

## Asia

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# Financials

## Our time has come

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**We are Overweight Asian financials heading into 2004 on clear signs that corporate re-gearing and a return to asset inflation will reverse the negative effects of excess liquidity on margins and increase return on capital.**

**Capex is back.** Asia's banks last began a capex lending cycle in 1993, with the Asian crisis dampening any hopes of a normal upturn since then. However, above-trend economic growth and rapidly rising utilisation rates mean that the need for new investment is imminent.

**Banks vs bonds.** Banks will fight the bond market for their share of this capex volume growth – and will lose more than they win. Nevertheless, the fixed-income markets will draw off deposit liquidity and aid banks' margins, a more important factor for profitability than loan growth.

**Start the squeezing.** Asian banks have resisted managing capital as balance sheets have shrunk and asset quality has been questionable. As margins return, banks with superior returns on equity will have more compelling reasons to acquire their underperforming peers and push capital out of the sector.

### Top stock recommendations

	B'berg code	Rec	Price (lcy) 26/11/03	12-m target price (lcy)	Market cap (US\$m)	FY04F			
						PER (x)	Yield (%)	EPS ch (%)	ROE (%)
Standard Chartered	2888 HK	BUY	122	140	18,382	14.8	3.1	35.9	N/A
Commerce-Asset	CAHB MK	BUY	4	5.05	2,722	12.8	1.3	22.5	9.7
Chinatrust FHC	2891 TT	BUY	34.3	50	5,529	10.8	2.8	47	17.0
Cosmos Bank	2837 TT	BUY	18	24.77	935	8.5	2.8	21.9	27.8
Korean Re*	003690 KS	BUY	36,200	49,800	322	4.2	3.6	21.3	17.8

\* Korean Re's target price was changed from Won43,800 on 4 December

Source: ING estimates

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Regional financials valuations		
P/BV (x)	02	03F
Hong Kong	2.1	2.5
Japan	1.3	2.8
Korea	1.3	1.4
Taiwan	1.8	1.6
Singapore	1.6	1.6
Malaysia	1.8	1.5
Thailand	2.2	2.1
Indonesia	1.7	1.5
Philippines	1.2	1.1
Australia*	2.5	N/A
India*	1.9	N/A

\*Data from IBES

Source: ING estimates

Regional financials valuations		
PER (%)	03F	04F
Hong Kong	20.3	16.7
Japan	30.3	20.5
Korea	16.1	7.3
Taiwan	15.4	12.3
Singapore	19.8	17.3
Malaysia	13.1	11.0
Thailand	14.0	11.0
Indonesia	9.1	7.3
Philippines	20.0	17.6
Australia*	12.8	11.5
India*	9.1	7.4

\*Data from IBES

Source: ING estimates

**Fig 1 Catalyst timeline for Financials**

Event (Description of event)	Market impact	1Q04	2Q04	3Q04	4Q04	1Q05
Interest rate reversal	Positive					
Asset reflation	Positive					
M&A	Neutral/Positive					

Source: ING estimates

## 2003 in summary

2003 has been a banner year for financials so far, with the banks outperforming benchmark indices in seven of 11 markets and turning in double-digit absolute gains everywhere except Australia. The best-performing markets for financials on an absolute basis were India, Japan and Indonesia, followed by Hong Kong, Korea and Malaysia. Laggards were Australia, the Philippines and Singapore.

On a relative basis, financials outperformed most in India and Japan, and underperformed significantly in Thailand and the Philippines.

**Fig 2 Asia-Pacific banks' share price performance**

	Bank sector performance	Country index performance	Bank outperformance
	YTD	YTD	YTD
Hong Kong	52%	33%	20%
Japan	82%	33%	49%
Korea	42%	29%	14%
Taiwan	28%	32%	-4%
Singapore	22%	30%	-7%
Malaysia	38%	23%	15%
Thailand	35%	85%	-50%
Indonesia	56%	52%	4%
Philippines	17%	33%	-16%
Australia	8%	7%	0.8%
India	113%	55%	59%

Note: As of 26 November 2003

Source: Bloomberg

## A look back

In our January financials strategy piece, we offered the observation that the Asian bank value trade was complete across the region, and that banks would have to make their way on earnings momentum from now on. This has largely come to pass, with investors now refocused squarely on prospects for market growth – witness the run-up of Hong Kong banks on China access – and top-line accretion, and we believe that the trend will only intensify in 2004.

In addition, we predicted that asset quality would return as a major driver of earnings results – although we did not (and still do not) call for a repeat of the worst days of the Asian crisis. Certainly balance sheet strength and credit quality have been key factors for Hong Kong (declining consumer charge-offs) and Korea (stubbornly high consumer charge-offs), among others.

These points led us to take a strategy of focusing on Southeast Asia and Korea while relatively underweighting developed markets such as Hong Kong, Singapore and Taiwan. We also highlighted consumer finance as an area that would offer opportunities despite high charge-offs and general gloom.

## 2004 outlook and themes

We are Overweight Financials throughout Asia, with our favourite markets in order of preference now Malaysia, Taiwan and Korea. These are the areas in which we see the greatest core earnings increases for the next part of the cycle. Our biggest Underweights and the primary reasons why are Hong Kong (scepticism on China access becoming China profits), Singapore (low gearing and poor ROEs) and the Philippines (continued heavy pressure from NPLs and ROPOA).

**Fig 3 Asia-Pacific financials market weightings**

Market	Position
Hong Kong	Underweight
Japan	Neutral
<b>Korea</b>	<b>Overweight</b>
<b>Taiwan</b>	<b>Overweight</b>
Singapore	Underweight
<b>Malaysia</b>	<b>Overweight</b>
<b>Thailand</b>	<b>Overweight</b>
Indonesia	Neutral
Philippines	Underweight
Australia	NR
India	NR

Source: ING estimates

## The return of lending margins

The revenue problem Asian banks have faced over the last four years is not, in our view, a lack of volume growth, although loan growth has been slack or negative in all countries over the period. Rather, it has been sharply falling margins which have impaired profitability.

This is not primarily a result of poor loan growth, but rather of excess liquidity. Asia's deposit base has been growing rapidly and now amounts to over 2x GDP, an historically high level. Excess liquidity in bank deposits gives banks an incentive to cut rates to try and deploy the surplus funds; as long as even one or two players are willing to do so, margins for the entire market will sink. Witness the horrific story of Hong Kong mortgage rates, which have fallen from prime +175bp in 1999 to prime -65bp currently.

Although we do believe that loan growth will pick up strongly, the real impact will come from increasing loan-to-deposit ratios. Banks' loan-to-deposit ratios (LDR) are down from an average of 134% in January 1998 to under 80% currently – a decline of more than 50% in this critical leverage measure.

Looking at the individual markets in our universe, we see that LDRs have declined over the past 12 months on falling loan balances in the major developed Asian markets – Hong Kong, Singapore and Taiwan – with modest recent improvement seen only in Singapore. However, strong loan growth in Thailand, Indonesia, Malaysia, the Philippines and Korea have led to increases or bottoming-out in the loan/deposit measure in all five markets.

## Capex and corporate reflation

Asia's banks have not seen the start of an up-cycle in corporate capex since 1993, and the resultant outflow of loans has exacerbated other problems including falling margins and weak asset quality. Among the weakest sectors across Asia have been manufacturing and large industrial projects. These projects were a staple of Asian loan growth (along with real estate) during the pre-crisis period, but have dried up as capacity utilisation has dropped below 75% in most industries and countries.

However, based on our forecasts for production demand, and the ageing of capacity built pre-crisis, we believe that demand for these loans will return over the next one-to-three-year cycle – Asia's corporates can not keep de-gearing as they increase capacity spending.

Due to the long lead time and "chunky" nature of industrial project construction, even a recovery in demand will take a while to result in substantial lending, so that these loans will not drive a loan recovery, but they will add staying power to the coming credit cycle.

Bear in mind that we believe that much of capex spending this time around will go to the fixed income markets rather than to the banks; however, even the inflow into the bond market will help reverse LDR erosion by drawing off excess liquidity from bank deposits as investors seek out higher rates.

## Interest rate reversal

Investors are trained to buy banks on rate cuts, but in Asia we are looking forward eagerly to rate rises in late 2004 and beyond. This is because Asian banks – unlike Western ones – are asset-sensitive, meaning that their assets reprice faster than their liabilities and, therefore, that earnings benefit in a rising-rate environment.

Earnings will expand because banks can typically lag any reflection of a rise in benchmark interest rates in their deposit pricing without losing too many customers, while the overwhelming majority of loans across the region reprice automatically.

## M&A

In the absence of high organic loan growth, banks with stable margin assumptions and some degree of pricing power can easily buy growth by taking over their neighbours. With Asia still overbanked, there is ample scope for well-managed institutions to grow by acquisition while taking capital out of the industry – and, thus, further reducing margin pressure.

We look for additional M&A activity this year in Taiwan, Thailand, Korea, Indonesia and Malaysia, primarily in-market transactions. The key markets for foreign bank entry will be China (bet on at least one majority-stake transaction this year), India (Asia's best growth market) and Korea (a rapidly consolidating large market).

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In Asia ex-Japan our recommendations are defined as follows:

**Buy:** At least 10% share price upside is expected over our 12-month view.

**Hold:** Share price movement of between -10% and +10% is expected on a 12-month view.

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