

Change in recommendation

## Asia ex-Japan

# Dah Sing Financial

Looking out for #1

## Banks

18/3/04

HK\$66.00

**Dah Sing announced a plan to list its banking operations (95% of the group) while maintaining the holding company listing. We see this as a dilutive deal with no purpose other than to entrench family control. Downgrade to SELL.**

**Going for the two-tier approach.** Dah Sing plans to list its banking subsidiary by offering a 15% stake to the public, while retaining ownership of the rest at the holding company level, which will also encompass DSF's insurance operations. The listing would raise funds for potential M&A, but depress ROE.

**Maintaining control.** The addition of a second tier is by management's own admission intended to maintain the Wong family's control of Dah Sing, exercised through their 37% stake in DSF. DSF can go as low as 51% ownership of Dah Sing Bank without impairing this control.

**The new Guoco?** As DSF becomes a holding company, expect a discount similar to that which Guoco enjoyed while it owned Dao Heng Bank. We are extremely displeased with a transaction that will create such a discount and dilute EPS and ROE in order to favour the controlling shareholder. **Downgrade from BUY to SELL.**

## Forecasts and ratings

	2001	2002	2003	2004F	2005F
Net int income (HK\$m)	1,680.8	1,828.5	1,686.8	1,741.4	1,999.0
Core earnings (HK\$m)	756.5	725.4	918.0	1,101.2	1,400.6
Net profit (HK\$m)	868.2	829.0	992.6	1,101.2	1,400.6
EPS (HK\$)	3.52	3.36	4.02	4.46	5.67
Ch to previous EPS (%)	NA	NA	NA	NA	NA
Core EPS (HK\$)	3.07	2.94	3.72	4.46	5.67
EPS growth (%)	6.0	-4.5	19.7	10.9	27.2
PER (x)	18.8	19.6	16.4	14.8	11.6
DPS (HK\$)	1.12	1.12	1.33	2.00	2.54
Yield (%)	1.7	1.7	2.0	3.0	3.9

Source: Company data, ING estimates

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Previously: Buy

## Sell

18 March 2004

Target price: 12 months

HK\$54 (-18%)

Bloomberg

440 HK

## Financial data

	2002	2003	2004F
ROE (%)	14.40	15.41	15.53
Core ROE (%)	12.60	14.25	15.53
ROA (%)	1.45	1.60	1.72
Core ROA (%)	1.27	1.48	1.72
NIM (%)	3.40	2.86	2.84
Cost/Income (%)	34.54	31.48	33.25
Overhead (%)	1.64	1.35	1.38
NPLs/Tot loans (%)	2.74	2.42	2.75
BVPS (HK\$)	24.70	27.51	29.95
Price/book (x)	2.67	2.40	2.20

## Share data

Market cap (US\$m)	2,088
Number of shares (m)	247
Daily turnover (US\$m)	11
Free float (%)	63.0
52-week hi/lo	31.50 - 66.00

## Performance (%)

	1m	3m	12m
Absolute	3.9	15.3	73.7
Relative to HSI	10.8	9.3	30.2

## Share price performance



Source: Datastream

# A complex deal

Dah Sing Financial suspended their shares and called a hasty analyst briefing this evening to unveil a radical restructuring of the group's structure—and unfortunately one which we believe will decrease shareholder value.

## Moving to a two-tier structure

In summary, DSF plans to list its banking operations (primarily Dah Sing Bank but also including tiny MEVAS Bank) separately on the Hong Kong stock exchange. The new company, which will contain these operations, will be named Dah Sing Banking Group (DSBG). DSF will remain listed as an overall holding company which controls DSBG (and so DSB) and also incorporated Dah Sing's insurance operations, which are not and will not be independently listed.

## Raising capital

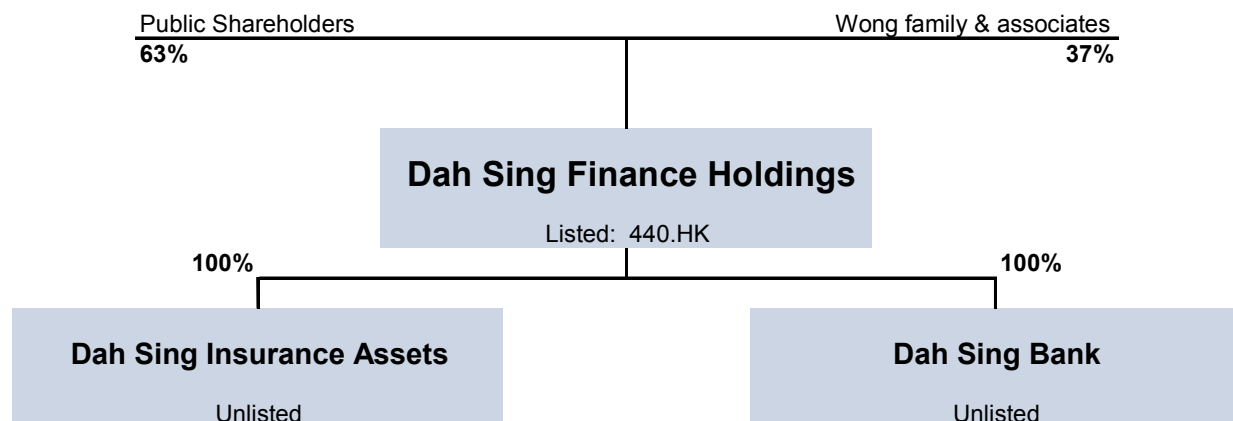
As part of the process, DSBG will seek to sell a 15% stake in an IPO. Although the normal Hong Kong listing requirement mandates a 25% minimum float, management believes that they will be able to get a waiver for DSBG.

Most of the shares will be new primary shares sold by the bank; however, management disclosed that some existing shares held by DSF may also be sold. In this way, additional capital will flow to both the bank group and top-tier holding company.

Note that this structure would allow DSF to sell at least an additional 34% of DSBG (worth approximately US\$675m at current prices) while still retaining absolute control of all the assets now in DSF.

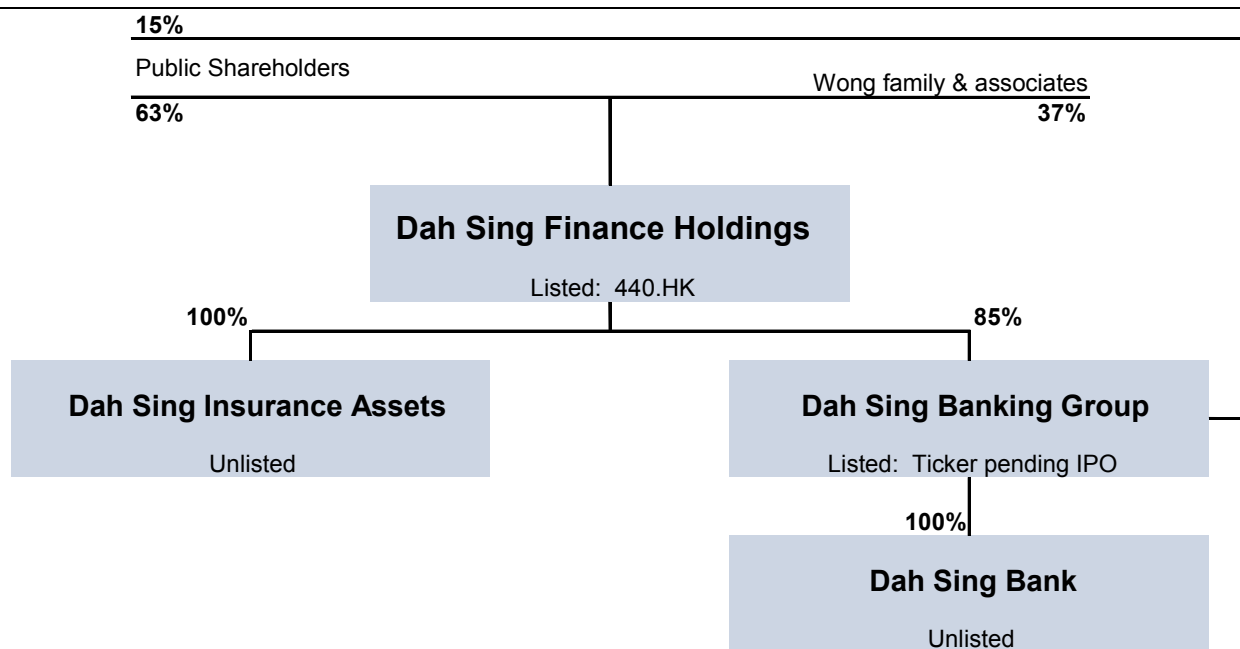
The figures below may be useful in illustrating this before we move on.

**Fig 1 Dah Sing: Current structure**



Source: Company reports, ING estimates

**Fig 2 Dah Sing: Proposed Structure**



Source: Company reports, ING estimates

## Some incentives

DSF are throwing a few bones to investors as part of the transaction. First, a special dividend is promised, although the amount is uncertain. We know that it will definitely be less than the amount of the DSBG offering proceeds, so that capital will increase at the company—definitely not what we were looking for. In addition, management commits that DSF will raise its dividend payout to 45-50% – not overly generous for a company which already has excess capital and is raising more.

Finally, management offers the consolation that holders of DSF will receive preferential allocation of shares in the DSBG IPO.

On the subject of incentives, management offered up the thought that splitting the company into two listed entities will allow the managements of the banking and insurance businesses to be effectively incentivized to manage their parts of the group.

We are not certain whether this is an admission that either the bank managers, insurance managers, or both have been intentionally working below peak potential because of bad incentives. But if so, we certainly wish that management had called this phenomenon to our attention before.

# Some simple questions

This transaction is in our view needlessly complex, and invites a number of questions which we are happy to take a swing at:

## 1) Why would Dah Sing issue more capital?

They certainly don't need it now—DSF has a total CAR of 20.4% and equity/assets of 10.6%. For almost two years we have been pressing management on the issue of returning capital, and the response has been that DSF was looking around carefully for potential acquisitions and also wanted to reserve some cash in case organic growth came back. If neither of these options turned out to be viable, management pledged to push excess capital out to shareholders.

Organic growth has not materialised, and although we have good prospects for this year, it is certainly nothing that the bank couldn't handle from internally generated funds.

That leaves M&A as the only real possibility for re-gearing.

## 2) Who could they possibly buy?

Management has highlighted China and Hong Kong as major areas of focus. In the banking world, we dismiss any serious thoughts of Dah Sing buying a Chinese bank—first, it is not allowed; and second, they are still too small. A minority stake is a possibility, but one about which we would be very likely negative as investors, as we generally eschew paying a premium to one bank to invest in another.

In Hong Kong, the usual suspects (+ one foreigner) are:

- **Liu Chong Hing.** Having been for sale for over a year, we assume that DSF has looked at it, and it is (like all HK banks) considerably more expensive than it was.
- **Wing Hang.** Similar market cap to DSF, WHB would be a chunky purchase post their acquisition of Chekiang First. We suspect that DSF would need to offer shares of DSBG plus cash to make an attractive offer, but would retain control of the merged bank. Bank of NY's remaining 20% stake is probably available as a starter.
- **Wing Lung.** Also family controlled and slightly smaller in market cap than DSF and WHB, Wing Lung could benefit from Dah Sing's more pro-active management; however, it's not clear that there would be enough cost savings to drive a transaction—plus, the controlling shareholders claim that they don't want to sell.
- **Bank of America (Asia).** Bank of America Corp is undergoing a big US merger and definitely not focussed on the non-North American consumer market. We think BOAA could be for sale and would make a nice acquisition for DSF.

Also, don't rule out an insurance acquisition. One caveat here is that insurance companies tend to have considerably lower ROEs than banks, so that it would be very difficult to make an accretive acquisition in the insurance space. Additionally, DSF doesn't really have enough critical mass in insurance to generate substantial cost savings from a merger.

### 3) Why not simply place new shares of DSF to pay for an acquisition?

We believe that DSF as a group will receive less money than it should by listing DSBG due to the latter's low free float. DSF shares will also be poor currency as they will likely get a holding company discount. So, even if management wants currency for M&A, why not simply do a placement of shares of the current entity?

Senior management was very open with us this evening about the primary reason for avoiding this, which is that it would dilute the control of the Wong family. Note that the two-tier structure will still allow the family to retain its control even if DSBG's stake in DSBG falls to 51%. Management said that they value having a stable significant shareholder.

From the perspective of minority investors, this attitude—while not exactly unknown in Asia—is simply abhorrent. We would like to see the company run for maximum return to all shareholders, instead of tailoring its strategy to fit the needs of a single group.

As a house with tremendous respect for the capabilities and operating record of Dah Sing management, this is more than somewhat shocking to us.

### 4) How much dilution should we expect?

Naturally management declined to discuss which banks might be M&A targets or partners, and wouldn't say even whether or not the company has already identified potential acquisitions or held any discussions at all, so it is difficult to assess the impact of any merger.

Investors are being asked to participate, in a sense, in a blind pool similar to that advertised during the South Sea Bubble as “an undertaking of great advantage, but no one to know what it is.”<sup>1</sup>

Without any reason to suspect that beneficial M&A is near, we have to assume that the cash raised will go into DSF's pool of short-term liquidity. At a projected yield of 1.2%, the proceeds raised (based on current prices) will increase net income by 2.6%, but decrease EPS by 11% based on 2003 pro-forma figures. More important for our valuation, ROE on a pro-forma basis would drop from 15.4% to 13.5%.

**Fig 3 DSF dilution analysis**

	2003A	2003 Pro-forma	%ch
Net Income (HK\$m)	992.6	1,018.8	2.6
EPS (HK\$)	4.02	3.59	-10.7
ROE	15.4	13.5	-1.9

Source: Company data, ING estimates

We will not adjust our earnings estimates until we have some kind of clarity on offering price et cetera, and until shareholders actually approve this plan—but bear in mind per the above that there is substantial potential downside to our current forecasts.

<sup>1</sup> History records that the pool was fully subscribed by a thousand investors within five hours of the books opening, doubtless to the chagrin of some 18<sup>th</sup> century analyst who tried to warn them off. The proprietor then closed up shop, set off for the Continent and was never heard from again.

# Valuation

Our previous valuation was based on a sustainable core ROE in excess of 17% for DSF. In addition to lower ROE, we have two other issues to address: one for each of the securities that will be traded within the group.

## The holding company discount

Dah Sing Financial will now become a holding company without much in the way of operations that anyone is interested in. Experience shows us that companies like this tend to trade at a discount to the market value of their components, rather than at a premium.

Our most on-point example is Guoco, which similarly controlled Dao Heng Bank (since sold to DBS in 2001). Although Guoco was the top-tier entity (and also had insurance and asset management assets as well), most investors preferred to buy the bank directly, to the point where Guoco would regularly trade at more than a 30% discount to the market value of its stake in Dao Heng alone.

Even taking a conservative 20% discount to our current valuation of DSF businesses, this would yield a price target of HK\$53—before any adjustments for lower ROE.

## The liquidity discount

Of course, we will also be able to buy the bank holding company directly in the future. One major negative for DSBG is that it will only have 15% float when listed—a significant drop from the 63% public float of Dah Sing today. At a US\$2bn market cap, liquidity is a material valuation issue—my inclination would be to take at least a 10% discount for lower liquidity...or to raise the beta and hence cost of equity in our model which amounts to the same thing. Bear in mind that the holding company may get a discount on top of this.

## Downgrading to Sell

Although we cannot be certain what M&A will bring, we are fairly confident of near-term dilution to both EPS and ROE. In addition, the technical factors above make the shares of either Dah Sing entity less attractive.

We are downgrading our estimate of future sustainable core ROE to 14%, and setting a target price of HK\$54 per share, equivalent to 1.8x forward BVPS.

We are similarly downgrading our rating from BUY to SELL.

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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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