPac management has tried to do with their emphasis on all-in-one accounts—however, SinoPac is probably too small to accomplish its aims in the present market, and seeing this it is seeking a larger merger partner.

On its own, SinoPac will not be able to boost returns much above the 10% level (still better than its low 7.4% cost of capital), giving the bank a fair value of NT$19.36 or 1.44x YE2004 book value. We therefore initiate coverage of the stock with a HOLD rating and price target of NT$19.36.

However, we believe that SinoPac will be successful in its search for a partner, and will be taken over by a domestic competitor or a foreign player. Although it is our practice never to set price targets based on hypothetical M&A, we nevertheless point out that in our opinion SinoPac is worth NT$21-3 per share to a domestic acquisitor, and potentially even more to a foreign player.

Introduction and structure

Founded in May 2002, SinoPac Holdings initially consisted of Bank SinoPac and SinoPac Securities, which was itself the result of an earlier merger with National Securities. The holding company umbrella was expanded further in 4Q02-1Q03 by the inclusion of other, smaller subsidiaries—SinoPac Call Centre, AnShin Card Services (formerly Aetna SinoPac), SinoPac Asset Management, SinoPac Marketing Consulting, SinoPac Venture Capital, SinoPac Life Insurance Agency, and SinoPac Property Insurance. Combined assets of the FHC totalled NT$473.6bn and net worth NT$44bn as of June 2003.

Mid-sized bank

Bank SinoPac had a market share of 1.53% in deposits and 1.49% in loans as of June 2003, ranking approximately 16th among 52 domestic banks. Consumer loans accounted for around 70% of total outstanding loans, with the overwhelming majority (90%) of these accounted for by residential mortgages.

Large-sized brokerage

The consolidation with National Securities in May 2002 strengthened SinoPac Securities' brokerage business. Its underlying market share jumped from 3.6% in 2001 to more than 5% currently, ranking it third in Taiwan after Yuanta Securities (6004 TT, NT$21.7, NR) and Fubon Securities (unlisted). SinoPac Securities also leads underwriting and online trading in Taiwan, with a market share of around 9% and 15%, respectively.

Credit cards just added in

SinoPac Holdings acquired a 39% stake of AnShin Card Services from ING Group at a total cost of US$30m and has since 3Q03 included AnShin Card Services under its holding umbrella. Right now SinoPac Holdings holds nearly 90% of AnShin Card Services. This credit card company has broken even since April 2003 and currently has around 400k credit cards in force. Pre-tax profit for 1Q-3Q03 was around NT$9m. Although its earnings contribution is still insignificant, the inclusion of this credit card company should help SinoPac Holdings enlarge both scale and scope of business.

Return

Return to shareholders at SinoPac Holdings (and Bank SinoPac previously) was not very impressive compared to other industry players. Prior to 2002, ROA was below 1% and ROE below 10%, due mainly to relatively high operating expense. This is somewhat odd given the bank's mortgage-centric loan portfolio, which should be relatively easy to service.

A possible reason is that Bank SinoPac launched the "Money Management Account" (MMA) in 2000, that integrates different types of financial services (eg deposits, securities/mutual fund trading, mortgage financing, and credit cards) together with Internet data transmission so as to provide "mobile bank" function. This was costly for SinoPac in its initial stages from both a hardware and software installation perspective.

Note that both ROA and ROE improved incrementally in 2002 driven by rising net interest margins, although the cost-to-income ratio remained high. This increase resulted from continued interest rate cuts starting in late 2000 together with a rigid mortgage pricing system that helped enlarge interest spread by 120-150bps in 2001-2002. However, the move to ARMs will constrain SinoPac's margins going forward.

Both ROA and ROE in 1H03 improved further driven by (1) non-interest income and (2) improved cost efficiency. Non-interest income in 1H03 grew 27% compared to 2H02 on the stock market rally and continuously improved income from long-term investment—although these merits were somewhat offset by declining bank spread.

Going forward, we expect bank spread to stabilise given limited room for further interest rate cuts. However, uncertainties remain given the volatile earnings streams of SinoPac Securities, which are highly sensitive to stock market turnover. At current, SinoPac Securities contributes around 40% to SinoPac Holdings' total bottom line.

Fig 83 Key earnings components: 1998-2004F (NT$m)

Yr to Dec	1998	1999	2000	2001	2002	2003F	2004F
Net Interest Income	2,882	3,468	4,271	4,760	7,128	6,166	5,877
Non-Interest Income	1,439	2,386	1,933	2,061	8,011	10,988	12,569
Non-Interest Expenses	2,734	3,090	3,489	3,971	9,025	9,690	10,354
Loan Loss Provisions	288	744	501	1,000	1,599	1,764	1,817
Core Income	993	1,791	1,659	1,386	3,378	4,850	5,333
Net Income	1,005	1,791	1,702	1,551	3,501	4,836	5,333
EPS (NT$)	0.66	1.13	0.97	0.80	0.93	1.27	1.40

Note: Consolidated since 2Q02

Source: SinoPac Holdings, ING Financial Markets

Fig 84 Key earnings components: 4Q01-2Q03F (NT$m)

Yr to Dec	4Q01	1Q02	2Q02	3Q02	4Q02	1Q03	2Q03
Net Interest Income	1,358	1,363	2,408	1,703	1,654	1,722	1,664
Non-Interest Income	218	646	3,978	1,544	1,843	1,626	2,687
Non-Interest Expenses	1,104	1,009	3,547	2,076	2,393	2,143	2,429
Loan Loss Provisions	440	250	453	344	553	353	573
Core Income	-57	649	1,781	556	392	591	1,142
Net Income	-78	660	1,717	609	515	608	1,100
EPS (NT$)	-0.04	0.34	0.49	0.16	0.14	0.16	0.29

Note: Consolidated since 2Q02

Source: SinoPac Holdings, ING Financial Markets

Fig 85 Key earnings ratios: 1998-2004F

Yr to Dec	1998	1999	2000	2001	2002	2003F	2004F
ROA	0.55%	0.90%	0.77%	0.60%	1.00%	1.07%	1.08%
Core ROA	0.55%	0.90%	0.76%	0.54%	0.96%	1.07%	1.08%
ROE	5.72%	8.89%	7.92%	6.82%	10.28%	10.52%	10.90%
Core ROE	5.65%	8.89%	7.73%	6.10%	9.92%	10.55%	10.90%
NIM	1.94%	2.15%	2.43%	2.42%	2.58%	1.63%	1.40%
Cost/Income	63.28%	52.78%	56.23%	58.21%	59.61%	56.49%	56.13%
Overhead	1.84%	1.92%	1.99%	2.02%	3.27%	2.56%	2.46%
Effective Tax Rate	23.50%	11.37%	25.08%	25.11%	25.18%	14.90%	15.00%

Note: Consolidated since 2Q02

Source: SinoPac Holdings, ING Financial Markets

Fig 86 Key earnings ratios: 4Q01-2Q03

Yr to Dec	4Q01	1Q02	2Q02	3Q02	4Q02	1Q03	2Q03
ROA	-0.11%	0.94%	1.88%	0.53%	0.46%	0.56%	0.96%
Core ROA	-0.08%	0.92%	1.95%	0.49%	0.35%	0.55%	1.00%
ROE	-1.33%	11.17%	20.56%	5.60%	4.63%	5.39%	9.85%
Core ROE	-0.98%	10.99%	21.33%	5.11%	3.52%	5.24%	10.22%
NIM	2.21%	2.15%	3.22%	1.99%	1.87%	1.84%	1.68%
Cost/Income	70.02%	50.21%	55.54%	63.93%	68.43%	64.01%	55.83%
Overhead	1.80%	1.59%	4.75%	2.42%	2.70%	2.29%	2.45%
Effective Tax Rate	273.85%	13.43%	25.38%	32.76%	28.92%	30.73%	15.31%

Note: Consolidated since 2Q02

Source: SinoPac Holdings, ING Financial Markets

Loan portfolio and growth

Conservative creditor

As opposed to some privately run banks that have been making efforts to increase exposure to high-yield consumer products like credit cards and cash cards, SinoPac is quite conservative in terms of product offering. Currently, 70% of Bank SinoPac's total loan portfolio are consumer loans, while nearly 90% of those (or more than 60% of total loans) are mortgages.

Management views residential mortgage clients as a critical source for further sales opportunities, for example deposit taking, credit cards, securities/mutual fund trading, HELOCs, personal financing, and even wealth management services. In 1H03, total mortgage by grew around 13% given the bank's aggressive ARM promotion and a low interest rate environment.

As of August 2003, ARMs accounted for approximately 50% of Bank SinoPac's total mortgage—somewhat less than with some of their competitors, indicating that there will be some further repricing to come.

New area – SME cash management

On the corporate front, Bank SinoPac tries to find its niche by focusing on small- and medium-sized enterprises (SMEs). Asides from traditional financial services, the bank now offers a variety of cash management services, such as financing & credit card insurance, account management fund appropriation, on line financial services, and supply chain management, via a comprehensive online financing platform—MMAb2b.com, launched in January 2001. SinoPac is the first Taiwanese bank launching the "E-factoring" business, and has recently signed a strategic alliance agreement with Test Rite (2908 TT, NT$16, Sell), the largest trade company in Taiwan, to provide its suppliers online financing cross Taiwan, Hong Kong and China.

Going forward, we expect mortgages to remain the key contributor for SinoPac's total loan growth. On the other hand, corporate banking, especially cash management for SME clients, should become more significant as seen in its continued growth momentum, given improved domestic economy and increasing communications/transactions across the Greater China area.

What is factoring?

When a seller invoices a buyer, domestic or overseas buyer, and assigns account receivables to Bank SinoPac, Bank SinoPac will provide a credit cover on the buyer and advance the funds to the seller. If there is a trade dispute, even if the buyer fails to pay the receivables due, Bank SinoPac guarantees the seller full payment for the invoiced amount.

Fig 87 Loan breakdown: 1998-2004F

Yr to Dec	1998	1999	2000	2001	2002	2003F	2004F
Total loans	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
Corporate	25.7%	26.6%	28.0%	26.0%	28.2%	28.0%	28.5%
Consumer	74.3%	73.4%	72.0%	74.0%	71.8%	72.0%	71.5%
Mortgage	65.1%	65.6%	62.4%	62.2%	61.5%	64.0%	63.0%
% to consumer loans	87.7%	89.4%	86.7%	84.1%	85.7%	88.9%	88.1%
Unsecured personal loans	9.1%	7.8%	9.6%	11.8%	10.3%	8.0%	8.5%
% to consumer loans	12.3%	10.6%	13.3%	15.9%	14.3%	11.1%	11.9%

Note: Loan breakdown for Bank SinoPac only

Source: Ministry of Finance, SinoPac Holdings, ING Financial Markets

Fig 88 Loan growth: 1998-2004F

Yr to Dec	1998	1999	2000	2001	2002	2003F	2004F
Total loans	5.6%	12.4%	16.0%	7.6%	34.6%	12.0%	9.3%
Corporate	-3.4%	16.1%	22.2%	0.1%	46.0%	11.2%	11.3%
Consumer	9.0%	11.1%	13.8%	10.6%	30.6%	12.3%	8.6%
Mortgage	12.8%	13.3%	10.4%	7.3%	33.0%	16.6%	7.6%
Unsecured personal loans	-11.9%	-4.2%	43.0%	32.0%	17.7%	-12.9%	16.1%

Note: Loan growth for Bank SinoPac only

Source: Ministry of Finance, SinoPac Holdings, ING Financial Markets

Asset quality

Mortgages no longer an asset quality shield

Bank SinoPac reported an MoF-defined NPL ratio of 2.17%, or 2.77% including loans under surveillance, as of June 2003. This is far below the industry average of 5.68% (or 7.97% in broad definition). Over the last five years or more, Bank SinoPac has kept its asset quality more or less intact and ranks among the domestic banks with the lowest NPL ratios. Management attributes this to strict policy for credit approval and more importantly limited exposure to high-yield products that are seen as risky.

While management at Bank SinoPac came mainly from Citibank and other major foreign banks, apparently they are more risk averse. They have been focusing on mortgage as this loan category in Taiwan—with LTVs of no more than 80-90% of the value of the underlying collateral—are generally considered less risky. Mortgage contributes to more than 60% of Bank SinoPac's total loan book, far higher than the industry average of 26%.

On the other hand, with falling property prices such a mortgage-centric strategy is no longer 100%-secured. Although mortgages are usually less risky than corporate loans and other high-yield consumer products, defaults on mortgage have increased given continued high unemployment. While Bank SinoPac has been adjusting its policy on geographical allocation by concentrating 80% of its mortgage in the metropolitan area where residents usually have better credit quality, recovery in such a highly geared loan portfolio will require a real recovery in the domestic property market.

Insufficient coverage

The other worrying indicator is the bank's NPL coverage, which has historically stayed at 70%-80% (and even higher prior to the year 2000), but fell below 40% starting in 2001, or even below 30% starting 1999 if taking into consideration the surveillance loans as well as foreclosed real estate.

By applying our standard regional reserve methodology to Bank SinoPac's currently-reported loan portfolio to gauge its reserve levels, we found that Bank SinoPac like most other Taiwanese banks also falls short of reserves, with 1H03 outstanding amount at 46% of our required level.

Fig 89 Bank SinoPac's reserve adequacy: 1H03 (NT$m)

	Gross amount	Reserve percentage	Required reserve
Pass	256,002	1%	2,560
Special Mention	1,203	5%	60
Substandard	2,623	20%	525
Doubtful	492	50%	246
Loss	164	100%	164
ORE	685	20%	137
Excess AIR	-	20%	-
Total	261,169		3,692
Actual Reserves			1,684
Shortfall			2,007
Actual/Required			46%
Shortfall/Capital			5%

Source: Bank SinoPac, ING Financial Markets

Margin

Like most other local players, Bank SinoPac has experienced margin compression since 2H02 due to the rising prevalence of the index-oriented lending rate scheme, and particularly its relatively high mortgage exposure. In the last four quarters, the bank's net interest margin fell steadily, reaching a record low of 1.68% in 2Q03.

Going forward, we nevertheless expect the downward trend in profitability to slow down and actually reverse in 2005, for three reasons. The first is the relatively high refinancing ratio—currently more than 50% of the existing mortgage borrowers have converted their outstanding positions into the ARM scheme. Another reason is management's intention to better utilise assets by placing excess funds into fixed-income instruments that generate higher returns than ordinary lending. Lastly is the expected rise in interest rates beginning in 2H04.

Fig 90 Key net interest margin components: 1998-2003F (%)

Yr to Dec	1998	1999	2000	2001	2002	2003F
Yield on Earning Assets	7.99%	7.67%	7.49%	6.86%	4.48%	2.85%
Cost of Interest-bearing Liabilities	6.29%	5.41%	5.15%	4.16%	2.75%	1.44%
Interest Spread	1.70%	2.27%	2.34%	2.70%	1.73%	1.41%
Net Interest Margin	1.94%	2.15%	2.43%	2.42%	2.58%	1.63%

Note: Consolidated since 2Q02
Source: SinoPac Holdings, ING Financial Markets

Fig 91 Key net interest margin components: 1Q02-2Q03F (%)

Yr to Dec	1Q02	2Q02	3Q02	4Q02	1Q03	2Q03
Yield on Earning Assets	4.88%	5.69%	4.53%	3.96%	3.57%	3.24%
Cost of Interest-bearing Liabilities	2.89%	3.31%	2.61%	2.27%	1.89%	1.67%
Interest Spread	1.99%	2.39%	1.92%	1.69%	1.68%	1.57%
Net Interest Margin	2.15%	3.22%	1.99%	1.87%	1.84%	1.68%

Note: Consolidated since 2Q02
Source: SinoPac Holdings, ING Financial Markets

Expansions

A foothold in China

Compared with most other small-sized, privately-run financial institutions, SinoPac Holdings is well positioned for China operations, for two reasons. Firstly, Bank SinoPac has a 100%-owned US subsidiary that has operated a China-based representative office for years. Secondly, Bank SinoPac has established a strategic alliance with Shanghai-based First Sino Bank (a joint venture between Shanghai Pudong Development Bank and Taiwanese shoemaker Pou Chen Corp. (9904 TT, NT$39.1, NR)), that has received the Chinese government's approval to engage in RMB business. Additionally, SinoPac Securities has set up a representative office in Shanghai. In truth, the parent holding company has already established a foothold in the greater China area.

Take-over target

Management seemed to change mentality dramatically subsequent to the failure of merger talks with CDIBH (2883 TT, NT$14.2, NR) and Grand Commercial Bank (unlisted), and recently has become aggressive in selling off itself. The rationale is quite simple—SinoPac Holdings is not big enough to attract potential take-over targets amid an environment where everyone wants to become as big as possible, so why not turn itself into a take-over target?

Which combination makes most sense?

Currently Chinatrust, Fubon, Cathay, and Taishin are rumoured potential acquirers. We believe the first three names have more chance to win in competing for SinoPac given their larger scale of business.

Chinatrust + SinoPac – Chinatrust would strengthen further its transaction-based corporate banking business by leveraging SinoPac's factoring expertise. In addition, as opposed to Cathay and Fubon, Chinatrust is more effective in terms of post-merger integration. Culturally Chinatrust shouldn't have problem working with SinoPac as top management of the two groups came mainly from Citibank. Although Chinatrust already has Grand Commercial Bank, as a bank-centred FHC we believe that the group will continue expanding until its market share reaches 10%.

Cathay + SinoPac – a further enlarged banking platform would help Cathay Financial cross-sell more of its insurance products. In addition, compared to Cathay Bank, SinoPac has a clearer balance sheet together with stable asset quality, which would make integration easier. More importantly, with the addition of SinoPac would immediately obtain a significant presence in the securities brokerage industry.

Fubon + SinoPac – compared to Chinatrust FHC and Cathay Financial, Fubon Financial will probably not be as ardent in wooing SinoPac at the current time. Integration between Fubon Bank and Taipei Bank is still in progress and apparently at a slower pace than that between Cathay Bank and UWCCB or Chinatrust and Grand Commercial. For now integration with IBA and further expansion of the securities arm would seem to be more critical than another bank buy-out. And given that Fubon will likely take IBA, SinoPac seems not as attractive as a starting point for China operations.

Taishin + SinoPac – we suspect that Taishin would love SinoPac Holdings only for its branch network. SinoPac's large mortgage portfolio has limited profitability and to some extent contradicts Taishin's strategy of focusing on high-yield products.

Fig 92 SinoPac financial summary

Income statement	2001A	2002A	2003F	2004F	2005F
(NT$m) Yr ended Dec					
Interest income	14,150	15,493	11,678	10,433	13,314
Interest expense	9,389	8,365	5,512	4,556	6,538
Net interest income	**4,760**	**7,128**	**6,166**	**5,877**	**6,776**
Ave. int. earning assets	*196,716*	*276,233*	*378,006*	*420,975*	*446,426*
NIM (%)	**2.42%**	**2.58%**	**1.63%**	**1.40%**	**1.52%**
Non-interest income	2,061	8,011	10,988	12,569	12,850
Total operating income	**6,822**	**15,139**	**17,154**	**18,446**	**19,626**
Non-interest expense	3,971	9,025	9,690	10,354	10,812
Pre provision profit	**2,851**	**6,114**	**7,463**	**8,092**	**8,813**
Loan loss provisions	1,000	1,599	1,764	1,817	2,001
Non-operating income	165	123	-14	0	0
Pre tax profit	**2,016**	**4,638**	**5,685**	**6,274**	**6,812**
Tax	465	1,137	849	941	1,022
Net profit	**1,551**	**3,501**	**4,836**	**5,333**	**5,791**
Core earnings	**1,386**	**3,378**	**4,850**	**5,333**	**5,791**
Per share data (HK$)					
EPS	0.80	0.93	1.27	1.40	1.52
DPS	0.47	0.34	0.45	0.49	0.53
Effective payout ratio (%)	*59%*	*36%*	*36%*	*35%*	*35%*
BVPS	11.99	11.95	12.33	13.28	14.30
ABVPS	11.99	11.95	12.33	13.28	14.30
Valuation					
Price to book value	1.5x	1.5x	1.5x	1.3x	1.3x
Price to adjusted book value	1.5x	1.5x	1.5x	1.3x	1.3x
Price to earnings	22.4x	19.2x	14.1x	12.8x	11.8x
Profitability ratios (%)					
Net interest margin	2.42%	2.58%	1.63%	1.40%	1.52%
Yield on interest earning assets	6.86%	4.48%	2.85%	2.41%	2.89%
Cost on interest bearing liabilities	4.16%	2.75%	1.44%	1.10%	1.50%
Net interest spread	2.70%	1.73%	1.41%	1.32%	1.39%
Non-int. income (% Op income)	30.22%	52.92%	64.06%	68.14%	65.47%
Cost to income	58.21%	59.61%	56.49%	56.13%	55.09%
Overhead ratio	2.02%	3.27%	2.56%	2.46%	2.42%
Cost coverage	171.78%	167.75%	177.02%	178.15%	181.51%
ROA	0.60%	1.00%	1.07%	1.08%	1.11%
ROE	6.82%	10.28%	10.52%	10.90%	10.99%
Oroa analysis					
Net interest margin	2.42%	2.58%	1.63%	1.40%	1.52%
Non-interest inc./gross inc.	30.22%	52.92%	64.06%	68.14%	65.47%
Efficiency ratio	58.21%	59.61%	56.49%	56.13%	55.09%
Provision/assets	0.36%	0.38%	0.37%	0.36%	0.37%
Operating return on assets	**1.09%**	**1.84%**	**1.61%**	**1.56%**	**1.60%**
Equity/assets	8.38%	10.60%	9.77%	10.03%	10.20%
Operating return on equity	**13.01%**	**17.32%**	**16.46%**	**15.58%**	**15.69%**

Source: SinoPac Holdings, ING Financial Markets

Fig 93 SinoPac financial summary

Balance sheet	2001A	2002A	2003F	2004F	2005F
(NT$m) As at Dec					
Gross loans	209,491	238,764	268,840	291,497	319,827
Loan loss reserves	*1,268*	*1,451*	*1,688*	*1,831*	*2,009*
Net loans	208,223	237,313	266,323	288,760	316,817
Total earning assets	206,317	346,149	409,862	432,087	460,765
Other assets	72,112	76,563	72,465	73,640	74,924
Total Assets	**278,429**	**422,712**	**482,328**	**505,728**	**535,689**
Deposits	241,694	323,453	363,718	381,478	405,680
Customer deposits	217,610	268,205	294,558	317,268	346,966
Other deposits	24,084	55,248	69,160	64,210	58,714
Other paying liabilities	5,000	7,000	21,564	21,564	21,564
Other liabilities	32,497	129,711	49,915	51,941	53,783
Total Liabilities	255,107	377,915	435,197	454,984	481,027
Equity with revaluation	**23,321**	**44,797**	**47,131**	**50,744**	**54,662**
Adjusted equity	**23,321**	**44,797**	**47,131**	**50,744**	**54,662**
Balance sheet ratios (%)					
Loan-to-deposit	86.7%	73.8%	73.7%	76.2%	78.6%
Equity to assets	8.4%	10.6%	9.8%	10.0%	10.2%
Total loan loss reserves to assets	0.46%	0.34%	0.35%	0.36%	0.37%
Asset quality					
Nonperforming assets	5,880	4,503	5,173	5,318	5,739
Special mention	3,730	2,095	1,268	1,386	1,533
Substandard	1,515	1,622	2,575	2,581	2,756
Doubtful	284	304	483	484	517
Loss	95	101	161	161	172
ORE	256	380	686	705	761
NPAs/total loans	2.8%	1.9%	1.9%	1.8%	1.8%
Reserve coverage of NPAs	21.6%	32.2%	32.6%	34.4%	35.0%
Required reserves	2,816	3,105	3,753	3,990	4,349
Actual reserves	1,268	1,451	1,688	1,831	2,009
Shortfall (surplus)	1,548	1,654	2,065	2,159	2,340
Actual to required reserves	45.0%	46.7%	45.0%	45.9%	46.2%
Shortfall to capital	6.6%	3.7%	4.4%	4.3%	4.3%
Growth rates					
(%, YoY)					
Income statement					
Net interest income	11%	50%	-14%	-5%	15%
Non-interest income	7%	289%	37%	14%	2%
Non-interest expenses	14%	127%	7%	7%	4%
Pre-provision earnings	5%	115%	22%	8%	9%
Loan loss provisions	100%	60%	10%	3%	10%
Core earnings	-16%	144%	44%	10%	9%
Net profit	-9%	126%	38%	10%	9%
Balance sheet					
Loan growth	20%	14%	12%	8%	10%
Interest earning assets	10%	68%	18%	5%	7%
Asset growth	18%	52%	14%	5%	6%
Deposit growth	18%	34%	12%	5%	6%
Shareholders' funds	5%	92%	5%	8%	8%

Source: SinoPac Holdings, ING Financial Markets

E.Sun FHC: Prodigal sun

We are initiating coverage of E.Sun FHC with a BUY rating and NT$24.64 price target, representing 2.1x YE2004 book value per share and 16.1x and 10.7x times 2004 and 2005 forward EPS, respectively.

E.Sun FHC is anchored by one of Taiwan's cleaner and more retail-oriented banks, with other significant interests in bills finance and securities. With only 52 branches, E.Sun is a small bank, and we would expect the company to be involved in M&A within the relatively near future, either as a buyer or a seller.

If a buyer as management would prefer to be, one of our concerns is how management will handle any purchase and integration given that we have seen some richly-priced deals in the past; however, our fears are assuaged by management's keen focus on cost efficiency—what we see as the key success factor for an in-market consolidation.

Introduction

Comprehensive financial service network

E.Sun Bank was originally founded in 1990 as one of the "new" crop of private banks in Taiwan, and has never been controlled by a single group, in line with its founders' desire to create a "professional" bank. In order to take advantage of the FHC Act, E.Sun FHC was founded in January 2002 to hold the banks and affiliates E.Sun Bills Finance and E.Sun Securities.

E.Sun Securities Investment Trust (previously 45% held by E.Sun Bank) was then added to the holding umbrella in June 2003 by exchanging each common share of E.Sun Securities Investment Trust for 1.18 shares of E.Sun FHC. The inclusion of minor affiliates E.Sun Venture Capital and E.Sun Insurance Agency was completed in October 2002 and July 2003, respectively. With over NT$25bn in total paid-in capital, E.Sun FHC now owns 100% of each of these subsidiaries.

The shareholder structure of E.Sun FHC is relatively diversified. Major shareholders include Cathay Group (Cathay Life owns 5.2% and its affiliate Wonda Investment 3.5%), Hsin Tung Yan Group (1.91%) and Hsing Ta Cement (1109 TT, owns 0.41%). Board members together hold a 14.3% stake. There has been speculation that Cathay would sell its stake if it were unable to gain full control of E.Sun; so far we see no evidence of this.

Fig 94 Profile of E.Sun FHC

Major subsidiaries	E.Sun Bank	E.Sun Bills Finance	E.Sun Securities	E.Sun Venture Capital	E.Sun Insurance Agency
Total assets (NT$m)	283,461	16,290	8,990	1,005	–
Total capital (NT$m)	18,175	4,265	3,060	1,000	10
Net worth (NT$m)	19,961	5,515	3,183	1,005	–
1H03 net profit (NT$m)	2,048	482	86	2	–

Note: Data as of 1H03

Source: E.Sun FHC, ING Financial Markets

Business lines

Although E.Sun began as an SME and small manufacturers' bank, the bank over the last 12 months has been intentionally increasing its focus on the retail segment, especially credit cards, residential mortgages, and the wealth management business.

On the corporate side, E.Sun's major initiatives includes the roll-out of corporate cash management products through E.Sun Bank's Treasury Management Unit and closer cooperation between corporate lending and bills finance operations. Comments on major businesses are as follows:

Mortgage lending: key to the retail sector, with room to grow

Within the consumer sector, E.Sun FHC places emphasis on mortgages as a key product despite their diminishing spreads. Mortgages are seen as a core part of the client relationship due to their long-term nature and high information content—mortgage customers are very sticky.

Currently, E.Sun Bank ranks as No.14 in mortgages; management believes that the bank must be in the top 10 to remain competitive, indicating a stronger marketing push to come. As of June 2003, mortgages accounted for approximately 38.5% of E.Sun Bank's total loan portfolio.

Product focus: CAP mortgages

Aside from the vanilla adjustable-rate-mortgage (ARM) product, to differentiate its offering E.Sun has also initiated the "CAP" mortgage, which is an ARM with a periodic interest rate cap, which protects customers against a precipitous rise in interest rates.

The CAP mortgage starts out as a typical ARM, with a current rate of as little as 2.33% (depending on credit spread), which adjusts along with the benchmark index. However, if the index goes above the cap rate (currently 3.98%), the borrower pays only the cap rate and not the higher coupon. Cap protection lasts for only five years of the 20-year loan duration, so the bank's downside is limited, but management reports that they do hedge the interest rate risk anyway—which reduces exposure but also cuts away some of the product margin. An up-front fee (currently ½ point) helps defray the hedging cost somewhat, however.

Although this product is very new (first launched in February but not promoted until mid-year) and hasn't sparked much interest from clients so far, this is not surprising given the historically-low interest rate environment. We believe that CAP mortgages will become much more popular once interest rates begin to move up.

Credit cards: Continued growth

E.Sun's credit card business has been growing rapidly. In 1H03, both cards issued and cards in force rose more than 40% YoY while revolving balances grew by more than 30% and charge volume was up 48%–all well ahead of the industry average (20%-25% YoY in the above categories).

As of June 2003, E.Sun Bank had 2.44m credit cards in issue, of which 1.83m represent active customer accounts. Revolving balances at the end of June totaled NT$15.4bn, on total 1H03 charge volume of NT$21.2bn. Ranked as the no.6 credit card issuer in Taiwan, E.Sun sees its natural competitors as the top five players, *ie* Chinatrust, Taishin, Cathay, Fubon, and Union Bank, rather than smaller names.

E.Sun Bank's acquisition cost is NT$500 per card; this is notably low compared to other major issuers we have surveyed, who run in the range of NT$700–800 per card. E.Sun Bank attributes the low costs of card acquisition to their lack of third-party marketing agents (who generally receive commissions of NT$600 or higher per card) and branch-based marketing strategy.

The credit card business contributes approximately NT$50m per month to the bank's pre-tax profit including all credit expenses, for an annualised run rate of NT$600m, or 15% of E.Sun Bank's FY02 after-provisioning pre-tax profit of NT$4bn. We expect the credit card business to continue growing over the next two to three years at 20%–25% per year in terms of both cards in force and card spending, with earnings contribution rising at a similar pace.

Cash cards: just an alternative

Management sees the "Take It" cash card as a matter of customer choice. While they prefer to make their major efforts in the credit card area, customers demand the cash card product and so E.Sun Bank will respond to that demand. However, management is concerned about the potential for rising delinquencies and charge-offs in cash cards, predicting some industry trouble in the segment over the next two years.

Cash cards are originated through E.Sun Bank branches and through "Top 6" convenience stores, but not via any independent sales agents or partners. E.Sun's acquisition cost for cash cards is approximately NT$300/card—quite high given that the bank is not marketing the product extensively. Management notes that this figure is high due to the start-up nature of the business (need to buy and amortise equipment, et cetera) and small portfolio size, and expects it to fall over time.

Since the product's launch in August 2002, E.Sun Bank has issued more than 200k cash cards, and has booked over NT$3.5bn in receivables (as of June 2003), ranking in 6th or 7th place among domestic players (following Cosmos, Taishin, Ta Chong, Chinese and Union Banks).

Management reports that they are not enthusiastic about growing the cash card business aggressively, and do not plan for double-digit expansion. This however is in conflict with the full-year guidance provided earlier of 500k cash cards issued with total receivables of NT$10bn by the end of FY03.

Wealth management: underway

Wealth management and consumer banking are highly dependent on cross selling; E.Sun FHC is now trying to devise metrics to appropriately measure how the bank is faring in this area. We do know that some critical successes have been achieved: E.Sun Bank's deposit accounts have increased substantially after its merger of E.Sun Securities under the FHC, and customers of the securities operation are responsible for an incremental 1,200 mortgage originations in last 12-18 months.

To build on these successes, E.Sun FHC has moved its ITC subsidiary under the holding company umbrella so that cross-marketing to bank customers is permissible. As for bancassurance, management states that the FHC will not buy or start an insurance company as the return on capital is too low; however, subsequent to the inclusion of E.Sun Insurance Agency, the group now can re-sell both P&C and life insurance to its customers.

Although this is all perfectly good banking practice, we feel that wealth management in Taiwan is still more of a buzzword than a business, and don't assign much weight to these nascent synergies in our forward projections.

Returns

Return to shareholders of E.Sun FHC have improved incrementally subsequent to the formation of the holding company umbrella. The speed-bump in 4Q02 was due to huge charge-offs that resulted in a net loss of NT$5bn, although both net interest margin and cost-to-income ratio continued to improve.

Note that pre-provision profit has been consistently strong, increasing by 30% in 2000, 32% in 2001, and 20% in 2002. Obviously credit costs are part of the return to shareholders—we are not making the case for pre-provision profits as "operating" as is done by some—our point is that revenue accretion and underlying profit are both already on strong trends; as we believe that most credit costs now being incurred are legacy ones and not part of the continuing business we project that shareholders will begin to see profit flowing through to the net line in 2003-4.

Credit costs as expressed in terms of loan loss provisions on the P&L statement, increased 3,372% YoY in 4Q02 to an annualized rate of 11.6% of assets from an average of 75bp in each of the preceding two years. On the other hand, net interest margin has continued to rise, from 2.3% in 4Q01 to a peak of 3.1% in 4Q02, while cost-to-income ratio dropped from 47.8% to 42.8% in the same period.

E.Sun's return on assets peaked in 1997 at just under 1% before falling as charge-offs rose to their 2002 peak. However, underlying profit growth has shown that the company has the ability to post a 1-1.25% ROA on its current book, even after including 25-50bp in continuing long-run credit costs. This translates into a 14-16% ROE.

In addition, we believe that an ongoing shift to higher-margin businesses, combined with the recovery of corporate lending in Taiwan, will boost ROE above this baseline level; we now project core ROE for E.Sun of 16.5% in 2004 and 19.6% in 2005.

Fig 95 Key earnings components: 1998-2004F (NT$m)

Yr to Dec	1998	1999	2000	2001	2002	2003F	2004F
Net Interest Income	2,149	2,752	4,075	5,280	6,649	6,983	7,090
Non-Interest Income	2,539	2,507	2,162	2,358	2,953	3,867	4,205
Non-Interest Expenses	2,404	2,534	2,708	2,963	3,974	4,520	4,635
Loan Loss Provisions	762	1,028	1,718	2,093	9,615	31	517
Core Income	1,313	1,518	1,480	1,924	-2,904	4,886	4,846
Net Income	1,329	1,512	1,420	1,928	-3,091	4,881	4,846
EPS (NT$)	1.09	0.97	0.84	1.06	-1.25	1.75	1.74

Note: Consolidated since 2002

Source: E.Sun FHC, ING Financial Markets

Fig 96 Key earnings components: 4Q01-2Q03 (NT$m)

Yr to Dec	4Q01	1Q02	2Q02	3Q02	4Q02	1Q03	2Q03
Net Interest Income	1,322	1,414	1,621	1,805	1,809	1,645	1,770
Non-Interest Income	285	747	679	584	944	1,058	939
Non-Interest Expenses	769	808	888	1,100	1,178	1,062	1,160
Loan Loss Provisions	237	494	574	315	8,232	48	-48
Core Income	114	702	602	746	-4,955	1,158	1,279
Net Income	106	563	613	748	-5,016	1,162	1,270
EPS (NT$)	0.06	0.25	0.27	0.41	-2.03	0.47	0.51

Note: Consolidated since 1Q02

Source: E.Sun FHC, ING Financial Markets

Fig 97 Key earnings ratios: 1998-2004F

Yr to Dec	1998	1999	2000	2001	2002	2003F	2004F
ROA	0.74%	0.72%	0.62%	0.77%	-1.12%	1.62%	1.47%
Core ROA	0.73%	0.73%	0.65%	0.77%	-1.06%	1.62%	1.47%
ROE	9.20%	8.61%	6.92%	8.80%	-13.76%	19.49%	16.54%
Core ROE	9.09%	8.65%	7.21%	8.78%	-12.93%	19.51%	16.54%
NIM	1.33%	1.46%	2.02%	2.41%	2.87%	2.83%	2.59%
Cost/Income	51.28%	48.20%	43.42%	38.80%	41.39%	41.66%	41.04%
Overhead	1.48%	1.35%	1.35%	1.35%	1.71%	1.83%	1.69%
Effective Tax Rate	13.75%	10.44%	18.26%	25.49%	27.16%	22.42%	21.11%

Note: Consolidated since 2002

Source: E.Sun FHC, ING Financial Markets

Fig 98 Key earnings ratios: 4Q01-2Q03

Yr to Dec	4Q01	1Q02	2Q02	3Q02	4Q02	1Q03	2Q03
ROA	0.16%	0.84%	0.89%	1.08%	-7.18%	1.59%	1.68%
Core ROA	0.17%	1.04%	0.87%	1.08%	-7.09%	1.58%	1.69%
ROE	1.86%	9.23%	9.36%	12.09%	-88.85%	20.48%	21.25%
Core ROE	1.99%	11.51%	9.19%	12.07%	-87.77%	20.42%	21.39%
NIM	2.32%	2.42%	2.74%	3.08%	3.13%	2.78%	2.96%
Cost/Income	47.83%	37.40%	38.63%	46.05%	42.78%	39.29%	42.80%
Overhead	1.35%	1.38%	1.50%	1.88%	2.04%	1.80%	1.94%
Effective Tax Rate	81.09%	18.19%	28.09%	23.33%	25.56%	27.30%	19.93%

Note: Consolidated since 1Q02

Source: E.Sun FHC, ING Financial Markets

Loan portfolio and growth

Credit expansion has been reasonably consistent over the last several years, except for a downturn in 2002 which is associated both with writedowns and with the general economic downturn. E.Sun has thus been gaining market share of lending, and the bank now accounts for 1.2% of the sector.

Like most other local peers, E.Sun Bank started operation focusing on corporate clients, especially small- and medium-sized enterprises (SMEs). Before 1997, corporate loans accounted for over 60% of E.Sun Bank's total loan portfolio, with one third of those extended to SMEs. The trend was then reversed gradually, and as of 2Q03 consumer loans accounted for 47% of E.Sun's total loan portfolio while corporate loans took up the remainder.

Management is guiding for further increase in the retail segment, expecting consumer loans to account for 60% of total loans by the end of 2003 and 65% in 2004. Mortgage lending remains the biggest contributor to total consumer loans, but its importance is diminishing over time as opposed to unsecured personal lending. As stated above,

E.Sun's strategy in mortgage lending should be distinguished from, say, that of Cosmos as management is still keen to make mortgage loans and sees them as a long-term viable product.

Going forward, we project that E.Sun's total loans will grow at an average of 9.7% YoY in FY03-05, given improved macroeconomic conditions and continued growth momentum in the retail segment, where unsecured personal lending will outpace mortgages and grow to represent over 25% of total consumer loans.

Fig 99 Loan breakdown: 1998-2004F

Yr to Dec	1998	1999	2000	2001	2002	2003F	2004F
Total loans	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
Corporate	55.0%	57.0%	53.0%	56.0%	56.0%	45.0%	37.0%
Consumer	45.0%	43.0%	47.0%	44.0%	44.0%	55.0%	63.0%
Mortgage	35.0%	36.6%	40.0%	38.0%	35.0%	40.0%	40.0%
% to consumer loans	77.8%	85.1%	85.1%	86.4%	79.5%	72.7%	63.5%
Unsecured personal loans	10.0%	6.4%	7.0%	6.0%	9.0%	15.0%	23.0%
% to consumer loans	22.2%	14.9%	14.9%	13.6%	20.5%	27.3%	36.5%

Note: Loan breakdown for E.Sun Bank only
Source: Ministry of Finance, E.Sun FHC, ING Financial Markets

Fig 100 Loan growth: 1998-2004F

Yr to Dec	1998	1999	2000	2001	2002	2003F	2004F
Total loans	16.5%	14.0%	8.6%	4.2%	-4.8%	9.5%	10.0%
Corporate	10.5%	18.2%	1.0%	10.1%	-4.8%	-12.0%	-9.6%
Consumer	24.9%	9.0%	18.7%	-2.5%	-4.8%	36.9%	26.0%
Mortgage	40.7%	19.2%	18.7%	-1.0%	-12.3%	25.1%	10.0%
Unsecured personal loans	-10.3%	-27.0%	18.8%	-10.7%	42.8%	82.5%	68.7%

Note: Loan growth for E.Sun Bank only
Source: Ministry of Finance, E.Sun FHC, ING Financial Markets

Asset quality

E.Sun reported a net charge-off of NT$9.4bn (including NT$7.6bn written off in December 2002) last year and effectively slashed its reported NPL ratio to 1.38% (2.43% including loans under surveillance) at year-end. In total, the group wrote-off a net NT$13.3bn from the beginning of 2000 through YE2002—an amount equivalent to 7.4% of remaining net loans at the end of the period. We view this as the majority of the write-off which will have to take place for E.Sun.

Asset quality has continued improving in 2003, with the reported NPL ratio down to 1.35% as of June due to (1) bad assets of NT$1,495m sold to Taiwan Asset Management Corp. (TAMCO), (2) net NPL reduction of NT$243m, and (3) net write-backs of NT$645m. NPL coverage was more than 75% in 2Q03.

Provisioning policy

The provisioning policy that E.Sun Bank has been taking on for its ordinary loan portfolio is stricter than that of most other local peers we have visited. E.Sun charges provisions of 0.5% of loans classified as Pass and 10% of loans classified as Substandard, whereas in Taiwan currently these two categories of loans are not required provisions. Note that our standard regional methodology is even more severe, taking a 1% provision against Pass and 20% against Substandard loans.

As for the rapidly growing credit card business, the underlying delinquencies are well controlled - under 2% on a 90-day basis, with annualised charge-offs of 2%. E.Sun

Bank usually writes off delinquent credit card receivable accounts fully at 180 days – somewhat later than some of its major competitors (Taishin writes off at 150 days) but still in line with global standards.

As for cash cards, due to the extra risk management perceives in this product credit approval is managed by a separate department based on different criteria from credit cards (an area in which management believes that it has more experience and expertise).

Credit quality for cash cards to date has been very high, with 90+ day delinquencies under 1% and annualised charge-offs running at about the same level. Naturally, management notes (and we vehemently agree) that the portfolio has not yet seasoned, and so a steady rise in credit costs should be expected. E.Sun does share the risk on these cards, off-loading 50% of its losses onto an insurance company in return for an undisclosed premium.

Reserve adequacy

When we apply our standard regional reserve methodology to E.Sun Bank's currently-reported loan portfolio to gauge its reserve levels, we find that E.Sun Bank like most other Taiwanese banks falls short of our theoretical measure of estimated loss and hence reserves, with the 2Q03 actual reserves at 63% of our required level.

However, bear in mind that in Taiwan we do not get disclosure from banks of the distribution of banks' NPLs among the Substandard, Doubtful, and Loss categories (nor are we able to get aging data for NPLs so as to classify them roughly on a period of delinquency basis), and so our estimate of required reserves is of necessity less accurate.

We do take comfort from the fact that the difference between our measure of reserves and the bank's actual implementation is less than 4% of total equity—essentially irrelevant to any discussion of the bank's solvency. We consider E.Sun to be the cleanest bank in our Taiwan universe—a status which should be taken into account when looking at the bank's price/book multiple: E.Sun in our view is entitled to a premium over similar banks because its book is much cleaner.

Fig 101 E.Sun Bank's reserve adequacy: 1H03 (NT$m)

	Gross amount	Reserve percentage	Required reserve
Pass	186,259	1%	1,863
Special Mention	1,158	5%	58
Substandard	1,685	20%	337
Doubtful	316	50%	158
Loss	105	100%	105
ORE	187	20%	37
Excess AIR	0	20%	0
Total	189,710		2,558
Actual Reserves			1,629
Shortfall			929
Actual/Required			64%
Shortfall/Capital			4%

Note: Only for E.Sun Bank
Source: E.Sun Bank, ING Financial Markets

Margins

E.Sun Bank's net interest margin has been trending upward over the last five years and peaked in 4Q02. Compared with its peers, however, this is partially because E.Sun started off in a poor position in terms of both interest spread and net interest margin. This is generally attributable to the bank's corporate-centred loan portfolio. While E.Sun has switched its business focus to consumer lending since 1998, given the resultant heavy emphasis on residential mortgages, the bank has been impacted strongly by the increasing prevalence of the index-oriented rate structure (ARM).

The ARM scheme caused E.Sun Bank's average spread to drop by 38bps and net interest margin by 35bps in 1Q03. These ratios recovered in 2Q03 by 29bps and 18bps, respectively, as unsecured lending and bills finance added higher-margin lending to the mix.

There is limited further downside from mortgage refinancing, as at August 2003 more than 70% of E.Sun Bank's existing mortgage customers have already refinanced into the ARM program; hence we expect margin compression from this area to be quite controlled going forward.

While E.Sun Bank foresees little spread compression on credit cards given that management discloses no intention of cutting card rates, we project that receivables of both credit cards and cash cards will lose 125-150bps of gross yield over the next 24 months, in line with our industry forecast. This will reduce E.Sun Bank's consumer loan spread by 69bps in FY04 and 99bps in FY05. Nevertheless, given its efforts mentioned above, E.Sun Bank should be able to maintain its overall net interest margin at above 2.5% over the following three years, and even to expand it as the rate cycle reverses.

Fig 102 Key net interest margin components: 1998-2003F (%)

Yr to Dec	1998	1999	2000	2001	2002	2003F
Yield on Earning Assets	6.40%	6.43%	6.61%	6.24%	5.32%	4.39%
Cost of Interest-bearing Liabilities	5.99%	5.34%	4.87%	4.17%	2.36%	1.68%
Interest Spread	0.41%	1.08%	1.74%	2.07%	2.96%	2.71%
Net Interest Margin	1.33%	1.46%	2.02%	2.41%	2.87%	2.83%

Note: Only for E.Sun Bank
Source: E.Sun FHC, ING Financial Markets

Fig 103 Key net interest margin components: 1Q02-2Q03 (%)

Yr to Dec	1Q02	2Q02	3Q02	4Q02	1Q03	2Q03
Yield on Earning Assets	5.31%	5.21%	5.40%	5.21%	4.60%	4.68%
Cost of Interest-bearing Liabilities	2.93%	2.50%	2.14%	1.96%	1.73%	1.52%
Interest Spread	2.38%	2.71%	3.27%	3.25%	2.87%	3.16%
Net Interest Margin	2.42%	2.74%	3.08%	3.13%	2.78%	2.96%

Note: Only for E.Sun Bank
Source: E.Sun FHC, ING Financial Markets

Competitive strategy

What are E.Sun FHC's differentiating characteristics vis-à-vis its competitors? The company doesn't spend much money on marketing, preferring instead to emphasise service quality – an area in which the bank has won several awards. Management sees a strong branch and customer network, as opposed to mass marketing, third party, and affiliate sales, as the best way to originate products, and their promotions are organised accordingly.

This means that the bank takes painstaking care to train its employees, with 6 months of training mandatory for all staff joining the bank. In addition, E.Sun FHC encourages its employees to take continuing education courses and licensing exams, such as those given by the Taiwan Academy of Banking and Finance. In fact, E.Sun employees have consistently taken top honours in these exams. Management remarks that "good quality service doesn't mean just being polite – it's about professionalism."

M&A and expansion

Banking arm needs to be bigger

E.Sun FHC as a whole has more than 3m customers and 70 offices, including 52 branches of E.Sun Bank, ten of E.Sun Securities, and five of E.Sun Bills Finance. Further expansion in the banking arm has become increasingly critical for top management in light of the mergers between Cathay and UWCCB, Fubon and Taipei Bank, and Chinatrust and Grand Commercial Bank.

To source funds for future M&As, in June 2003 E.Sun issued US$180m in 1.5-year ECBs at a premium of 24% and a yield to redemption of –1%. Potential M&A candidates include both domestic banks and community-level financial institutions.

In addition to M&A and organic growth within Taiwan, E.Sun management do not rule out the possibility of selling a strategic (but presumably non-controlling) stake in exchange for an alliance with a foreign bank or finance company.

Moving overseas

E.Sun Bank's Hong Kong branch was established in May 2002 and was then upgraded into a full banking license in July 2003. In addition, due to its low reported NPL ratio (below the 2.5% that qualifies for additional rewards from the MoF), E.Sun beat out Taishin, SinoPac, and Taipei Bank in competing for the right to apply for a rep office license in Dongguan, China. Management will soon submit application to the People's Bank of China for local approval.

Asia aside, E.Sun Bank currently has a branch in Los Angeles, and the group is planning to acquire an LA-based local bank, specialised in consumer banking, to expand further its Pan-Pacific service network. E.Sun Bank has received MoF approval on this and has submitted applications to the US Fed and California State Department of Banking.

Fig 104 E.Sun financial summary

Income statement	2001A	2002A	2003F	2004F	2005F
(NT$m) Yr ended Dec					
Interest income	14,419	12,368	11,489	12,045	17,340
Interest expense	9,139	5,720	4,506	4,955	7,553
Net interest income	**5,280**	**6,649**	**6,983**	**7,090**	**9,787**
Ave. int. earning assets	*219,263*	*231,893*	*247,047*	*273,982*	*299,998*
NIM	**2.41%**	**2.87%**	**2.83%**	**2.59%**	**3.26%**
Non-interest income	2,358	2,953	3,867	4,205	4,787
Total operating income	**7,638**	**9,602**	**10,850**	**11,295**	**14,574**
Non-interest expense	2,963	3,974	4,520	4,635	5,662
Pre provision profit	**4,675**	**5,628**	**6,330**	**6,660**	**8,911**
Loan loss provisions	2,093	9,615	31	517	461
Non-operating income	4	-188	-5	0	0
Pre tax profit	**2,586**	**-4,174**	**6,293**	**6,142**	**8,450**
Tax	658	-1,083	1,412	1,296	1,794
Net profit	**1,928**	**-3,091**	**4,881**	**4,846**	**6,657**
Core earnings	**1,924**	**-2,904**	**4,886**	**4,846**	**6,657**
Per share data (NT$)					
EPS	1.06	-1.25	1.75	1.74	2.39
DPS	0.70	0.00	0.79	0.80	1.20
Effective payout ratio	*66.0%*	*0.0%*	*45.0%*	*45.9%*	*50.2%*
BVPS	12.55	8.96	10.05	11.01	13.40
ABVPS	12.55	8.96	10.05	11.01	13.40
Valuation					
Price to book value	1.5x	2.1x	1.9x	1.7x	1.4x
Price to adjusted book value	1.5x	2.1x	1.9x	1.7x	1.4x
Price to earnings	17.6x	-14.9x	10.7x	10.7x	7.8x
Profitability ratios					
Net interest margin	2.4%	2.9%	2.8%	2.6%	3.3%
Yield on interest earning assets	6.2%	5.3%	4.4%	4.2%	5.5%
Cost on interest bearing liabilities	4.2%	2.4%	1.7%	1.7%	2.4%
Net interest spread	2.1%	3.0%	2.7%	2.5%	3.2%
Non-int. income (% Op income)	30.9%	30.8%	35.6%	37.2%	32.8%
Cost to income	38.8%	41.4%	41.7%	41.0%	38.9%
Overhead ratio	1.4%	1.7%	1.8%	1.7%	1.9%
Cost coverage	257.8%	241.6%	240.0%	243.7%	257.4%
ROA	0.8%	-1.1%	1.6%	1.5%	1.8%
ROE	8.8%	-13.8%	19.5%	16.5%	19.6%
Oroa analysis					
Net interest margin	2.4%	2.9%	2.8%	2.6%	3.3%
Non-interest inc./gross inc.	30.9%	30.8%	35.6%	37.2%	32.8%
Efficiency ratio	38.8%	41.4%	41.7%	41.0%	38.9%
Provision/assets	0.8%	3.4%	0.0%	0.2%	0.1%
Operating return on assets	**1.3%**	**-1.0%**	**2.6%**	**2.3%**	**2.8%**
Equity/assets	8.6%	7.8%	8.8%	8.9%	9.9%
Operating return on equity	**15.7%**	**-12.3%**	**28.9%**	**25.6%**	**28.9%**

Source: E.Sun FHC, ING Financial Markets

Fig 105 E.Sun financial summary

Balance sheet	2001A	2002A	2003F	2004F	2005F
(NT$m) As at Dec					
Gross loans	193,190	181,206	196,966	217,047	237,695
Loan loss reserves	*1,514*	*1,541*	*1,607*	*1,978*	*2,273*
Net loans	190,263	178,856	194,519	214,139	234,403
Total earning assets	231,220	232,566	261,528	286,436	313,560
Other assets	34,653	51,862	55,614	57,009	64,676
Total Assets	**265,874**	**284,429**	**317,143**	**343,445**	**378,235**
Deposits	231,564	239,875	266,136	289,631	315,650
Customer deposits	225,029	222,335	232,512	251,113	272,457
Other deposits	6,535	17,540	33,625	38,518	43,193
Other paying liabilities	5,000	9,840	16,239	15,839	15,439
Other liabilities	6,506	12,592	6,802	7,339	9,852
Total Liabilities	243,070	262,308	289,177	312,809	340,941
Equity with revaluation	**22,804**	**22,121**	**27,965**	**30,636**	**37,294**
Adjusted equity	**22,804**	**22,121**	**27,965**	**30,636**	**37,294**
Balance sheet ratios					
Loan-to-deposit	82.8%	75.2%	73.7%	74.6%	75.0%
Equity to assets	8.6%	7.8%	8.8%	8.9%	9.9%
Total loan loss reserves to assets	0.57%	0.54%	0.51%	0.58%	0.60%
Asset quality					
Nonperforming assets	5,472	2,319	2,325	2,462	2,626
Special mention	3,730	2,095	943	623	683
Substandard	4,046	1,710	1,725	1,840	1,910
Doubtful	759	321	323	345	358
Loss	253	107	108	115	119
ORE	415	181	187	198	211
NPAs/total loans	2.9%	1.3%	1.2%	1.1%	1.1%
Reserve coverage of NPAs	27.7%	66.4%	69.1%	80.3%	86.6%
Required reserves	3,541	2,512	2,629	2,858	3,093
Actual reserves	1,514	1,541	1,607	1,978	2,273
Shortfall (surplus)	2,027	971	1,022	880	820
Actual to required reserves	42.8%	61.3%	61.1%	69.2%	73.5%
Shortfall to capital	8.9%	4.4%	3.7%	2.9%	2.2%
Growth rates (YoY)					
Income statement					
Net interest income	29.6%	25.9%	5.0%	1.5%	38.0%
Non-interest income	9.1%	25.2%	30.9%	8.7%	13.8%
Non-interest expenses	9.4%	34.1%	13.7%	2.5%	22.2%
Pre-provision earnings	32.5%	20.4%	12.5%	5.2%	33.8%
Loan loss provisions	21.8%	359.5%	-99.7%	+++	-10.9%
Core earnings	30.0%	-250.9%	-268.3%	-0.8%	37.4%
Net profit	35.8%	-260.3%	-257.9%	-0.7%	37.4%
Balance sheet					
Loan growth	7.8%	-5.9%	8.7%	10.2%	9.5%
Interest earning assets	11.5%	0.6%	12.5%	9.5%	9.5%
Asset growth	12.5%	7.0%	11.5%	8.3%	10.1%
Deposit growth	11.4%	3.6%	10.9%	8.8%	9.0%
Shareholders' funds	8.5%	-3.0%	26.4%	9.6%	21.7%

Source: E.Sun FHC, ING Financial Markets

Cosmos: A universe of consumers

We are initiating coverage of Cosmos Bank with a BUY rating and price target of NT$24.77, representing 60% upside from current levels. Cosmos management has successfully re-made a low-return corporate bank into a consumer-driven franchise with the largest share of the cash card market. We see lots more growth ahead for Cosmos—although its dominance in cash cards will assuredly fade—as well as M&A potential.

Introduction

Structure and business

Cosmos Bank was founded in 1991 by Tainan-based Prince Automobile Group (unlisted), which continues to hold an approximately 12% stake. The bank started with its main business focus on corporate banking, but has since 1995 switched to the consumer segment as it found corporate loans too competitive, low yielding, and of poor credit quality.

Expansion through M&A

Cosmos Bank has been building its network in line with the growth of its consumer banking business. The bank grows its branch platform mainly by acquiring community-level financial institutions located in middle and southern Taiwan (eg Tainan, Miaoli, and Hsinchu). Given that its (reported) NPL ratio is below the legally-required 5% (2.68% as of 1H03), Cosmos Bank is allowed by the Ministry of Finance to reallocate up to 1/3 of the branches of these newly-acquired credit unions to more value-added regions (eg Taipei City).

Subsequent to the acquisition of a Hsinchu-based credit union, Cosmos Bank now has 63 domestic branches.

Fig 106 Expansion in domestic branch network

Date of acquisition	Apr-98	Aug-01	Oct-02	Jul-03
Target acquired	Tainan 4th Credit Union	Miaoli Credit Union	Cosmos Bills Finance	Hsinchu 5th Credit Union
No. of branches added	11	7	4	10
Total No. of domestic branches	42	49	53	63

Source: Cosmos Bank, ING Financial Markets

Cash card

As the leading edge of its switch in business focus from corporate banking to retail segment, Cosmos Bank introduced the “George & Mary” cash card in July 1999. As of June 2003, Cosmos Bank had over 1.01m cash card accounts and receivables of more than NT$60bn, accounting for a domestic market share of over 50%. This also represents a huge gap between Cosmos and Taishin (the second largest cash card issuer) which has approximately 450k cards in issue and NT$13bn in receivables.

Cosmos Bank expects its cash card receivables to reach NT$80bn by YE2003 and NT$100-NT$120bn (25%-50% YoY growth) by the end of 2004. We are somewhat more conservative (but still relatively bullish), projecting a YE2003 balance of NT$74bn and 2004 growth of 18%.

Based on Japan’s experience that total cash card loans account for 2% of its GDP, Cosmos Bank projects Taiwan’s cash card market will exceed NT$200bn in terms of receivables within two years, vs around NT$100bn currently.

Although we take a more cautious view than bank management on overall growth, we do see several strategies that differentiate Cosmos Bank from other major cash card issuers, and we believe that the bank will remain a leading player.

Compared to some local peers that launched this new product completely on their own or acquired partial know-how on cash cards from Japanese partners/consultants, Cosmos Bank has fully transferred techniques, credit methodologies, and hardware/software from Acom Corp., Japan's second largest finance company. The system was then revised and maintained by Acom's ex CIO, who joined Cosmos Bank two years ago as an in-house expert.

Cosmos Bank is also known for having the quickest cash card approval process in the industry, and is able to issue a cash card within 20-30 minutes, vs more than two days for some other local peers. We do see other banks catching up to Cosmos here, but speed is a powerful inducement to clients and is valued considerably more than are lower rates.

Finally, Cosmos has the advantage of lacking a large credit card portfolio, and so does not have to fear cannibalization of its customer base by lower-rate cash cards. Both Chinatrust and Taishin—both institutions with very good consumer lending ability in this market—are handicapped in issuing cash cards because aggressive marketing to the banks' existing customers would cut into their credit card franchises.

Returns

Return to shareholders at Cosmos has ranged from poor to abysmal in the past, with ROE never breaking into double digits. The worst year was 2000, when the bank wrote off NT$5bn in bad debt and booked a net loss of NT$3.2bn at the bottom line.

A partial turnaround was first seen in 2001 resulting in a ROE of 7.4%. However, returns dropped again in 2002, driven again by higher charge-offs of NT$2.3bn (vs NT$761m in FY01), despite improved margins and cost efficiency. The charge-off effect, expressed in terms of loan loss provisions on the P&L statement, increased more than three times year-over-year in FY00 and FY02, respectively. On the other hand, net interest margin (NIM) continued rising, from less than 2% in FY98 to 4.7% in FY02, while the cost-to-income ratio dropped from 59.9% to 47.8% in the same period.

We view this as a natural effect of Cosmos' portfolio re-orientation, as corporate loans continues to run off (or be written-off) and high-margin consumer loans increase.

The repositioning is already beginning to show its effect—1H03 ROE was 13.2% on a net basis, even after amortization of NPL losses incurred in prior periods. We project that Cosmos will end the year at close to a 15% ROE, and continue to advance in 2004.

Fig 107 Key earnings components: 1998-2004F (NT$m)

Yr to Dec	1998	1999	2000	2001	2002	2003F	2004F
Net Interest Income	2,906	3,807	4,539	5,101	8,237	11,491	12,676
Non-Interest Income	1,554	1,532	26	1,023	1,440	2,005	2,881
Non-Interest Expenses	2,673	2,961	3,049	3,619	4,628	5,738	6,477
Loan Loss Provisions	798	1,416	5,270	895	3,061	2,432	1,812
Core Income	866	886	-2,986	1,314	1,553	4,541	6,327
Net Income	879	790	-3,196	1,040	1,192	3,088	3,762
EPS (NT$)	0.66	0.56	-2.28	0.74	0.67	1.74	2.12

Source: Cosmos Bank, ING Financial Markets

Fig 108 Key earnings ratios: 1998-2004F

Yr to Dec	1998	1999	2000	2001	2002	2003F	2004F
ROA	0.53%	0.42%	-1.73%	0.55%	0.58%	1.38%	1.58%
Core ROA	0.52%	0.47%	-1.61%	0.70%	0.75%	2.03%	2.67%
ROE	5.71%	4.88%	-24.59%	7.41%	6.41%	14.50%	15.56%
Core ROE	5.62%	5.47%	-22.98%	9.36%	8.36%	21.32%	26.17%
NIM	1.95%	2.27%	2.81%	3.12%	4.68%	6.09%	6.15%
Cost/Income	59.94%	55.47%	66.79%	59.09%	47.83%	42.52%	41.64%
Overhead	1.79%	1.76%	1.89%	2.22%	2.63%	3.04%	3.14%
Effective Tax Rate	12.35%	7.83%	20.45%	18.42%	21.87%	14.74%	12.94%

Source: Cosmos Bank, ING Financial Markets

Loan portfolio and growth

To improve its earnings stream amid intensifying competition, Cosmos Bank has gradually adjusted its loan portfolio since 2000, switching from corporate loans to consumer loans. Before 2000, corporate loans contributed over 70% of Cosmos' total loan portfolio, while consumer took up the remainder.

The change is even more pronounced than that particular statistic would indicate, as mortgages used to account for more than 50% of Cosmos Bank's total consumer loans before the growth in cash cards caught up. Cosmos now makes mortgage loans only under duress, and doesn't promote them at all, due to their thin spreads. Cash card loans accounted for approximately 40% of total loans as of 2Q03 and we expect this ratio to exceed 45% in FY04.

Cash cards aside, Cosmos Bank re-started its corporate banking business in 4Q02, eschewing the old-line big corporate loans that got the bank into trouble before, and instead focusing on small- and medium-sized enterprises (SMEs), or so-called "Micro-small" companies that usually have limited access to bank loans.

Compared to ordinary corporate loans, these SME loans are more profitable and less risky due to government support. Mainly working capital financing, the SME loans are rendered based on cash flow, with interest rates between 8%-13%. 50% to 80% of these SME borrowings are guaranteed by a government-sponsored "Small and Medium Business Credit Guarantee Fund."

Outstanding SME loans to date amount to more than NT$3bn, representing less than 5% of total loans but growing steadily. Cosmos Bank has no interest in residential mortgage and automobile loans, given their increasingly thinner profitability.

Fig 109 Loan breakdown: 1998-2004F

Yr to Dec	1998	1999	2000	2001	2002	2003F	2004F
Total loans	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Corporate	71.0%	71.0%	67.0%	62.0%	50.0%	45.0%	44.0%
Consumer	29.0%	29.0%	33.0%	38.0%	50.0%	55.0%	56.0%
Mortgage	15.5%	14.5%	13.0%	11.0%	8.0%	8.2%	8.2%
% to consumer loans	53.4%	50.0%	39.4%	28.9%	16.0%	14.8%	14.6%
Unsecured personal loans	13.5%	14.5%	20.0%	27.0%	42.0%	46.9%	47.8%
% to consumer loans	46.6%	50.0%	60.6%	71.1%	84.0%	85.2%	85.4%

Source: Cosmos Bank, ING Financial Markets

Credit expansion has been consistently above that of the sector except in 2000 and 2002, with dips then due to non-demand factors. The contraction in 2000 was due to the bank's intentional reduction in corporate lending, down from 71% to 67% of total loans. Mortgages in the retail segment were also cut back, given the introduction of

cash cards. In addition, total loans in both years were hurt by write-offs of bad loans—but *performing* loans continued to advance.

Going forward, we project that total loans will grow at an average of 9% per year in FY2003-05, given improved macroeconomic conditions and continued growth momentum in the cash card business, which represents over 90% of the bank's unsecured personal loans. In addition, loans to small- and medium-sized enterprises (SME), focused on working capital financing, should begin to drive up corporate lending starting in 2004.

Fig 110 Loan growth: 1998-2004F

Yr to Dec	1998	1999	2000	2001	2002	2003F	2004F
Total loans	18.5%	5.1%	-7.0%	8.3%	-1.2%	10.0%	9.5%
Corporate	20.2%	5.1%	-12.3%	0.2%	-20.3%	-1.0%	7.8%
Consumer	14.6%	5.1%	5.8%	24.7%	30.1%	21.0%	11.5%
Mortgage	22.5%	-1.7%	-16.7%	-8.4%	-28.1%	12.1%	10.2%
Unsecured personal loans	6.7%	12.9%	28.2%	46.2%	53.8%	22.7%	11.7%

Source: Cosmos Bank, ING Financial Markets

Asset quality

Cosmos' asset quality has been a weak point for almost all of the bank's history. The bank's reported NPL ratio rose from 3.3% at YE1997 to as high as 8.5% during 2001. Including loans under surveillance and foreclosed real estate, total non-performing assets accounted for nearly 12% of total loans by YE2002. Despite huge charge-offs in 2000 and 2002 that slashed the NPA ratio to 4.7% as of June 2003, reserve adequacy remains a concern for Cosmos Bank.

On the book, NPL coverage ratio stood at 22.5% in 2Q03. In addition, we have applied our standard regional reserve methodology to Cosmos Bank's currently-reported loan portfolio to gauge its reserve levels. In addition, we have estimated the severity of NPLs, apportioning them among the standard categories of Substandard, Doubtful, and Loss, with loans under surveillance considered Special Mention.

On our methodology, Cosmos Bank falls far short in reserving at only 27% of our required level. The shortfall of NT$4.3bn at 1H03 amounts to some 22% of the bank's gross equity.

Fig 111 Cosmos Bank's reserve adequacy: 1H03 (NT$m)

	Gross amount	Reserve percentage	Required reserve
Pass	144,175	1%	1,442
Special Mention	4,037	5%	202
Substandard	5,617	20%	1,123
Doubtful	1,053	50%	527
Loss	351	100%	351
ORE	4,738	20%	948
Excess AIR	419	20%	84
Total	160,391		4,676
Actual Reserves			1,577
Shortfall			3,099
Actual/Required			34%
Shortfall/Capital			16%

Source: Cosmos Bank, ING Financial Markets

We believe most of these problem assets came from corporate loans, mainly from lending in middle and southern Taiwan given that this was Cosmos Bank's focus in the early years.

On the consumer side, Cosmos Bank has been able to manage the credit risk of its cash cards quite effectively due in no small part to a well-tested risk management system (transplanted from its Japanese partner) and partly to the country's comprehensive credit data-sharing systems, the National Credit Card Centre (NCCC) and Joint Credit Information Centre (JCIC).

The systems issue—while relentlessly unsexy—is not a minor one. Witness the recent travails of Mega FHC, which was ordered by the government in early October to cease issuing cash cards due to what regulators termed a "severe fault" in the bank's systems. This fault allowed at least one cardholder with an NT$25,000 credit line to withdraw NT$33 million (~US$1m), not a comforting sign to investors.

Currently Cosmos has a 90+ day delinquency rate on cash cards of less than 3% and a 180+ day delinquency rate of 1.8%-1.9%. Annualised charge-offs are only 1.5%, while annual fraud losses are approximately NT$2m, a small fraction of the industry total of NT$2.6bn. Charge-offs will undoubtedly increase as the portfolio ages and as penetration increases, but a blow-out is unlikely; we forecast charge-offs (not delinquencies) rising by over 60bp over the next two years.

Margins

Cosmos Bank's net interest margin has been trending upward over the last five years due to the shift towards higher-margin consumer loans. Compared with its peers, Cosmos Bank is in a better position in terms of both interest spread and net interest margin.

With an average spread of 10%, cash cards currently contribute 70% of Cosmos Bank's pre-provisioning pre-tax profit. Management expects the ratio to be sustained at around this level in 2004, as high growth in cards is matched by increased sales of wealth management-related products, such as mutual funds and bancassurance.

Cash card margins have risen in the last two years as funding costs have fallen due both to consistently declining benchmark interest rates and to excess deposit liquidity. Given the bank's limited exposure to residential mortgages, Cosmos is able to uphold its overall profitability despite the increased prevalence of the index-oriented rate structure, which uses either deposit rates or commercial paper rates as benchmarks.

In other words, for most other local peers lending rates now move proportionally in line with deposit rate cuts, eliminating the ability to lag rate rises and falls to cushion margins.

Going forward, Cosmos Bank expects both its cash card rate (18.25%) and profitability to be sustained at current levels and foresees no throat-cutting price competition among the top five players within three years. We however believe that this is a somewhat rosy scenario. Going forward, we expect cash card rate to fall by 150bps in the following eighteen months, and Cosmos Bank will inevitably comply with it. Nevertheless, we believe the bank should be able to maintain its overall net interest margin at above 4% in the following 2-3 years, based on (1) continued growth in cash cards both in amount and in proportion to total loans and (2) increased exposure to high-margin SME loans.

Fig 112 Key net interest margin components: 1998-2003F (%)

Yr to Dec	1998	1999	2000	2001	2002	2003F
Yield on Earning Assets	7.47%	7.63%	8.26%	7.60%	7.45%	7.85%
Cost of Interest-bearing Liabilities	6.69%	5.42%	5.06%	4.66%	2.83%	1.98%
Interest Spread	0.78%	2.21%	3.20%	2.94%	4.62%	5.88%
Net Interest Margin	1.95%	2.27%	2.81%	3.12%	4.68%	6.09%

Source: Cosmos Bank, ING Financial Markets

Fig 113 Cosmos financial summary

Income statement	2001A	2002A	2003F	2004F	2005F
(NT$m) Yr ended Dec					
Interest income	12,989	13,489	15,411	16,472	17,432
Interest expense	7,887	5,251	3,927	3,821	4,103
Net interest income	**5,101**	**8,237**	**11,484**	**12,651**	**13,329**
Ave. int. earning assets	*163,255*	*175,977*	*188,605*	*206,131*	*227,454*
NIM	**3.12%**	**4.68%**	**6.09%**	**6.14%**	**5.86%**
Non-interest income	1,023	1,440	2,005	2,881	3,512
Total operating income	**6,125**	**9,677**	**13,488**	**15,532**	**16,842**
Non-interest expense	3,619	4,628	5,737	6,474	6,559
Pre provision profit	**2,506**	**5,048**	**7,751**	**9,058**	**10,283**
Loan loss provisions	895	3,061	2,432	1,812	2,526
Non-operating income	-275	-361	-1,453	-2,565	-2,565
Pre tax profit	**1,337**	**1,626**	**3,866**	**4,681**	**5,192**
Tax	297	435	784	936	1,038
Net profit	**1,040**	**1,192**	**3,083**	**3,745**	**4,154**
Core earnings	**1,314**	**1,553**	**4,536**	**6,310**	**6,719**
Per share data (NT$)					
EPS	0.74	0.67	1.74	2.11	2.35
DPS	0.00	0.00	0.00	0.50	0.60
Effective payout ratio	*0.0%*	*0.0%*	*0.0%*	*23.6%*	*25.6%*
BVPS	10.02	10.49	12.02	13.64	15.33
ABVPS	10.02	10.49	12.02	13.64	15.33
Valuation					
Price to book value	1.5x	1.5x	1.3x	1.1x	1.0x
Price to adjusted book value	1.5x	1.5x	1.3x	1.1x	1.0x
Price to earnings	20.9x	23.0x	8.9x	7.3x	6.6x
Profitability ratios					
Net interest margin	3.1%	4.7%	6.1%	6.1%	5.9%
Yield on interest earning assets	7.6%	7.5%	7.9%	7.6%	7.3%
Cost on interest bearing liabilities	4.7%	2.8%	2.0%	1.8%	1.9%
Net interest spread	2.9%	4.6%	5.9%	5.8%	5.4%
Non-int. income (% Op income)	16.7%	14.9%	14.9%	18.5%	20.9%
Cost to income	59.1%	47.8%	42.5%	41.7%	38.9%
Overhead ratio	2.2%	2.6%	3.0%	3.1%	2.9%
Cost coverage	169.2%	209.1%	235.1%	239.9%	256.8%
ROA	0.6%	0.6%	1.4%	1.6%	1.6%
ROE	7.4%	6.4%	14.5%	15.5%	15.3%
Oroa analysis					
Net interest margin	3.1%	4.7%	6.1%	6.1%	5.9%
Non-interest inc./gross inc.	16.7%	14.9%	14.9%	18.5%	20.9%
Efficiency ratio	59.1%	47.8%	42.5%	41.7%	38.9%
Provision/assets	0.5%	1.4%	1.1%	0.7%	1.0%
Operating return on assets	**1.1%**	**1.5%**	**3.1%**	**3.7%**	**3.6%**
Equity/assets	7.2%	8.5%	9.3%	9.9%	10.3%
Operating return on equity	**15.1%**	**17.2%**	**32.9%**	**37.1%**	**34.4%**

Source: Cosmos Bank, ING Financial Markets

Fig 114 Cosmos financial summary

Balance sheet	2001A	2002A	2003F	2004F	2005F
(NT$m) As at Dec					
Gross loans	149,510	149,207	166,140	183,581	204,121
Loan loss reserves	*1,781*	*1,137*	*1,422*	*1,007*	*824*
Net loans	145,888	145,641	162,337	179,941	200,365
Total earning assets	171,001	180,952	196,257	216,006	238,902
Other assets	25,043	37,401	33,322	29,098	23,754
Total Assets	**196,044**	**218,353**	**229,579**	**245,104**	**262,656**
Deposits	176,651	194,490	202,879	215,052	229,030
Customer deposits	174,382	191,817	200,449	212,476	226,287
Other deposits	2,269	2,673	2,430	2,576	2,743
Other paying liabilities	2,269	2,673	2,430	2,576	2,743
Other liabilities	5,353	5,286	5,401	5,877	6,431
Total Liabilities	182,004	199,776	208,281	220,929	235,461
Equity with revaluation	**14,040**	**18,577**	**21,298**	**24,174**	**27,195**
Adjusted equity	**14,040**	**18,577**	**21,298**	**24,174**	**27,195**
Balance sheet ratios					
Loan-to-deposit	83.6%	75.5%	80.7%	84.1%	87.8%
Equity to assets	7.2%	8.5%	9.3%	9.9%	10.4%
Total loan loss reserves to assets	0.91%	0.52%	0.62%	0.41%	0.31%
Asset quality					
Nonperforming assets	38,031	16,766	15,178	13,237	11,103
Special mention	20,444	4,725	3,967	3,511	2,932
Substandard	9,792	5,720	5,427	4,691	3,946
Doubtful	1,836	1,073	1,017	880	740
Loss	612	358	339	293	247
ORE	5,346	4,891	4,428	3,861	3,239
NPAs/total loans	25.8%	11.4%	9.3%	7.3%	5.5%
Reserve coverage of NPAs	4.7%	6.8%	9.4%	7.6%	7.4%
Required reserves	6,730	4,601	4,547	4,335	4,133
Actual reserves	1,781	1,137	1,422	1,007	824
Shortfall (surplus)	4,949	3,464	3,125	3,328	3,309
Actual to required reserves	26.5%	24.7%	31.3%	23.2%	19.9%
Shortfall to capital	35.3%	18.6%	14.7%	13.8%	12.2%
Growth rates (YoY)					
Income statement					
Net interest income	12.4%	61.5%	39.5%	10.3%	5.4%
Non-interest income	+++	40.7%	39.2%	43.7%	21.9%
Non-interest expenses	18.7%	27.9%	24.0%	12.9%	1.3%
Pre-provision earnings	65.3%	101.5%	53.7%	17.0%	13.5%
Loan loss provisions	-83.0%	242.1%	-20.6%	-25.5%	39.4%
Core earnings	-144.0%	18.1%	192.5%	39.3%	6.5%
Net profit	-132.5%	14.6%	159.1%	21.8%	10.9%
Balance sheet					
Loan growth	4.4%	-0.6%	11.6%	10.5%	11.2%
Interest earning assets	10.0%	5.8%	8.5%	10.1%	10.6%
Asset growth	8.9%	11.4%	5.1%	6.8%	7.2%
Deposit growth	9.3%	10.1%	4.3%	6.0%	6.5%
Shareholders' funds	8.0%	32.3%	14.6%	13.5%	12.5%

Source: Cosmos Bank, ING Financial Markets

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