Company analysis

Hong Kong

Paul Sheehan
Hong Kong (852) 2848-8580
paul.sheehan@asia.ing.com

Standard Chartered

Will the hunter become the hunted?

Maintained

Buy

26 February 2004

Banks

24/02/04

HK$136.50

Target price: 12 months

HK$160

Bloomberg

STAN LN/2888 HK

Standard Chartered has suffered two potential threats to its Asian strategy in recent days: the loss of the Koram Bank bidding war to Citibank and the death of its largest shareholder. The bank itself may now be in play.

Forget Koram, but don't forget Korea. Although the tender is only just beginning, we have little choice but to conclude that STAN's hopes of buying Koram have been dashed — albeit with a US$100m+ gain on their investment. However, we do not think that SCB is on the verge of giving up its Korea strategy, with other potential targets including Korea First and KEB.

Khoo stake puts STAN in play. The death of Khoo Teck Puat and our conclusion that his 13.5% stake in Standard will be sold make us believe that the bank may be vulnerable to a takeover bid. Our favoured bidders are Citi and JP Morgan.

Potential for a defensive deal. We have long talked about the potential for a significant Asian merger for STAN, with DBS being the prime possibility. South Africa would also allow Standard to bulk up in a profitable fashion.

Forecasts and ratings

Yr to Dec	2001	2002	2003	2004	2005
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	1.06	1.41
Ch to previous EPS (%)	-	-	-	-	-
Core EPS (US$)	0.56	0.73	0.93	1.19	1.55
EPS growth (%)	13.0	13.3	30.5	28.7	32.4
PER (x)	31.3	27.8	21.3	16.5	12.4
DPS (US$)	0.42	0.47	0.52	0.64	0.84
Yield (%)	2.4	2.7	3.0	3.7	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)	3.04	2.89	2.70

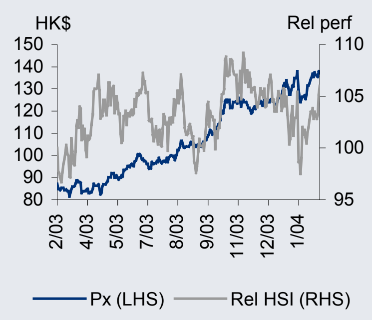
Share data

Market cap (US$m)	20,428
Number of shares (m)	1,167
Daily turnover (US$m)	44
Free float (%)	100
52-week hi/lo	81.50 - 138.50

Performance (%)

	1m	3m	12m
Absolute	1.1	12.8	56.4
Relative to HSI	2.2	(0.4)	7.8

Share price performance



Source: Datastream

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A strategic rebuff

On 23 February, Citigroup announced that it had reached agreement with Koram's board and with the JP Morgan/Carlyle group, the bank's largest shareholder, to make a tender offer for all of the bank's shares at Won15,500 per share. Although Standard had taken steps towards an acquisition of Koram itself, acquiring a 10% stake from the Samsung Group, we believe that they have been effectively trumped by the Citibank bid.

Citi's offer will be effective if at least 80% of the shares are tendered, so that StanChart's 10% stake alone will not be enough to scuttle a merger. We believe that Citibank will be successful in acquiring and eventually de-listing Koram, and that SCB will tender its shares and walk away, consoled by a gain of approximately US$106m on its investment of US$154m in August of 2003.

With the bid now almost 70% above SCB's last purchase of stock, we do not believe that StanChart will chase Koram, especially against an adversary with far superior resources.

Don't give up on Korea just yet

We definitely do not believe that StanChart will abandon its ambitions for Korea after losing Koram. Remember that the bank has started its own retail business from scratch in the country; while still small, this has the potential to develop quickly in such a concentrated market. In addition, there are still plenty of other fish in the sea.

Other potential targets for STAN

We think the most likely target for StanChart is unlisted Korea First Bank, which is controlled and 51% owned by Newbridge Capital. Newbridge has spent several years cleaning up the loan book and modernising the operations of KFB, which would now be a viable platform for any bidder who could expand the asset base — something we believe SCB would have no trouble doing.

Bear in mind that Newbridge does have the ability to convey the government's 49% stake in the bank to a buyer as well through a drag-along agreement, so that this would be a relatively simple transaction.

Additionally, we believe that Lone Star would be a seller of its controlling stake in Korea Exchange Bank (004940 KS, Won8,100, Not Rated) at the right price, despite a short holding period. However, KEB would be a large deal for STAN to do for cash, and we do not expect that Lone Star would want shares.

An additional possibility is that SCB might buy a stake in LG Card from creditors and assume management control, probably in co-operation with another local bank such as Hana (002860 KS, Won27,450, BUY).

Khoo shareholding up for grabs

Legendary Malaysian investor Khoo Teck Puat died over the weekend at age 89, leaving behind control of a 13.5% stake in STAN, which he acquired as a "white knight[1]" in the mid-1980s when the bank was under siege by Lloyds.

Fig 1 Standard Chartered's major shareholders

Group	Shareholding	Mkt Val (US$m)
Khoo Teck Puat (estate of and related companies)	13.50%	2,800
Fidelity Investments	5.06%	1,049
Capital Group	3.39%	703
Prudential PLC	3.02%	626

Source: Bloomberg

The stake is mainly held via three listed but illiquid family companies (two of which are suspended from trading) listed in Singapore, Goodwood Park Hotel, Central Properties, and Hotel Malaysia Ltd.

Fig 2 Khoo entities holding StanChart shares

Company	Ticker	Price (S$)	Mkt Cap (US$m)
Goodwood Park Hotel	GPK SP	Suspended	NA
Central Properties Ltd.	CEN SP	37.6	664
Hotel Malaysia Ltd	HML SP	Suspended	NA

None of these companies is rated by ING Financial Markets.
Source: Bloomberg

Although we are obviously not privy to details of Mr. Khoo's estate planning, we note that 1) based on estimates of his wealth by Forbes Magazine and the Straits Times, his stake in STAN represents the majority of his net assets; and 2) we believe that there will be substantial estate taxes to be paid on this estate. Furthermore, a perusal of the financial statements of the three entities above reveals that a portion of their investments (presumably including Standard shares) are pledged as collateral for bank loans.

All of this leads us to conclude that the Khoo stake is now, or soon will be, for sale — obviously dependent on a good price as we assume that the elder Mr. Khoo's investing savvy has been passed on to the next generation by both genetic material and good example.

As this is the only significant non-institutional holding of StanChart, we are virtually certain that it will attract an outsized amount of interest from strategic buyers rather than purely institutional investors.

Although the Khoo stake is not in and of itself a control stake, it would probably suffice to block a competing bid unless the price differential was large. On that basis, we expect that any bank interested in owning StanChart — now or ever — will promptly be chatting with family representatives.

[1] Along with Y.K. Pao and Robert Holmes a Court.

Can Standard hold off a bid?

Like most management teams, we suspect that Standard's management is averse to being sold. They will have several arrows in their quiver with which to either deflect a transaction or at least gain some negotiating leverage.

The most obvious way for STAN to head off any potential transaction would be to buy the Khoo stake itself. This would have the salutary effect of raising ROE, and with some marginal assets still on the books, we think it could conceivably be done without much of an earnings penalty, meaning that a purchase could be earnings-accretive despite the lofty PBV valuation of Standard shares.

The issue here is one of capital: STAN does not run with massive excesses, as do some of its Singaporean and Hong Kong counterparts, and so would be hard pressed to retire the stake. On our calculations, the bank would wind up with Tier 1 of 5.6% and total capital of 11.3% post a transaction — too low for an emerging market bank in our opinion, and likely to be frowned upon by regulators.

Two other classic anti-takeover ploys remain:

1) Make the potential bride look uglier

STAN could conceivably pay a big special dividend or initiate share buybacks, sell off (or spin off) one of its prime divisions (perhaps forming Standard Bank of the Middle East or Standard Bank of Africa), or contract to buy something unpalatable.

We don't under any circumstances see the management team doing something like this, which would potentially damage shareholders.

2) Marry someone else first

The best remedy for a takeover is after all another takeover: STAN could buy or merge with someone else in order to become a larger entity and thus harder to take over. In addition, an accretive merger would probably raise the trading multiple of the stock, and thereby make SCB less attractive to an outside player. The characteristics of a good defensive play are as follows:

- **Accretion.** We believe that existing STAN investors would reject a dilutive deal. Accretion must be demonstrated within a one-year time frame — no "long-term strategic" deals need apply.
- **Scale.** Any acquisition (or collection of purchases) must be large enough to make STAN materially larger and commensurately harder to acquire.
- **Consistency.** Standard can't give up its emerging markets focus, nor would it be advisable to enter a market totally unrelated to the bank's existing platform, such as Latin America. Anything the group buys needs to tie into the strategy that is already working.

What options does StanChart have on this score?

- **Hong Kong:** We believe that management has already looked at most of the banks available in Hong Kong, and having done nothing, we don't think they see tremendous value at current prices — a view with which we strongly concur. The best fit would likely be Dah Sing (due to its large personal lending and credit card books), but DSF's market cap of just over US$2.0bn is not large enough to significantly deter an acquisitor.

- **China:** Lots of banks available, but virtually none that would allow STAN full control and merger and hence almost no chance of an immediately accretive merger. We don't believe even in the current China mania that such a transaction would be enough to head off an SCB sale.

- **Korea:** Having lost Koram, we believe that StanChart is overwhelmingly likely to bid for another bank in Korea, as previously described. However, even buying KEB at a premium to its current market cap of US$4.2bn would not be dispositive in heading off Standard's own acquisition. In addition, either Lone Star or Newbridge would be likely to want cash for the deal — and US$4-5bn in cash would be difficult for SCB to cough up.

- **SE Asia:** Nothing big enough.

- **South Africa:** As discussed in our last Standard report[2], management has revealed plans to look at further acquisitions (following on from that of twenty20) in South Africa, and we highlighted some potential names including Standard Bank, FirstRand, ABSA, and Nedcor. At US$2.7-8.3bn in market cap, a significant acquisition here could fulfil all three criteria described above.

- **Singapore:** Our long-time view is that StanChart and DBS will get together, which would serve a number of purposes for both sides:

  <u>Standard</u>

  - Buys good regional assets (including additional HK scale) at a discount to its own valuation.
  - Strengthens position in Singapore as a dominant bank.
  - Begins to service DBS' clientele in Malaysia, leading to a stronger combined product.
  - Adds scale in credit cards.
  - Add access to Asian investors via a liquid Singapore listing and index weighting.

  <u>Singapore/Temasek/DBS</u>

  - Bring a true regional and expansionary bank to Singapore, developing the financial sector.
  - Allow Temasek to trade out of its DBS stake, which looks to us to be increasingly peripheral to the holding company's banking strategy.
  - Bring a stronger management team in most countries.
  - Add access to European investors via the UK listing and index weighting.

Add to this that DBS' market cap of US$13.1bn and Temasek's control of a significant amount of the merged entity (Temasek owns approximately 31% of DBS but might also be persuaded to take up some or all of the Khoo stake initially) would likely fend off all but the most determined bidders for the company at this point, and we think such a deal is more likely than ever.

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[2] *<u>Standard Chartered: Believe and Prosper</u>*, dated February 19, 2004.

Who are the potential bidders for Standard?

What if Standard can't keep from being put in play? We certainly think the company is very attractive on a standalone basis, and in terms of its entrée into some very closed and difficult-to-penetrate markets, the company is *sui generis*.

Any number of bank groups would be interested in such a prime franchise; probably only the onset of the Asian crisis and intervening US bank consolidation kept SCB from being acquired previously.

Fig 3 Potential bidders for StanChart

Company	Ticker	Price (lcy)	Mkt Cap (US$bn)	ING Rating
Citigroup	C US	49.44	255.0	NR
JP Morgan Chase	JPM US	40.20	82.7	NR
Bank of America	BAC US	81.45	117.4	NR
HSBC	HSBA LN	865.50	179.5	HOLD
Royal Bank of Scotland	RBS LN	1,717.00	96.3	BUY
Barclays PLC	BARC LN	506.50	62.9	HOLD
Lloyds TSB	LLOY LN	464.00	49.6	HOLD

Source: Bloomberg, ING.

We believe that the most likely suitors of STAN will be the large American banks. Why? The prime reasons are the relative weakness of the US dollar *vs.* the euro and the advanced state of consolidation among large US banks. Currently, we see most European banks interested either in intra-European M&A or in bulking-up their US platforms before all the attractive targets are gone.

In contrast, US banks are at a severe disadvantage in trying to buy European assets as the currency has moved against them — witness as an example Citi's recent run at Deutsche Bank. Since the three US banks named above are basically at their limits for US M&A — in the banking sector, at least — it makes eminent sense for them to go where the growth is and where their money still goes a long way: Asia.

Key comments on specific banks:

Citigroup. Far and away the most likely bidder, Citi has the resources to buy Standard and an existing platform in most Asian countries to add to it. The addition of Koram and Citi's Taiwan and China networks will add full coverage of Asia ex-Japan, while the Associates operations in Japan provide a base there. We have been of the opinion that it is time for Citi to put some balance sheet in Asia — this is a golden opportunity to do so.

JP Morgan. Somewhat less likely than Citi given that it is already involved in another merger and therefore somewhat distracted. However, JP Morgan has always had a decent presence at the governmental and top corporate level in Asia, and so would be comfortable getting in deeper.

Bank of America. Seriously doubtful as a StanChart bidder. BOA certainly has the resources, but is also going through a large merger integration. Finally, although the old (pre-Nationsbank) BOA had one of the best overseas networks of any US bank, this was largely dismembered and sold from the late-1980s onwards as BOA sank into financial trouble. BOA's sole remaining significant operation in Asia is its bank in Hong

Kong — which we believe to be for sale. This does not appear to be a management team that is spending a lot of time looking to buy Asian assets.

HSBC. A non-starter. HSBC could never obtain regulatory approval to merge in Hong Kong, nor we suspect in Singapore.

Lloyds. A previous bidder for STAN in 1986, Lloyds has stayed in touch, even buying the Chartered Trust business from SCB in 2000. However, of late, Lloyds has been exiting from emerging markets after a series of earnings disappointments — note the sale of the bank's Brazilian operations to HSBC in late 2003 — and we don't see significant appetite here for what would be a very significant shift in the bank's risk profile back towards emerging markets.

Barclays. A more intriguing possibility, BARC is both larger than Lloyds and more immersed in developing markets — in particular in Africa, where it is virtually the only significant international competitor to SCB. However, management has clearly stated that the bank's bias is towards expansion in the UK and continental Europe, and Barclays has little in Asia currently (post the sale of its BZW equities business to CSFB in 1997) aside from its Barclays Capital corporate finance operations.

RBS. A master acquisitor with a US$96bn market cap, RBS is a credible bidder for almost any significant banking asset that comes up for sale. However, it is heavily concentrated in the UK and Ireland, with its main international expansion taking place in the US as the group expands its Citizens Financial unit — now the 19th largest US bank group with some US$73bn in assets.

We believe that RBS will focus on US consolidation in order to diversify Citizens away from its current markets of Rhode Island, New Hampshire, Connecticut, and Pennsylvania.[3]

[3] For full details of our view on US bank consolidation, please refer to our recent report: *JP Morgan / Bank One: Impact on Asia and HSBC*, dated January 19, 2004.

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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.

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

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