Equity Markets

ING FINANCIAL MARKETS

Company results

Hong Kong

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Standard Chartered

Believe and prosper

Maintained

Buy

19 February 2004

Banks

18/02/04
HK$137.50/GBp 927.5

Target price: 12 months
HK$160/GBp1090 (+17%)

Bloomberg
STAN LN/2888 HK

STAN reported earnings that beat ING and street estimates. The company continues to grow strongly, but is hurt by the low rate environment. We maintain our BUY rating and increase our price target to HK$160.

Good news across the board. Standard's earnings increased in every market, ranging from a low of +3.4% in Singapore to a high of +49.5% in Africa. Revenues also grew in all markets save Singapore and Malaysia. Non-developed Asia was extremely robust in the period as well, with big contributions from Thailand, Indonesia, and Taiwan.

On the prowl. StanChart finally has both enough capital and a high enough multiple to turn its attention to acquisitions. Management are still in the running for Koram in Korea, and highlighted South Africa as another market in which they are willing to grow via M&A.

Give me cost discipline—but not yet! Cost-to-income and aggregate non-interest expense rose in the period, despite management's goal of a 50% cost/income ratio. Although costs did rise more slowly than revenues, we need to see management's investments pay off in 2004 in order to keep the faith.

Forecasts and ratings

Yr to December	2001	2002	2003	2004F	2005F
Net int. income (US$m)	2,832.0	2,898.0	2,913.0	3,361.7	3,912.5
Core earnings (US$m)	628.5	853.6	1,082.9	1,384.2	1,806.9
Net profit (US$m)	631.0	736.0	963.0	1,239.6	1,641.4
EPS (US$)	0.56	0.63	0.82	1.062	1.41
Ch to previous EPS (%)	n/a	n/a	n/a	0.5	4.9
Core EPS (US$)	0.56	0.73	0.93	1.19	1.55
EPS growth (%)	13.0	13.3	30.5	28.7	32.4
PER (x)	31.6	27.9	21.4	16.6	12.5
DPS (US$)	0.42	0.47	0.52	0.64	0.84
Yield (%)	2.4	2.7	3.0	3.6	4.8

Source: Company data, ING estimates

Financial data

	2002	2003	2004F
ROE (%)	11.48	14.00	16.95
Core ROE (%)	13.32	15.74	18.92
ROA (%)	0.67	0.83	1.00
Core ROA (%)	0.77	0.93	1.11
NIM (%)	3.01	2.90	3.16
Cost/Income (%)	54.89	53.85	50.83
Overhead (%)	2.50	2.52	2.45
NPLs/Tot loans (%)	4.83	3.99	3.55
BVPS (US$)	5.75	6.05	6.48
Price/book (x)	3.06	2.91	2.72

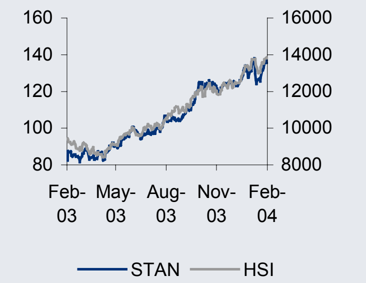
Share data

Market cap (US$m)	**20,578**
Number of shares (m)	1,167
Daily turnover (US$m)	44
Free float (%)	100.0
52-week hi/lo	81.50-138.00

Performance (%)

	1m	3m	12m
Absolute	6.2	13.2	66.7
Relative to HSI	1.3	-1.7	19.6

Share price performance



Source: Datastream

Contents

Summary

Rising profits...

STAN reported solid 2H03 and FY03 profits of US$502m and US$963m, respectively, up 31% and 34% from the prior year. All regions reported profit growth, and all except for Singapore and Malaysia also had significant revenue growth.

...rising returns...

Profits drove both ROA and ROE up: the critical return on capital measure hit 14% for the year, and was over 16% on a core basis—beating HSBC for the first time since before the Asian crisis.

...and rising dividends

Shareholders are sharing in the returns with a dividend increase (+11% over 2002) and a prospective yield of 3.6%.

Investments diverting profits—for now

Management pulled some of the bank's investment plans forward into 2003 due to what they see as extremely solid fundamentals for almost all of the bank's markets. This raised the cost-to-income level—investors will need to see returns on these investments in 2004.

M&A now a viable option

SCB is looking at acquisitions in Korea and South Africa, among others, and may participate in consolidation in Thailand as well. We see good prospects for accretive deals, especially in South Africa.

Raising EPS, price target: maintain BUY

We have raised our 2004-05 EPS forecasts by 1-5%, and increased our fair value price target from HK$140 per share to HK$160 per share (GBp1090). We maintain our BUY rating on the stock and continue to believe that Standard is one of the most compelling emerging market banking plays available.

Results and returns

Standard Chartered reported earnings yesterday evening after the close in Hong Kong, producing a good result free of special items that nonetheless beat our estimates and consensus.

Net income was US$963m for the full year, implying a second-half gain of US$502m and thus a consecutive half increase versus our expectation of a slightly weaker 2H03. Full-year earnings were up 31% from 2002's US$735m result, while 2H income alone was up 34% YoY and 9% HoH.

Note that we use net income attributable to common shareholders as our final bottom line; we consider dividends paid on fixed income (non-participating) preferred shares to be interest expense and reduce our top line appropriately as these instruments are simply a financing mechanism.

Fig 1 Key earnings components: 1997-2005

US$m	1997	1998	1999	2000	2001	2002	2003	2004F	2005F
Net Interest Income	2,219	2,500	2,621	2,656	2,832	2,898	2,913	3,362	3,912
Non-Interest Income	1,364	1,398	1,201	1,381	1,505	1,476	1,785	1,764	1,875
Non-Interest Expenses	1,857	2,036	2,226	2,714	2,585	2,401	2,530	2,605	2,713
Loan Loss Provisions	256	723	801	470	731	720	547	440	455
Core Income	1,075	788	554	476	629	854	1,083	1,384	1,807
Net Income	977	766	531	1,002	631	736	963	1,240	1,641
EPS (US$)	0.99	0.77	0.51	0.92	0.56	0.63	0.82	1.06	1.41

Source: Company data, ING estimates

Fig 2 Key earnings components: 2H99-2H03

US$m	2H99	1H00	2H00	1H01	2H01	1H02	2H02	1H03	2H03
Net Interest Income	1,309	1,324	1,332	1,393	1,439	1,486	1,412	1,430	1,483
Non-Interest Income	618	633	748	759	746	743	733	889	896
Non-Interest Expenses	1,145	1,152	1,562	1,267	1,318	1,176	1,225	1,225	1,305
Loan Loss Provisions	412	257	213	269	462	407	313	314	233
Core Income	258	367	109	398	245	432	422	509	574
Net Income	244	350	652	392	239	360	376	461	502
EPS (US$)	0.23	0.33	0.60	0.35	0.21	0.32	0.32	0.40	0.43

Source: Company data, ING estimates

Increasing returns

StanChart continues to make definite strides in improving both asset and equity returns. ROA climbed to 0.83% for the full year from 0.67% in 2002, and ROA on a core basis (with the primary difference being the exclusion of tax-effected securities gains and the addition of goodwill amortisation and other non-cash charges) climbing to 0.93% from 0.77%.

Although STAN has continued to reduce its gearing on both a regulatory capital (CAR) and equity/assets basis, ROE has also improved, rising to 14% for the year on a net basis and 15.7% on a core basis. 2H03 ROE was actually above 16%, a level last reached in 1998. Note that this level should put SCB's return above that of HSBC for the full year—again, the first such occasion since pre-Asian crisis times.

Fig 3 Key earnings ratios: 1997-2005

	1997	1998	1999	2000	2001	2002	2003	2004F	2005F
ROA	1.31%	0.98%	0.64%	1.06%	0.60%	0.67%	0.83%	1.00%	1.23%
Core ROA	1.44%	1.00%	0.66%	0.50%	0.60%	0.77%	0.93%	1.11%	1.36%
ROE	23.90%	17.25%	10.83%	17.93%	10.36%	11.48%	14.00%	16.95%	20.80%
Core ROE	26.30%	17.75%	11.30%	8.52%	10.32%	13.32%	15.74%	18.92%	22.90%
NIM	3.42%	3.66%	3.56%	3.18%	3.09%	3.01%	2.90%	3.16%	3.38%
Cost/Income	51.83%	52.23%	58.24%	67.23%	59.60%	54.89%	53.85%	50.83%	46.89%
Overhead	2.86%	2.98%	3.02%	3.25%	2.82%	2.50%	2.52%	2.45%	2.34%
Effective Tax Rate	26.87%	30.82%	30.31%	44.20%	37.02%	30.89%	30.54%	32.49%	31.00%

Source: Company data, ING estimates

Fig 4 Key earnings ratios: 2H99-2H03

	2H99	1H00	2H00	1H01	2H01	1H02	2H02	1H03	2H03
ROA	0.56%	0.79%	1.35%	0.74%	0.44%	0.65%	0.67%	0.79%	0.84%
Core ROA	0.59%	0.83%	0.23%	0.75%	0.45%	0.78%	0.75%	0.87%	0.96%
ROE	9.27%	13.17%	22.54%	11.45%	6.95%	11.43%	11.42%	13.44%	14.25%
Core ROE	9.78%	13.82%	3.76%	11.62%	7.12%	13.72%	12.81%	14.83%	16.30%
NIM	3.38%	3.34%	3.13%	2.98%	3.01%	3.10%	2.87%	2.83%	2.88%
Cost/Income	59.45%	58.91%	75.05%	58.88%	60.32%	52.76%	57.11%	52.82%	54.85%
Overhead	2.96%	2.91%	3.66%	2.71%	2.76%	2.45%	2.49%	2.42%	2.53%
Effective Tax Rate	30.19%	32.76%	64.58%	35.39%	39.51%	31.11%	30.64%	30.51%	30.56%

Source: Company data, ING estimates

Cost discipline somewhat lax

Standard management have highlighted their desire to reduce the cost/income ratio to 50%, so it was a slightly unwelcome surprise to see both aggregate costs and cost/income rise during the second half, from 52.8% to 54.9%. The overhead ratio (cost per dollar of average assets) also rose slightly both half-over-half and year-on-year, indicating that what we have is not revenue insufficiency but higher costs.

Fig 5 Non-interest expense breakdown: 2002-03

	FY02	FY03	% Chg
Expenses:			
Staff	1,270	1,353	6.5%
Premises	269	290	7.8%
Other	673	640	-4.9%
Depreciation and amortisation	345	381	10.4%
---premises and equipment	189	247	30.7%
---goodwill	156	134	-14.1%
Total operating expenses	2,557	2,664	4.2%

Source: Company data, ING estimates

While it is true that total costs increased by only 4.2% during 2003 while group revenue increased by 7.4%, we were expecting a better performance given the group's oft-touted initiatives to centralise processing at Standard's Chennai and Kuala Lumpur hubs and to standardise product offerings and front-end systems across the region.

Management stated several times during the course of the evening that the increase in costs is a one-off that is actually related to the unexpected strength of the economy in many of STAN's markets, which caused management to make the decision to accelerate product launches and planned capex into 2003 from 2004.

Examples given were the roll-out of Manhattan Card in Singapore in 2H03 and the Mortgage One offset product throughout the region. In addition, branch openings in India, Nigeria and Indonesia have contributed to the general rise in staff and premises costs.

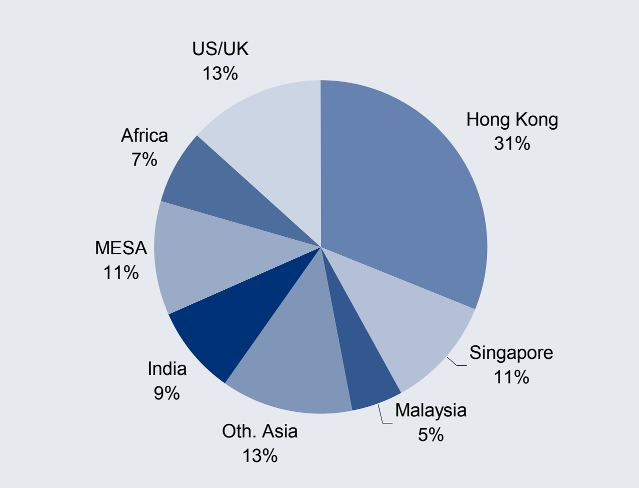
Finally, management flagged an increased pension contribution and a change in the depreciation schedule for software as items that contributed to cost increases during 2003; we don't expect either to be a recurring item.

Geographic breakdown

The portion of group earnings and revenues contributed by Hong Kong and Singapore continues to decline despite a double-digit increase in Hong Kong's bottom line and positive (albeit slow) growth in Singapore. StanChart's book is becoming ever more diversified as Africa and non-developed Asia begin to kick into gear economically; both are standouts with over 40% growth in EBT YoY.

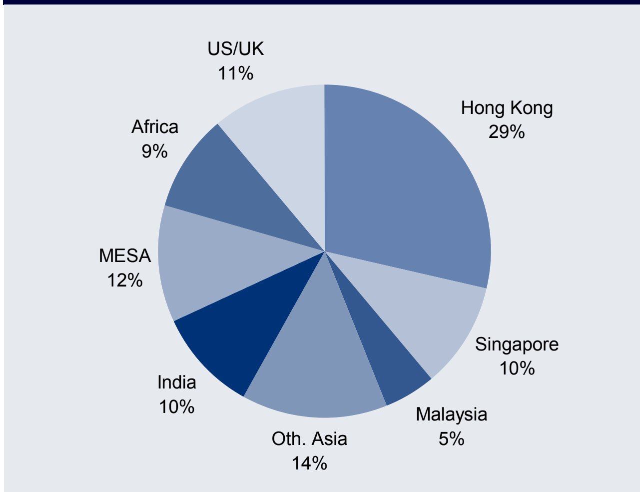
Management notes particularly strong results in the consumer business for Thailand (revenues +22% YoY) and Indonesia (revenues +36% YoY), with Taiwan also becoming a significant contributor after being loss-making as recently as two years ago.

Fig 6 STAN revenue by market: FY02



Source: Company data, ING estimates

Fig 7 STAN revenue by market: FY03



Source: Company data, ING estimates

In terms of dollar contribution to the overall result improvement, the Hong Kong consumer business did lead the way as expected, adding US$100m to EBT over the 2002 result even on falling revenues. Other major contributors were the African (+US$53m YoY) and Indian (+US$36m YoY) wholesale businesses, and the non-developed Asia consumer business, as noted above, which added US$36m in incremental gains.

On the negative EBT side, the big losers were the Hong Kong wholesale business, which was largely hurt by falling interest rates and hence margins on its core treasury products, the group-level consumer business, which is awaiting a relaunch of its revamped Jersey offshore banking operations, and both the Indian and African consumer businesses.

This last is somewhat surprising given good revenue growth in those markets, but we attribute the lack of profit to capex and direct costs necessary to start up these businesses (which are relatively undeveloped) and to timing differences between the booking of assets and the arrival of net income.

Fig 8 2003 largest incremental contributions by business line

Top 5 Contributors:	US$m	Top 5 Detractors:	US$m
Operating Profits:		**Operating Profits:**	
HK consumer	100	HK wholesale	-39
Africa wholesale	53	Group consumer	-17
Group	40	India consumer	-16
India wholesale	36	Africa consumer	-3
Other Asia consumer	36		
Revenues:		**Revenues:**	
Africa wholesale	78	Group wholesale	-60
Other Asia wholesale	62	HK consumer	-58
India wholesale	54	Group consumer	-16
Other Asia consumer	48	Singapore wholesale	-13
Africa consumer	33	Malaysia wholesale	-4

Source: Company data, ING estimates

Fig 9 Pre-tax earnings components by market: FY03

US$m, FY2003	Hong Kong	Singapore	Malaysia	Oth. Asia	India	MESA	Africa	US/UK	Total
Net interest income	942	334	173	400	255	341	248	275	2,968
Non-interest income	416	154	63	282	213	208	195	254	1,785
Non-interest expense	-626	-212	-136	-430	-218	-235	-283	-524	-2,664
Operating profit before provisions	732	276	100	252	250	314	160	5	2,089
Provisions and write-downs	-305	-33	2	-99	-64	2	-9	-41	-547
EBT	427	243	102	153	186	316	151	-36	1,542
% of EBT	27.7%	15.8%	6.6%	9.9%	12.1%	20.5%	9.8%	-2.3%	100.0%
% Chg, YoY	16.7%	3.4%	30.8%	45.7%	12.0%	8.2%	49.5%	NM	22.2%

Source: Company data, ING estimates

Fig 10 Pre-tax earnings components by market: FY02

US$m, FY2002	Hong Kong	Singapore	Malaysia	Oth. Asia	India	MESA	Africa	US/UK	Total
Net interest income	1,077	359	168	362	228	319	203	347	3,063
Non-interest income	339	126	66	210	166	182	129	258	1,476
Non-interest expense	-622	-209	-143	-406	-190	-196	-228	-563	-2557
Operating profit before provisions	794	276	91	166	204	305	104	42	1,982
Provisions and write-downs	-428	-41	-13	-61	-38	-13	-3	-123	-720
EBT	366	235	78	105	166	292	101	-81	1,262
% of EBT	29.0%	18.6%	6.2%	8.3%	13.2%	23.1%	8.0%	-6.4%	100.0%

Source: Company data, ING estimates

Fig 11 STAN breakouts by business line and market: FY03

US$m, 2003	Hong Kong	Singapore	Malaysia	Oth. Asia	India	MESA	Africa	US/UK	Total
Total:									
Revenues	1,358	488	236	682	468	549	443	529	4,753
Costs*	626	212	136	430	218	235	283	390	2,530
Provisions	305	33	(2)	99	60	(2)	9	34	536
Operating Profit	427	243	102	153	186	316	151	98	1,676
Wholesale:									
Revenues	403	159	74	349	244	309	273	450	2,261
Costs*	210	101	57	241	89	106	124	328	1,256
Provisions	23	(7)	(21)	41	1	(18)	5	34	58
Operating Profit	170	65	38	67	150	221	144	81	936
Consumer:									
Revenues	955	329	162	333	224	240	170	79	2,492
Costs*	416	111	79	189	129	129	159	62	1,274
Provisions	282	40	19	58	59	16	4	-	478
Operating Profit	257	178	64	86	36	95	7	17	740

* Excludes goodwill and other non-cash charges.

Source: Company data, ING estimates

Fig 12 STAN breakouts by business line and market: FY03 (%chg YoY)

% Chg, YoY	Hong Kong	Singapore	Malaysia	Oth. Asia	India	MESA	Africa	US/UK	Total
Total:									
Revenues	-4.1%	0.6%	0.9%	19.2%	18.8%	9.6%	33.4%	-12.6%	4.7%
Costs*	0.6%	1.4%	-4.9%	5.9%	14.7%	19.9%	24.1%	-4.2%	5.4%
Provisions	-28.7%	-19.5%	-115.4%	62.3%	57.9%	-115.4%	200.0%	-70.4%	-24.7%
Operating Profit	16.7%	3.4%	30.8%	45.7%	12.0%	8.2%	49.5%	30.7%	18.2%
Wholesale:									
Revenues	0.0%	-7.6%	-5.1%	21.6%	28.4%	7.3%	40.0%	-11.8%	6.5%
Costs*	5.0%	-1.9%	-10.9%	5.2%	17.1%	15.2%	19.2%	-4.4%	3.7%
Provisions	-483.3%	-216.7%	133.3%	1266.7%	NM	500.0%	NM	-71.2%	-46.8%
Operating Profit	-18.7%	3.2%	65.2%	21.8%	31.6%	11.1%	58.2%	97.6%	17.7%
Consumer:									
Revenues	-5.7%	5.1%	3.8%	16.8%	9.8%	12.7%	24.1%	-16.8%	3.1%
Costs*	-1.4%	4.7%	0.0%	6.8%	13.2%	24.0%	28.2%	-3.1%	7.1%
Provisions	-35.0%	14.3%	-13.6%	0.0%	55.3%	0.0%	33.3%	-100.0%	-20.7%
Operating Profit	63.7%	3.5%	16.4%	72.0%	-30.8%	2.2%	-30.0%	-50.0%	18.8%

* Excludes goodwill and other non-cash charges.

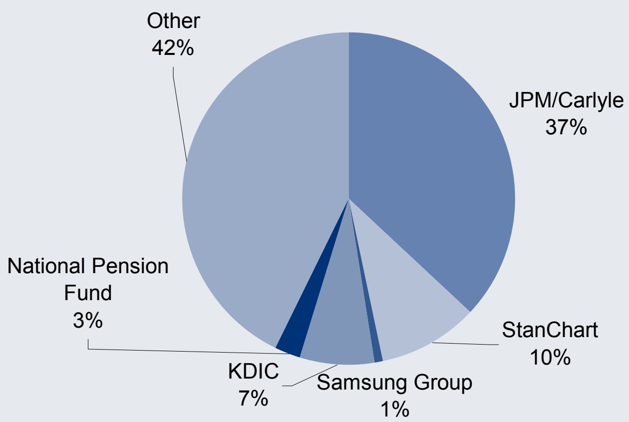
Source: Company data, ING estimates

Korea and Koram purchase

At the time of writing, Standard and Citigroup are still locked in combat over the 36% stake in Koram Bank held by the JP Morgan/Carlyle Group consortium, with a winner expected to be declared at any time.

Recall that STAN purchased a 9.76% stake (19.8m shares at an average price of Won9,187) in Koram Bank from Samsung Group companies Samsung Electronics (3.68%) and Samsung Life (6.08%) in early August. The total purchase price was US$154m.

Fig 13 Koram shareholder structure



Source: Company data, ING estimates

Since that time, however, Koram shares have been on a tear, closing yesterday (18 February) at Won14,650 and giving StanChart a paper gain of approximately US$92m on its 10% shareholding. It is entirely possible that the bank will bow out and sell to Citibank; management have been very clear in stating that they will not pay an uneconomic price for access to the Korean market.

We do believe that a transaction at Won16,000-18,000 per share is still feasible for StanChart and would be accretive, especially given Standard's ability to refinance Koram's high-cost debt due to its better credit rating[1]. However, with good deals in abundance in Asia, high organic growth, and limited capital, SCB may very well decide to pass.

Bear in mind, however, that STAN does have other options even in Korea. In particular, we highlight two banks already controlled by foreigners that are in both cases financial buyers and not long-term holders: Newbridge Capital's Korea First Bank and Lone Star's KEB. Of the two, we favour KFB as it has largely cleaned up its act over the past three years. In addition, the bank is unlisted and Newbridge has the ability to convey a 100% interest to a buyer, making the transaction clean and easy.

We expect to hear about the winner of the Koram auction soon—probably while the ink is still wet on this report.

[1] For further details, please refer to our recent report, *Koram Bank: Implications of possible acquisition by Standard Chartered Bank*, dated September 23, 2003.

Thailand consolidation

Under the aegis of the government's new master plan for the financial sector, a new wave of consolidation is being ushered into the Thai banking industry. We believe that the sector will be consolidated into 15 core banking institutions, with most finance companies, IBFs, and credit foncier companies going away.

StanChart currently has both its own branch and a 75% stake in Standard Chartered Nakornthon Bank (SCNB). Under the new one presence rule of the Financial Institutions Development Plan, SCB (along with ABN-AMRO and UOB) will have to choose which entity to keep.

We believe that they will elect to merge the branch of the UK entity into SCNB in order to keep the latter's branch network; our Thai banking head, Andrew Stotz, points out that STAN is unlikely to get a shot at owning a Thai bank in the future if it lets SCNB go now.

With the company's business in Thailand currently very strong (consumer banking revenues in the country were up 22% in 2003), it is likely that SCB would also look at any other banks or consumer finance companies up for sale, with the possible intention of increasing the group's presence in the market.

It would be difficult to buy a bank and show near-term accretion due to the lack of significant cost savings (SCNB's platform is too small to offer much on this score); in addition, investors would be likely to react poorly (based on our experience with the Nakornthon acquisition) to the consolidation of additional NPLs on STAN's balance sheet.

For this reason, we see an opportunistic finance company purchase as more likely to occur in 2004.

South Africa

Management disclosed in a press interview yesterday evening that the group is considering further acquisitions in South Africa as a means of accelerating its re-entry into the market.

Standard gave up its banking licence in South Africa in 1987 (spinning off what is now Standard Bank of SA). In 4Q03, the group was awarded a new full bank charter, however, and is recommencing operations in both consumer banking (primarily through its recently acquired Internet bank, Twenty20) and corporate lending.

However, buying an existing franchise would be an easy way to jumpstart the penetration of what is the largest market in Africa, and one ever more critical to success in the rest of the continent as South African companies begin to expand out of their home country.

Fig 14 South African bank valuations

		Price	Mkt. Cap.	Assets	Trailing	PER (x)		
Bank Group	**Ticker**	**2/19/04**	**US$m**	**US$m**	**PBV (x)**	**FY02A**	**FY03E**	**FY04E**
Standard Bank	SBK SJ	4060	8,282	45,432	2.07	10.24	8.78	7.61
FirstRand*	FSR SJ	937	7,793	52,873	2.30	10.78	10.42	8.18
ABSA**	ASA SJ	4649	4,610	34,080	1.80	15.97	8.80	7.29
Nedcor	NED SJ	6450	2,699	31,918	1.02	6.31	9.84	6.51
Average					1.80	10.83	9.46	7.40

* June FYE. ** March FYE.

All estimates per I/B/E/S

Source: Company data, Bloomberg, I/B/E/S, ING estimates

A South African acquisition would also seem as though it could be done at an accretive valuation, even assuming a decent-sized premium. The four major South African banking groups (*see table above*) trade at an average of under 10x 2003 EPS and at only 7.4x consensus 2004 EPS, meaning that any deal would be likely to increase ROE from day one, in addition to potential network synergies and cost cutting.

A potential catalyst is that the local regulator is trying to increase overall capital requirements, which will probably make it necessary for at least some of the banks to raise capital if they are to stay independent—or alternatively provide a good excuse for selling out.

Hong Kong subsidiarization

Standard Chartered management announced in January that the bank will apply to incorporate its Hong Kong business locally, injecting existing offices into a new domestic entity. Standard's business now operates in Hong Kong as a branch of the UK bank, despite holding a full Hong Kong banking licence.

CEPA motivation

The impetus behind StanChart's actions is the necessity of having a locally-incorporated company in order to be eligible for expanded China branching rights and faster approval of RMB activities under CEPA.

Because China is the focus for this move, we also believe that STAN may seek approval to inject its existing mainland branches (which are not part of the Hong Kong operations, but, like them, branches of the lead bank) into the new Hong Kong entity, in order to consolidate the China business. This would have the benefit of adding more seasoned China branches to the new ones that the bank can be expected to open; as the mainland government assesses banks' fitness to engage in new activities in part on the aggregate profitability of China operations, we believe that such a move would result in faster expansion.

Potential tax benefits

By incorporating in Hong Kong, StanChart may be able to have a portion of its earnings taxed at the lower Hong Kong rate rather than the higher prevailing UK rate (effective tax rate was 31% in 2002-03 and 37% in 2001. We estimate that these tax benefits could bolster STAN's net income by US$30-35m per annum over the next few years, an increase of approximately 3-4% based on 2003 earnings. We await further clarity on the specific structure and tax strategies before increasing our estimates on this basis, however.

It is probable that any tax advantage would only apply to profits retained within the Hong Kong business; any monies remitted out to the group would then be eligible for taxation at the top tier level at UK rates. Such a structure might incentivise SCB to begin to run more of its Asian business through the Hong Kong entity in order to minimise tax across the board. However, this could cause problems paying out dividends if money begins to pile up in the HK bank.

Higher capital may be necessary

The HKMA requires a minimum CAR of 10% from locally incorporated banks; in practice, we are informed by bankers that banks are mandated to maintain a substantial cushion above this level. Standard tends to have lower Tier 1 (8.8% at YE03 vs total CAR of 14.6%) than its local peers. However, HSBC has always gotten away with a different standard in Hong Kong, and it is plausible that STAN would also get considerable slack from the HKMA given its rigorous FSA supervision and long track record.

Rates and margins

Overall interest margins are declining at Standard Chartered due mainly to the low interest rate environment and its impact on free funds return and treasury/ALM activities, but also in part due to timing differences given the bank's strong growth.

Net interest margin, by our calculations, declined by 10bp during the year, although the second half was slightly better than the first. Note that we consider non-participating preferred share dividends to be interest expense, one reason why our margin numbers differ from those given out by the bank.

Fig 15 Key net interest margin components: 1998-2003

	1998	1999	2000	2001	2002	2003
Yield on Earning Assets	9.52%	7.77%	7.71%	6.85%	5.31%	4.68%
Cost of Interest-bearing Liabilities	6.51%	4.92%	5.36%	4.12%	2.56%	1.97%
Interest Spread	3.01%	2.85%	2.35%	2.72%	2.75%	2.72%
Net Interest Margin	3.66%	3.56%	3.18%	3.09%	3.01%	2.90%

Source: Company data, ING estimates

Fig 16 Key net interest margin components: 2H00-2H03

	2H00	1H01	2H01	1H02	2H02	1H03	2H03
Yield on Earning Assets	8.26%	6.97%	6.44%	5.20%	5.44%	4.49%	4.81%
Cost of Interest-bearing Liabilities	5.85%	4.53%	3.49%	2.33%	2.70%	1.87%	1.99%
Interest Spread	2.41%	2.44%	2.95%	2.86%	2.73%	2.62%	2.82%
Net Interest Margin	3.13%	2.98%	3.01%	3.10%	2.87%	2.83%	2.88%

Source: Company data, ING estimates

The major margin compression came from Hong Kong, Singapore, and the UAE, with India also dropping ~20bp of spread from 2002. Bucking the margin tide were non-developed Asia and non-UAE MESA.

Falling interest rates also hit some components of fee income as well as the classical interest rate book: SCB's cash management balances increased by 24% during the year, yet total revenue was flat.

Fig 17 Net interest margin by country (%)

	Hong Kong	Singapore	Malaysia	Oth. Asia	India	UAE	MESA	Africa	US/UK	Total
2003	2.4	1.8	2.5	2.4	4.0	3.4	3.8	6.7	0.8	2.8
2002	3.0	2.3	2.6	2.3	4.2	4.1	3.4	6.9	1.0	3.1
Chg	(0.6)	(0.5)	(0.1)	0.1	(0.2)	(0.7)	0.4	(0.2)	(0.2)	(0.3)

Source: Company data

Standard will benefit from a turn in the interest rate cycle, but management took pains to emphasise that the group's 2004 budget is not dependent on rate hikes, nor does it even assume them.

Loan portfolio

Standard Chartered has among the best organic growth of any bank in our universe, and certainly is tops among the Hong Kong (or Singaporean) banks. Gross loans grew by 4.7% YoY for 2003, and by 6.1% HoH in the last period of the year. This achievement is even more estimable considering that STAN has been steadily shrinking its Americas, UK, and head office portfolio while trying to reduce risk capital in the wholesale business.

Singapore and Malaysia remained very strong markets for loan growth in 2H03, as did Africa and the rest of Asia. India and MESA are still showing good growth on a full-year basis, but posted "*only*" 3.8% and 6.0% HoH growth at year-end.

Fig 18 Loan growth by country

	Balance (US$m)			% Change	
	2H02	1H03	2H03	HoH	YoY
Loans, Gross	57,477	56,689	60,169	6.1%	4.7%
Hong Kong	21,313	20,045	20,845	4.0%	-2.2%
Singapore	8,060	8,357	9,781	17.0%	21.4%
Malaysia	4,201	4,302	5,009	16.4%	19.2%
Other Asia Pacific	6,390	6,551	7,124	8.7%	11.5%
India	2,458	2,991	3,106	3.8%	26.4%
Middle East and South Asia	4,883	5,279	5,594	6.0%	14.6%
Africa	1,168	1,347	1,739	29.1%	48.9%
Americas, UK, and Head Office	9,004	7,817	6,971	-10.8%	-22.6%

Source: Company data, ING estimates

The standout sector continues to be consumer lending, as SCB makes good on its plan to become the retail bank for Asia, Africa, and the Middle East. Credit cards continue to decline overall—entirely due to Hong Kong—but other personal lending makes up for this. Corporate lending also notched up a very respectable gain in 2H03.

Fig 19 Loan growth by product

	Balance (US$m)				% Change	
	1H02	2H02	1H03	2H03	HoH	YoY
Corporate lending	26,645	27,876	26,599	29,027	9.1%	4.1%
Mortgages	20,059	20,388	20,571	20,725	0.7%	1.7%
Credit cards	3,578	3,359	3,249	3,329	2.5%	-0.9%
Other consumer	5,069	5,835	6,270	7,088	13.0%	21.5%

Source: Company data, ING estimates

Fig 20 Loan portfolio breakdown by sector: 1998-2003

US$m	YE1998	% Total	YE2000	% Total	YE2002	% Total	YE2003	% Total
Customer Loans, Gross	44,790	100.0%	53,484	100.0%	57,477	100.0%	60,169	100.0%
Loans to Individuals	22,070	49.3%	25,292	47.3%	29,601	51.5%	31,142	51.8%
--Mortgages	13,493	30.1%	17,776	33.2%	20,388	35.5%	20,725	34.4%
--Other Consumer	8,577	19.1%	7,516	14.1%	9,213	16.0%	10,417	17.3%
Wholesale Banking	22,720	50.7%	28,192	52.7%	27,876	48.5%	29,027	48.2%
--Loans to Governments	926	2.1%	1,225	2.3%	945	1.6%	1,111	1.8%
--Agriculture, forestry and fishing	432	1.0%	613	1.1%	562	1.0%	702	1.2%
--Mining and quarrying	430	1.0%	560	1.0%	809	1.4%	740	1.2%
--Manufacturing	6,553	14.6%	8,251	15.4%	8,323	14.5%	8,395	14.0%
--Electricity, gas and water	511	1.1%	931	1.7%	716	1.2%	974	1.6%
--Construction	576	1.3%	488	0.9%	344	0.6%	440	0.7%
--Commerce	6,488	14.5%	6,737	12.6%	4,984	8.7%	5,424	9.0%
--Transport, storage and communication	948	2.1%	2,572	4.8%	2,786	4.8%	2,946	4.9%
--Financing, insurance and business services	4,109	9.2%	5,135	9.6%	5,939	10.3%	5,799	9.6%
--Other	1,747	3.9%	1,680	3.1%	2,468	4.3%	2,496	4.1%

Source: Company data, ING estimates

Asset quality

Asset quality is improving at Standard Chartered, as evidenced by lower provisions—the bad debt charge fell by 24% for the full year and by 26% in 2H03. NPLs on the balance sheet were down 12% year-on-year and 8% in 2H03 alone, evidence that the Asian economic recovery is in full swing.

This level of bad loans equates to approximately 4% of customer loans, not bad for an emerging market bank, and down from a peak of 5.6%. Our estimate of weighted NPLs also declined to 1.68% of total loans from 1.87% at mid-year.

Our analysis shows that the flow of new NPLs has slowed to under US$200m per half—a very manageable level for the bank.

Fig 21 NPL migration: 1H02-2H03

US$m	2H02	1H03	2H03
NPLs at beginning of period	3,227	2,811	2,678
Net charge-offs	600	424	388
Net new NPL inflows	184	291	174
NPLs at end of period	2,811	2,678	2,464

Source: Company data, ING estimates

Do bear in mind, however, that much of the risk in the SCB loan book—as can be clearly seen from the bank's Hong Kong experience of the past few years—is in unsecured consumer lending, which tends not to create balance sheet NPLs, as most of its problem assets are 100% charged-off when delinquent 180 days.

In order to capture this pool as well, we also look at the net charge-off figures on a period-by-period basis. 2003's net charge-offs (after sizeable recoveries, which are not sustainable) were only 135bp on average loans. Although this was lower than provisioning by 44bp, we see it as a normal reaction to a material overprovisioning in 2002 and a very full reserve.

Fig 22 Charge-off summary: 1998-2003

BP on average loans	1998	1999	2000	2001	2002*	2003
Provisions	163.79	170.60	91.83	135.53	127.94	91.22
Net Charge-offs	30.72	68.25	161.71	176.32	(33.76)	135.41
Provisions less charge-offs	133.07	102.36	(69.88)	(40.79)	161.70	(44.19)
Accumulated Reserves	335.07	417.38	313.01	256.23	407.28	338.01

Note: Reserve calculation changed during 2002

Source: Company data, ING estimates

Fig 23 Charge-off summary: 2H00-2H03

BP on average loans	2H00	1H01	2H01	1H02*	2H02	1H03	2H03
Provisions	41.11	49.86	84.92	72.78	53.61	52.55	38.21
Net Charge-offs	99.26	70.62	104.78	(141.26)	102.77	70.96	63.62
Provisions less charge-offs	(58.15)	(20.76)	(19.85)	214.04	(49.16)	(18.41)	(25.42)
Accumulated Reserves	309.90	276.18	254.03	461.16	392.59	365.20	332.39

Note: Reserve calculation changed during 2002

Source: Company data, ING estimates

Reserve adequacy

We have the usual complaints about Standard's poor disclosure, which makes our regional reserve methodology less accurate. In this case, however, it's not much of a stretch to accept the adequacy of the reserve given that on-balance-sheet risk is declining and coverage looks to be more than 100% of our (very conservative) application of the Ricketti model of required reserving as shown below.

Note that we do make allowances for the Nakornthon NPLs, which are covered by the loan management agreement with the government, under which SCB's actual potential loss on these assets is strictly limited.

Fig 24 Reserve adequacy: 2H03

US$m	Gross amount	Reserve percentage	Required reserve
Pass	59,307	1%	593
Special Mention	363	5%	18
Substandard	970	20%	194
Doubtful	605	50%	303
Loss	526	100%	526
ORE	-	20%	-
Excess AIR	-	20%	-
Total	61,771		1,634
Actual Reserves			2,027
Shortfall			(393)
Actual/Required			124%
Shortfall/Capital			-6%

Source: Company data, ING estimates

Valuation and rating

Based on our new earnings targets, Standard Chartered is currently trading at 21.4x trailing and 16.6x forward net EPS, and at 19.0x and 14.9x trailing and forward core EPS, respectively. This is a discount to the HK sector average PER for 2004 of 17.5x despite Standard's greater liquidity, better management (compared with most smaller local banks), and broad-based growth prospects. We think such a discount is unwarranted.

Our cost of capital methodology pegs fair value for Standard post these results at HK$160, or approximately GBp1090, based on a 23% sustainable core ROE. At our target price, STAN would be trading at 3.2x YE 2004 BVPS and at 19.2x 2004 EPS and 14.6x 2005 EPS, still well below historical highs.

We maintain our **BUY** rating on Standard Chartered with an increased price target of HK$160.

Fig 25 Valuation at Current Price

	2002	2003	2004F	2005F
Share Price (US$)	17.63			
Share Price (HK$)	137.50			
Share Price (GBP)	927.50			
PER (x)	27.88x	21.37x	16.60x	12.54x
Core PER (x)	24.04x	19.00x	14.87x	11.39x
PUP (x)	10.40x	9.49x	8.16x	6.69x
P/BV (x)	3.06x	2.91x	2.72x	2.50x
P/ABV (x)	4.48x	4.05x	3.58x	3.13x

Source: Company data, ING estimates

Fig 26 Valuation at Target Price

	2002	2003	2004F	2005F
Share Price (US$)	20.51			
Share Price (HK$)	160			
Share Price (GBP)	1,088			
PER (x)	32.44x	24.87x	19.32x	14.59x
Core PER (x)	27.97x	22.11x	17.30x	13.25x
PUP (x)	12.10x	11.04x	9.50x	7.79x
P/BV (x)	3.57x	3.39x	3.17x	2.91x
P/ABV (x)	5.22x	4.71x	4.17x	3.64x

Source: Company data, ING estimates

Fig 27 Cost of capital valuation summary

5yr swap rate	3.27%
Market risk premium	4.60%
Estimated forward Beta	1.0
Cost of capital	7.9%
Sustainable LT core ROE	23.0%
Implied PBV (x)	2.92
2005F BVPS (HK$)	54.91
Implied target price (HK$)	160.49
Difference	22.99
Upside	16.7%

Source: Company data, ING estimates

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Recommendations

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.

Sell: At least 10% share price downside is expected over our 12-month view.

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