Equity Markets

ING FINANCIAL MARKETS

Sector analysis

Pan Asia

Asian Financials

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Banks and Financial Services

PAN-ASIAN

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We remain overweight financials as a sector within Asia-Pacific based on resumed credit demand from corporates and our forecast of a reversal of margin-destroying excess liquidity as investors move from bank deposits into risk assets.

Included inside this report are comments on regional themes for the next 12 months, a precis of each market in Asia/Japan including banks, finance companies, securities and exchanges, and insurance, and a brief summary of each of our covered companies.

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A list of ING's corporate relationships with the companies featured in this report is available on request.

Summary & top picks

Regional weightings.

We have changed our regional financials weightings since our last update in September, with the primary move being a downgrade of Malaysia to Neutral from Overweight. There is absolutely nothing wrong with our former top pick market and we still show substantial upside to many of the stocks we cover; however, with an average 12-month trailing return of 76% for our Malaysian financials universe, the banks are not as cheap as they used to be.

Our top market is now Taiwan, where the post-election turmoil has made it possible to pick up great franchises in a consolidating market at a discount, followed by Thailand and Korea. Of the largest markets, we remain Overweight Japan and Underweight Hong Kong, and have also moved Singapore from a Neutral to Underweight for balance, despite strong first quarter earnings results.

Remember that these are relative calls and that we still have high-conviction BUY ratings in Underweight markets and SELL ratings in Overweight markets. Also bear in mind that some markets consist of multiple sectors: banks, insurers, securities, and finance companies.

Fig 1 Asia-Pacific market weightings

Market	Financials weighting
Hong Kong	Underweight
Japan	**Overweight**
Singapore	Underweight
Taiwan	**Overweight**
Korea	**Overweight**
Malaysia	Neutral
Thailand	**Overweight**
Indonesia	**Overweight**
Philippines	Neutral

Source: ING estimates

Regional valuation.

Financials are generally trading at a discount to the broad market, despite much better gearing to economic growth and a substantially higher yield than Asian stocks as a whole. We know from backtesting that the key predictive bank valuation ratios for generating outperformance are price/book and trailing (rather than forward) PER.

Note that on a P/BV basis both Taiwan and Malaysia stand out as very overvalued compared with peer averages—why aren't they both underweight? In large part the key is to remember that our country valuations are weighted by market cap, and that in each of those markets we are negative on the largest or second-largest financial institution (Maybank in Malaysia and First FHC in Taiwan).

Fig 2 Country average bank valuations (weighted average by market cap)

	P/BV			PER		
	2002	2003	2004F	2002	2003	2004F
Hong Kong	2.79	2.46	2.37	22.01	18.45	15.96
Japan	NM	3.61	2.91	NM	29.68	17.00
Singapore	1.62	1.52	1.39	21.50	18.65	14.74
Taiwan	2.05	2.09	1.84	18.31	23.75	13.94
Korea	1.58	1.54	1.35	10.99	NM	9.43
Malaysia	2.60	2.39	2.20	23.03	18.45	16.41
Thailand	2.69	1.98	1.77	19.20	12.51	9.13
Indonesia	2.09	1.77	1.51	12.52	7.94	6.60
Philippines	1.35	1.30	1.25	21.01	16.67	15.68
Average	2.10	2.07	1.84	18.57	18.26	13.21

Source: Company data, ING estimates

Fig 3 EPS growth by market (banks)

	Average			Weighted average		
	2003	2004F	2005F	2003	2004F	2005F
Hong Kong	6.6	31.5	22.9	19.8	16.0	15.6
Japan	135.1	61.7	12.9	10.1	79.9	16.1
Singapore	17.3	26.3	22.6	16.9	26.3	22.7
Taiwan	3.9	75.2	23.7	(10.7)	74.3	24.0
Korea	(37.6)	202.1	36.3	(20.1)	104.0	53.5
Malaysia	31.2	16.5	17.3	25.3	12.9	18.0
Thailand	62.5	40.0	(7.1)	45.4	40.1	(4.9)
Indonesia	90.3	20.8	15.7	57.6	20.3	17.6
Philippines	30.3	4.4	13.8	21.1	6.5	12.8

Source: Company data, ING estimates

Regional top picks.

Listed below are some of our top recommendations for banks and non-banks across the region (all stocks listed below are rated BUY).

Fig 4 Regional top picks: Banks

Company	Code	Market	ING analyst
Standard Chartered Bank	STAN LN / 2888 HK	Hong Kong	Paul Sheehan
Taishin FHC	2887 TT	Taiwan	Nora Hou
Bank International Indonesia	BNII IJ	Indonesia	Liny Halim
Bank of Fukuoka	8326 JP	Japan	Ned Akov
Industrial Bank of Korea	024110 KS	Korea	Young Chung Mok
Bank of Ayudhya	BAY TB	Thailand	Andrew Stotz

Source: Company data, ING estimates

Fig 5 Regional top picks: Non-banks

Company	Code	Market	ING analyst
Hyundai Securities	003450 KS	Korea	Mark Barclay
Oriental Fire & Marine	000060 KS	Korea	Mark Barclay
Aeon Thana Sinsap	AEONTS TB	Thailand	Marc Lavoie
Hong Kong Exchange & Clearing	388 HK	Hong Kong	Peter Williamson

Source: Company data, ING estimates

Market summary

Hong Kong

We remain Underweight Hong Kong on high valuations and a lacklustre operating environment. Although mainland China is the attraction for almost all of the Hong Kong banks, we believe that actual profits and return on capital are quite a ways off despite CEPA and WTO. In separate sections, we discuss our views on HSBC and Standard Chartered, and our continuing preference for the latter due to its high growth prospects. Also note that HKEx is one of our top picks in the non-bank sector.

Japan

We are Overweight Japan from a bank perspective, with our key insights focusing around a bottom-up analysis of corporate creditworthiness and prospects for renewed credit demand. Our favourites in the market are SMFG and UFJ, as well as Bank of Fukuoka among the regionals.

We are Neutral on the Japanese brokerage sector on the theory that deregulation and competition from online services have permanently eroded margins and valuation multiples.

Singapore

Singapore is still stuck in low gear, with the key issues for the banks remaining capital management (especially pending new bank-specific requirements to be announced this year) and divestment of non-core assets. With no in-market consolidation seen in the near future, all three banks are looking out to the region for growth and acquisitions—but having failed to move strongly when prices were low, it will be extremely difficult for the big three to make accretive acquisitions now. UOB remains our favourite, with DBS and Hong Leong Finance also rated BUYs.

Korea

It would be difficult for Korea not to show improvement going forward after the dismal operating performances of 2002-03, and yet the level of (not entirely unwarranted) distrust of managements is such that many investors remain unconvinced that the market will not simply lurch from disaster to disaster forever. History shows that Korean banks are best bought when unloved and distrusted, one reason we are confident recommending the market at this time.

We believe that falling unemployment and organised workouts will reduce consumer write-offs, and that corporate Korea is not on the verge of another debt crisis. Additionally, high deposit rates in Korea provide a cushion for margins and a potential source of fee revenue as banks move expensive deposit customers into fee-generating off-balance-sheet products.

Our top picks in banks are IBK, Kookmin and Shinhan. In the brokerage sector, we remain negative, with Hyundai Securities and Daishin Securities' preferred shares our only interesting plays in the sector. We are Neutral on the insurers, with BUYs on Samsung Fire & Marine and Oriental Fire & Marine.

Malaysia

Malaysia has strong underlying fundamentals, with loan growth advancing to an estimated 7.2% and bad assets continuing to trend down. However, new interest rate rules are expected to trim margins somewhat, reducing underlying profit growth to 6% for 2004. The swing catalysts for the market are regulatory changes (in particular expanded branching rights for foreign banks) and M&A. We are now Neutral on Malaysian financials, with top picks Hong Leong Bank and Commerce Asset-Holding.

Taiwan

Taiwanese banks are benefiting from consolidation and from the removal of systemic risk concerns that have overshadowed the sector for five years or more. Although the state banks are still troubled, a vibrant private bank sector has grown to be especially significant in high margin and high-growth businesses. The recent DPP victory is a setback for hopes of immediate economic integration with the mainland, but even so, signs of expanded access for the banks are beginning to show. Our top picks are consumer banking masters Taishin, Cosmos and Chinatrust.

Thailand

Thai banks will have good years for revenue growth in 2004-05 despite more limited asset expansion on a shift to lower-cost deposits and the replacement of expensive hybrid capital instruments. On the asset side, a shift away from defensive short-term assets and continuing workout of non- or low-yielding NPLs will raise asset returns. The fact that the strong margin environment will be complemented by falling provision charges and followed by the start of a credit expansion cycle foreshadows a long up-cycle for Thai bank profits.

In addition, the consolidation of the finance sector, and in particular the merger of banks and finance companies, holds promise for the surviving companies, and offers investors a chance to monetise their holdings in smaller, illiquid—but still operationally attractive—companies, which will be bought. Our favourite banks are BAY and KBANK followed by BBL; we also like AEONTS and MIDA among the finance companies.

Indonesia

Indonesia has the best macro environment of any of our markets, with good GDP growth, interest rates steadily falling from a high nominal level and very low credit/GDP. In addition, the comprehensive cleanup by IBRA means that we aren't worried about legacy NPLs as in Thailand or even Malaysia. Finally, the merger of banks and finance companies (viz, Danamon-Adira) is adding legs to what has been a long bank run. Our top pick is BII, followed by Danamon and BCA.

Philippines

Philippine banks are actually showing surprisingly good loan growth and are trading on only 1.3x book value, reasons why we peg the market as Neutral in our universe rather than Underweight. Unfortunately, the heavy overhang of bad loans and foreclosed property (ROPOA in local parlance) casts doubt on the stated book numbers and keeps earnings valuations higher than we should like. However, keep your eyes open for a turn…someday. Top pick now is BPI.

Putting liquidity to work

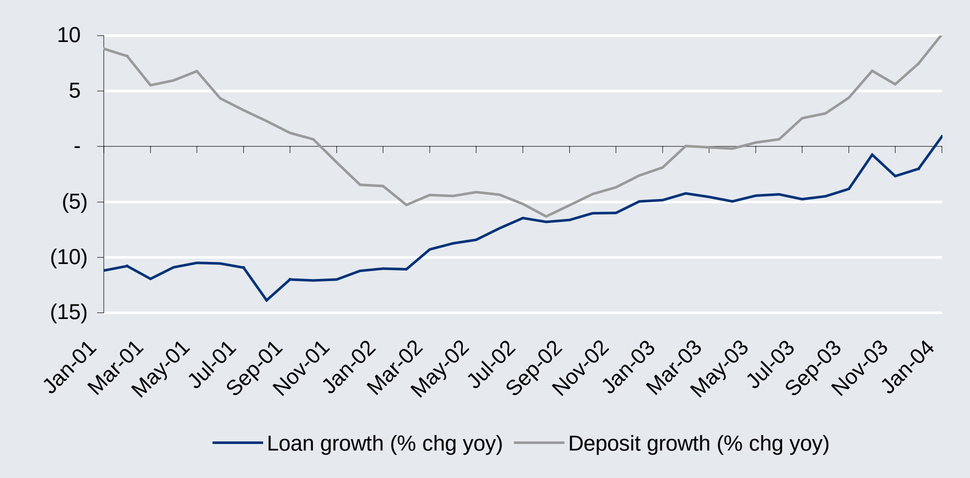
Across the region Asian banks have been experiencing an unprecedented surfeit of liquidity, with deposits continuing to rise at a double-digit pace despite punitively-low (in over half the region actually negative on a real basis) deposit rates.

Why are Asian investors continuing to save even when given such paltry—nominal savings rates at low as Hong Kong's 1/10th of a basis point—incentives? In part, this is a natural response to the collapsing asset prices of the Asian Crisis, when the normal stores of value for retail investors—domestic equities and property—caused exceptional losses.

Those who had got used to thinking of property in particular as a risk-less asset class, even when leveraged, turned around and began to attribute extraordinary risk to such investments and consequently reduced the amount of new money flowing into the sector.

Almost by default, the funds that once would have gone to property or to equity markets have wound up in bank deposits, which are seen as the ultimate risk-free asset and a source of stability in turbulent economic times.

Fig 6 Hong Kong loan growth vs. deposit growth: 2001-present



Source: Company data, ING estimates

For example, in Hong Kong deposits have grown at an average rate of approximately 1% pa over the last three years, while loans have declined by an average of 7.5%. Although the nominal rate of deposit increase is small, remember that Hong Kong has experienced deflation throughout this period and that benchmark savings rates have declined from 450bp to 0.1bp. In absolute terms, the post-crisis period has seen deposits grow by over HK$900bn while loan balances have shrunk by HK$350bn.

Regional LDR is at an historic low

Banks' loan-to-deposit ratios (LDR) across the region are down from their post crisis peak of 118% in January 1998 to only 78.5% currently – a 39% decline in this critical leverage measure, albeit up from the average trough of 70.3%. LDR has declined in big developed economies and small emerging ones alike, with Hong Kong falling from a peak of 150.9% to 57.5% today and Thailand dropping from 138.5% to 80.1%.

Fig 7 LDR: 1998-present

	Post-crisis peak		Trough		Current	YoY Chg
Hong Kong	150.9%	Jan-98	57.1%	Dec-03	57.5%	-5.2%
Singapore	115.2%	Jan-98	84.2%	Mar-00	85.7%	-3.1%
Taiwan	92.1%	Jan-98	72.6%	Oct-03	73.2%	-2.0%
Korea	108.0%	Jan-98	75.6%	Feb-00	98.2%	6.2%
Malaysia	129.6%	Jan-98	104.0%	Jan-00	111.7%	-3.5%
Thailand	138.5%	Jan-98	68.6%	Nov-01	80.1%	0.3%
Indonesia	109.2%	Jun-98	34.6%	Mar-00	48.7%	5.7%
Philippines	96.78%	Feb-98	65.6%	Dec-02	73.2%	7.5%

Source: Company data, ING estimates

Fig 8 Asian loan growth

	1999	2000	2001	2002	2003
Hong Kong	-14.9%	-12.5%	-11.2%	-5.0%	-2.0%
Singapore	-2.9%	4.7%	5.8%	-1.6%	7.0%
Taiwan	3.3%	3.2%	-0.9%	-3.3%	2.8%
Korea	24.9%	24.2%	15.0%	32.0%	14.1%
Malaysia	-4.5%	5.4%	3.9%	4.6%	4.8%
Thailand	-10.1%	-11.9%	-2.8%	12.3%	4.4%
Indonesia	-53.8%	19.5%	14.3%	18.8%	6.8%
Philippines	0.7%	2.6%	1.7%	-1.5%	12.6%

Source: Company data, ING estimates

Why is a low LDR undesirable? Excess liquidity in banks over and above lending needs must be reinvested in securities or interbank instruments at ever-lower rates, reducing net interest income and returns. Deposit rates of near zero in most major Asian markets mean that reduced earning asset yields and spreads cannot be passed along to customers via deposit rate cuts—part of this scenario is known as the negative endowment effect.

Worst of all, the extra liquidity encourages pricing warfare to capture the limited market for profitable loans. Despite a market size that has not grown at all since 1999, Hong Kong's mortgage spreads have fallen from 175bp *over* prime to 270bp *under* prime—a difference of 445bp of spread, which has reduced the theoretical ROE on a fresh mortgage by 75%. Likewise in Singapore, mortgage rates have fallen by 150-175bp (at the long end) over the past three years, with teaser rates in the first 1-3 years down by as much as 250bp and now starting as low as 1.33%.

Even the Thai and Indonesian banks—beneficiaries of much stronger economic momentum than the developed Asian markets—have seen rate competition for the limited lending opportunities available.

Excess deposit liquidity in our covered Asian banking universe now exceeds US$300bn, based on a conservative 90% equilibrium LDR. Assuming the actual average incremental spread (less credit spread) of 300bp which could be gained by lending out these funds, Asian banks are ceding a whopping 17bp of ROA to underleverage.

Fig 9 LDR: Hong Kong

Source: Central bank, ING estimates

Fig 10 LDR: Singapore

Source: Central bank, ING estimates

Fig 11 LDR: Korea

Source: Central bank, ING estimates

Fig 12 LDR: Taiwan

Source: Central bank, ING estimates

Fig 13 LDR: Thailand

Source: Central bank, ING estimates

Fig 14 LDR: Malaysia

Source: Central bank, ING estimates

Fig 15 LDR: Indonesia

Source: Central bank, ING estimates

Fig 16 LDR: Philippines

Source: Central bank, ING estimates

Credit demand is low, but here comes the capex

As ING's strategy view has noted over an extended period, Asian corporates have brought their balance sheet gearing to a 22-year low since 1997, with corporates running an aggregate 35% net debt-to-equity across the region. In the aftermath of Asia's post-crisis lending contraction (characterised by an almost complete risk intolerance on the part of banks—an unwillingness to extend credit under any circumstances), banks have tried to make up for the absence of corporates on the borrowing scene by focusing more on personal lending to build balances – which has led to horrific consumer credit disasters in Korea and Hong Kong, notably.

With the consumer no longer unleveraged, banks must increase corporate lending in order to produce significant loan growth. Fortunately, rising GDP growth across Asia will force corporates to gear up once again in order to keep pace with demand and maintain ROE.

However, the spoiler to what seems like a perfect environment for Asian banks to resume their historical role as very efficient beneficiaries of a strong macro environment though robust loan growth is the rise of deep and liquid domestic currency fixed income markets in every country in Asia—a relatively new phenomenon and one certainly not present during the last capex cycle in 1993.

Much long-term investment is temperamentally more suited to the bond market than to bank lending; we believe that insurance companies with long-term liabilities are much better repositories for much of this project-driven credit than are banks, hence the use of the bond market as an intermediary will bring in new investors and lower the cost of funds. Note that the availability of local-currency assets which match the liability profile of life insurance companies (along with looser rules on where they can invest) can be expected to usher in a more profitable and predictable era for the industry.

But back to banks: if they will lose out on an increasing share of credit demand to the fixed income markets as spending rebounds, where's the positive news?

(Balance sheet) size doesn't matter

As we have often said, the problem Asian banks have is not a growth problem—it's a margin problem. As investors, we are driven almost exclusively by return on capital, and not by balance sheet size, market share, or other such fripperies of ego. With capital difficult to manage in the short run and massive gearing changes seemingly not on the cards, the only way to achieve our ambition of goosing ROE is by increasing margins.

Unfortunately for Asian bankers, margins have been going steadily in the wrong direction. Banks have lost over 50bp of spread since the crisis, with a further 9bp contraction coming in 2003. Lost margins are another way of highlighting loss of pricing power. Banks can, of course, have interest rate pricing power in two ways: deposits and loans.

Deposit pricing power has never been greater. Banks with large and convenient networks in developed Asia are able to bring in stable core deposits at almost zero interest rates, while even emerging Asian banks find themselves surfeited with liquidity and have lowered rates to match. The major constraint on bank pricing power for liabilities is now that they cannot fall below zero—so further upside to earnings from here is limited.

In lending, however, pricing power is almost wholly absent. The excess of liquidity and low LDRs have combined to drive asset margins on the most commoditised products – eg, residential mortgages – to near zero.

Liquidity run-down is the quiet hero

Our analysis shows that the beneficial impact of three trends will draw excess liquidity out of the banking system, and by tightening the supply of money will restore banks' pricing power on the lending side—thus leading to an increase in margins. These trends are as follows:

- **Strong corporate credit demand.** As described above, we believe that the corporate gearing cycle has already turned. Although much of the credit issuance will indeed go to the bond market, we believe that investor dollars which flow into this market will come (directly or indirectly) from bank deposits—the consensus Asian risk-free asset.

- **Increased demand for real estate and domestic equities.** Retail depositors are currently over-allocating their savings to bank deposits due to a string of losses and scandals in the property and stock markets. We believe that this is aberrational, and that as bad memories fade and economic growth continues to advance, retail investors will return, thus choking off the supply of new deposits. Note that both investment property and market indices in all major Asian markets have current yields that exceed the prevailing rate of interest on bank deposits.

- **Rising unemployment, falling uncertainty.** Unemployment and the threat of unemployment cause people to increase their cash balances as a hedge against uncertainty. Typically, as unemployment recedes, consumers begin to reduce their stocks of cash after approximately a six-month lag period. ING calculations show that a 1% fall in unemployment is worth an estimated US$220bn in deposit reductions[1].

[1] Please refer to ING's recent report, *Get ready for the consumption surprise*, dated February 9, 2004.

M&A

Every year in Asia dawns bright with the promise of transformational M&A, and generally ends in disappointment over the limited outcome. At the classic analytical risk of saying "this time it's different," we believe that the coming 18 months will see some major transactions in each of three primary areas: intra-market M&A, cross-border (but intra-Asian) M&A, and outside financial institutions coming into Asia.

One of the major stumbling blocks which has prevented bank managements from properly managing capital (Singapore, Hong Kong) or disposing of bad assets (Japan, Taiwan, Philippines, Thailand) is the thought that—sooner or later—we are bound to return to the salad days of favourable macro and 20%+ annual loan growth out as far as the eye can see.

Almost no one save the Australians (and a tip 'o the hat to Hang Seng) has been willing to bite the bullet and focus on return on capital in a maturing market. We believe that this will change quickly in an up market, as savvy players realise that asset growth is not a requirement for expanded profitability—but rather something you can buy if you have your other operating parameters (gearing, margins) in line. Key areas to watch:

- **Intra-market:** Most countries in Asia still have too many banks for the amount of business they do; we see opportunities in Taiwan (one of the most fragmented banking markets anywhere), Thailand (where banks are buying into the long-ignored consumer space by absorbing finance and leasing companies), Malaysia (ready for one more round of consolidation before full deregulation and foreign entry in 2007), Hong Kong, and Indonesia.

- **Intra-Asia:** Cross-border M&A is much trickier than intra market because, without overlapping branch networks, there are typically minimal cost savings and therefore the transactions tend not to work financially. However, there are some legitimate reasons for pan-Asian M&A.

  First, there are now a few Asian banks (Standard Chartered, DBS) who bring a broad network in the region to bear on any new acquisitions, and which have well-developed management structures and systems which can add value, as well as high multiples which make accretive acquisitions easier to find.

  Secondly, there are real questions in some of the smaller markets about the sustainability of a one-market brand in an era of increasing sophistication of risk management (viz., Basel 2 implementation) and mass marketing. For a Philippine—or even Singaporean— bank to compete against global brand names such as Citibank and HSBC will be increasingly difficult as minimum efficient scale increases.

- **Out of market:** As the US banking market consolidates, large groups like Citi and JP Morgan – which are probably unable to make further American acquisitions on competition grounds – will be driven abroad to look for growth. Given the strong Euro/weak Dollar relationship and anaemic growth in Europe, as well as the US banks' strong brand names here, we believe that they will look to Asia for non-organic growth.

Regional valuation tables

Fig 17 Asia-Pacific financials universe: regional valuation

Company	Price	BVPS			P/BV			EPS			PER		
	(lcy)	2002	2003	2004F	2002	2003	2004F	2002	2003	2004F	2002	2003	2004F
HONG KONG													
HSBC	115.00	43.12	53.00	55.34	2.67x	2.17x	2.08x	5.13	6.24	7.27	22.40x	18.42x	15.82x
STAN	123.50	44.86	47.21	50.53	2.75x	2.62x	2.44x	4.93	6.43	8.28	25.04x	19.19x	14.91x
HSB	98.25	22.79	20.73	20.83	4.31x	4.74x	4.72x	5.21	4.99	5.01	18.86x	19.69x	19.62x
BOCHK	13.95	5.39	5.70	5.96	2.59x	2.45x	2.34x	0.63	0.75	0.90	22.10x	18.52x	15.52x
BEA	22.80	13.00	13.83	14.12	1.75x	1.65x	1.61x	0.89	1.32	1.40	25.69x	17.25x	16.25x
DSF	55.25	24.70	27.51	29.02	2.24x	2.01x	1.90x	3.36	4.02	4.42	16.45x	13.74x	12.50x
IBA	3.28	3.21	3.13	3.19	1.02x	1.04x	1.03x	0.19	0.09	0.17	17.04x	37.44x	19.11x
JCG	6.30	4.63	4.67	4.98	1.36x	1.35x	1.26x	0.34	0.33	0.50	18.78x	19.21x	12.70x
AEON	5.85	2.52	2.64	3.00	2.32x	2.21x	1.95x	0.50	0.28	0.51	11.61x	20.88x	11.53x
HKEX	15.20	5.35	4.42	4.54	2.84x	3.44x	3.34x	0.66	0.87	0.92	22.99x	17.47x	16.57x
Avg					2.39x	2.37x	2.27x				20.10x	20.18x	15.45x
Wtd avg					2.79x	2.46x	2.37x				22.01x	18.45x	15.96x
JAPAN													
Banks													
MTFG	1,020,000	417,951	530,105	579,444	2.44x	1.92x	1.76x	(30,239)	45,270	53,339	-33.73x	22.53x	19.12x
UFJ	654,000	67,382	99,671	136,785	9.71x	6.56x	4.78x	(126,805)	9,966	39,614	-5.16x	65.62x	16.51x
Mizuho	499,000	(18,026)	99,483	123,093	-27.68x	5.02x	4.05x	(254,525)	18,323	28,639	-1.96x	27.23x	17.42x
SMFG	781,000	106,577	225,192	286,037	7.33x	3.47x	2.73x	(84,324)	36,510	65,929	-9.26x	21.39x	11.85x
Sumitomo Trust	674	361	393	434	1.86x	1.71x	1.55x	(51)	35	45	-13.27x	19.01x	15.00x
Yokohama	652	313	344	378	2.08x	1.90x	1.73x	14	35	39	47.75x	18.57x	16.67x
Shizuoka	997	722	789	820	1.38x	1.26x	1.22x	17	34	31	58.41x	29.06x	32.00x
Fukuoka	606	497	601	632	1.22x	1.01x	0.96x	13	31	35	47.72x	19.32x	17.19x
Avg					-0.21x	2.86x	2.35x				51.29x	27.84x	18.22x
Wtd avg					-2.73x	3.61x	2.91x				52.00x	29.68x	17.00x
Brokers													
Nomura	1,815	816	846	914	2.22x	2.14x	1.99x	86	61	83	21.21x	29.63x	21.92x
Daiwa	850	430	408	431	1.98x	2.08x	1.97x	(98)	(5)	29	-8.65x	-178.95x	28.98x
Nikko	671	374	353	353	1.79x	1.90x	1.90x	(36)	(12)	17	-18.63x	-57.11x	38.80x
Matsui	3,660	355	363	417	10.30x	10.08x	8.78x	21	17	77	171.47x	217.39x	47.63x
Avg					4.07x	4.05x	3.66x				96.34x	123.51x	34.33x
Wtd avg					2.51x	2.50x	2.32x				33.86x	45.44x	27.91x
SINGAPORE													
Banks													
DBS	13.90	9.74	10.13	10.79	1.43x	1.37x	1.29x	0.71	0.66	0.90	19.61x	21.10x	15.50x
UOB	13.70	8.03	8.45	8.79	1.71x	1.62x	1.56x	0.64	0.77	0.94	21.40x	17.91x	14.53x
OCBC	12.20	7.15	7.80	9.44	1.71x	1.56x	1.29x	0.52	0.72	0.86	23.67x	16.98x	14.19x
Avg					1.61x	1.52x	1.38x				21.56x	18.66x	14.74x
Wtd avg					1.62x	1.52x	1.39x				21.50x	18.65x	14.74x
Non-banks													
GE Life	12.00	3.46	4.29	4.78	3.47x	2.79x	2.51x	0.50	0.66	0.68	24.19x	18.12x	17.60x
SGX	1.69	0.84	0.80	0.58	2.02x	2.11x	2.92x	0.07	0.07	0.12	24.90x	24.49x	14.63x
Hong Leong Fin	3.00	2.67	2.72	2.86	1.12x	1.10x	1.05x	0.20	0.20	0.23	15.32x	15.19x	13.10x
Avg					2.20x	2.00x	2.16x				21.47x	19.27x	15.11x
Wtd avg					2.83x	2.41x	2.37x				23.00x	18.93x	16.34x
MALAYSIA													
Maybank	11.10	3.57	3.76	3.95	3.11x	2.95x	2.81x	0.47	0.56	0.60	23.75x	19.84x	18.60x
Public Bank	3.02	1.21	1.35	1.51	2.50x	2.23x	2.00x	0.13	0.16	0.20	22.83x	18.77x	15.06x
CAHB	5.20	2.64	3.00	3.31	1.97x	1.73x	1.57x	0.22	0.30	0.37	23.44x	17.33x	13.89x
AMMB	3.98	1.46	1.92	2.08	2.72x	2.08x	1.91x	0.13	0.16	0.23	29.98x	25.07x	17.47x
EON Capital	5.25	2.67	3.34	3.82	1.97x	1.57x	1.37x	0.37	0.47	0.56	14.32x	11.08x	9.46x
Hong Leong	5.35	2.37	2.72	3.01	2.26x	1.96x	1.78x	0.35	0.40	0.34	15.20x	13.23x	15.58x
RHB Capital	2.27	1.90	1.47	2.25	1.19x	1.54x	1.01x	0.07	0.13	0.15	31.16x	17.48x	15.37x
Avg					2.25x	2.01x	1.78x				22.95x	17.54x	15.06x
Wtd avg					2.60x	2.39x	2.20x				23.03x	18.45x	16.41x

All prices in this report are as of 22 April 2004.

Source: Company data, ING estimates

Fig 17 Asia-Pacific financials universe: regional valuation – cont.

	Price	BVPS			P/BV			EPS			PER		
Company	**(lcy)**	**2002**	**2003**	**2004F**	**2002**	**2003**	**2004F**	**2002**	**2003**	**2004F**	**2002**	**2003**	**2004F**
KOREA													
Banks													
Kookmin	47,000	31,605	28,964	32,306	1.49x	1.62x	1.45x	3,992	(1,819)	3,975	11.77x	-25.84x	11.82x
Shinhan	23,000	13,550	15,164	17,170	1.70x	1.52x	1.34x	2,060	1,242	2,683	11.17x	18.52x	8.57x
Koram	15,200	7,526	7,805	8,926	2.02x	1.95x	1.70x	1,293	227	1,720	11.76x	66.83x	8.83x
Hana	27,800	16,066	18,853	23,232	1.73x	1.47x	1.20x	2,288	2,603	4,372	12.15x	10.68x	6.36x
IBK	8,600	7,510	7,532	8,439	1.15x	1.14x	1.02x	1,269	489	1,207	6.78x	17.60x	7.13x
Daegu	8,790	5,390	6,091	6,818	1.63x	1.44x	1.29x	1,023	838	1,030	8.59x	10.49x	8.53x
Pusan	7,430	5,562	6,387	7,018	1.34x	1.16x	1.06x	1,009	827	990	7.36x	8.99x	7.50x
Avg					1.58x	1.47x	1.29x				9.94x	22.18x	8.39x
Wtd avg					1.58x	1.54x	1.35x				10.99x	22.24x	9.43x
Brokers													
Hyundai	6,080	11,964	11,109	8,391	0.51x	0.55x	0.72x	179	(557)	(1,579)	33.95x	-10.91x	-3.85x
Samsung	25,600	22,212	23,772	25,088	1.15x	1.08x	1.02x	774	855	1,671	33.09x	29.93x	15.32x
Daishin	17,300	16,515	16,382	16,645	1.05x	1.06x	1.04x	180	567	809	96.32x	30.53x	21.38x
LGIS	10,700	10,279	10,128	10,606	1.04x	1.06x	1.01x	954	362	(24)	11.22x	29.59x	-444.82x
Daewoo	4,715	5,914	5,334	5,736	0.80x	0.88x	0.82x	283	(296)	261	16.66x	-15.94x	18.06x
Avg					0.91x	0.92x	0.92x				38.25x	30.02x	-97.51x
Wtd avg					0.96x	0.96x	0.94x				34.98x	29.95x	-109.55x
Insurance													
Samsung F+M	82,100	38,779	39,368	48,007	2.12x	2.09x	1.71x	5,190	5,057	3,508	15.82x	16.23x	23.40x
Korean Re	43,700	31,173	33,964	38,813	1.40x	1.29x	1.13x	6,363	5,374	6,375	6.87x	8.13x	6.85x
Oriental F+M	17,600	17,160	20,942	22,164	1.03x	0.84x	0.79x	5,089	3,970	2,690	3.46x	4.43x	6.54x
Avg					1.51x	1.40x	1.21x				8.71x	9.60x	12.27x
Wtd avg					2.01x	1.97x	1.62x				14.53x	15.05x	21.21x
TAIWAN													
Chinatrust	38.00	17.35	16.00	19.55	2.19x	2.38x	1.94x	2.61	1.14	3.16	14.56x	33.33x	12.03x
First FHC	27.00	14.99	14.58	15.96	1.80x	1.85x	1.69x	(6.47)	(1.45)	1.38	-4.17x	-18.62x	19.57x
Taishin	32.20	15.36	15.11	16.32	2.10x	2.13x	1.97x	1.77	2.02	2.71	18.19x	15.94x	11.88x
SinoPac	19.00	11.95	12.33	13.28	1.59x	1.54x	1.43x	0.93	1.27	1.40	20.43x	14.96x	13.57x
E.Sun	22.70	8.96	10.05	11.01	2.53x	2.26x	2.06x	(1.25)	1.75	1.74	-18.16x	12.97x	13.05x
Cosmos	23.00	10.49	11.31	12.89	2.19x	2.03x	1.78x	0.67	0.82	2.08	34.18x	28.19x	11.05x
Avg					2.07x	2.03x	1.81x				21.84x	21.08x	13.52x
Wtd avg					2.05x	2.09x	1.84x				18.31x	23.75x	13.94x
THAILAND													
Banks													
BBL	98.00	37.84	53.56	60.44	2.59x	1.83x	1.62x	4.28	6.73	9.32	22.92x	14.57x	10.52x
KBANK	54.50	14.91	20.58	24.99	3.66x	2.65x	2.18x	2.84	6.29	6.19	19.19x	8.66x	8.80x
SCB	48.25	16.64	23.88	24.87	2.90x	2.02x	1.94x	(3.99)	3.96	5.35	-12.10x	12.19x	9.02x
KTB	11.30	5.82	6.70	7.38	1.94x	1.69x	1.53x	0.72	0.78	1.46	15.78x	14.52x	7.73x
BAY	12.90	9.14	10.02	11.30	1.41x	1.29x	1.14x	1.15	1.30	1.57	11.27x	9.93x	8.23x
Avg					2.50x	1.89x	1.68x				17.29x	11.97x	8.86x
Wtd avg					2.69x	1.98x	1.77x				19.20x	12.51x	9.13x
Finance companies													
NFS	16.20	13.57	14.75	14.36	1.19x	1.10x	1.13x	0.64	0.89	1.11	25.29x	18.19x	14.55x
SPL	38.50	21.36	22.47	25.16	1.80x	1.71x	1.53x	3.89	4.21	5.38	9.90x	9.13x	7.16x
TISCO	30.00	8.91	10.44	12.60	3.37x	2.87x	2.38x	1.63	2.49	2.86	18.37x	12.07x	10.49x
AEONTS	141.00	30.14	38.82	52.09	4.68x	3.63x	2.71x	9.28	13.48	18.55	15.20x	10.46x	7.60x
MIDA	25.75	2.15	1.50	2.80	11.96x	17.17x	9.21x	0.36	1.04	2.10	70.64x	24.76x	12.28x
Avg					4.60x	5.30x	3.39x				27.88x	14.92x	10.42x
Wtd avg					11.02x	15.69x	8.48x				65.57x	23.66x	12.17x
INDONESIA													
BCA	3,925	2,042	2,316	2,658	1.92x	1.69x	1.48x	387	499	591	10.15x	7.87x	6.64x
Danamon	3,500	1,390	1,729	2,069	2.52x	2.02x	1.69x	312	461	566	11.23x	7.59x	6.18x
Panin	370	249	274	311	1.49x	1.35x	1.19x	28	32	38	13.15x	11.52x	9.64x
BII	150	70	85	102	2.13x	1.77x	1.47x	6	24	29	23.18x	6.26x	5.11x
Avg					2.02x	1.71x	1.46x				14.43x	8.31x	6.89x
Wtd avg					2.09x	1.77x	1.51x				12.52x	7.94x	6.60x
PHILIPPINES													
BPI	46.00	26.09	27.08	28.06	1.76x	1.70x	1.64x	2.72	2.99	3.47	16.90x	15.41x	13.27x
Metrobank	25.00	32.35	33.73	35.33	0.77x	0.74x	0.71x	1.53	1.85	1.48	16.30x	13.51x	16.91x
Equitable-PCI	40.00	34.52	36.56	39.22	1.16x	1.09x	1.02x	1.00	1.61	1.89	39.91x	24.87x	21.20x
PNB	23.00	42.52	44.44	35.65	0.54x	0.52x	0.65x	(5.16)	0.45	(2.73)	-4.46x	51.11x	-8.41x
Avg					1.06x	1.01x	1.00x				24.37x	17.93x	17.13x
Wtd avg					1.35x	1.30x	1.25x				21.01x	16.67x	15.68x

Source: Company data, ING estimates

Hong Kong

Playing the China card

Rating: Underweight

We remain **UNDERWEIGHT** Hong Kong financials in our regional financials portfolio with our rationale and analysis set forth below. However, we are still quite positive on consumption-related banks, as we believe that these companies are still undervalued and will lead in improving their results as reflation kicks in.

Our favourite financials in a rapidly shrinking field of Buy-rated Hong Kong stocks are **Standard Chartered** and **Aeon Credit**. Although it is leveraged to some of the same consumption-based drivers as the preceding, we have downgraded **Dah Sing Financial** to Sell based on poor corporate governance.

Key points from our sector analysis:

- Hong Kong banks are near historical peak valuations on both trailing and forward P/E bases. Statistically, this is a good time to sell rather than buy.
- Margins in Hong Kong are thin and competition engendered by excess deposits is keeping them low. Although this hardly makes Hong Kong unique within Asia, the market has been hit the hardest due to the absolute low level of deposit rates (benchmark HSBC savings rate is now *1/10th of a basis point*), which makes it difficult to cut funding costs further.
- High hopes for China access will inevitably turn sour at some point as investors come to grips with the fact that significant profitability is quite a way off.
- M&A fervour is receding, dimming hopes that marginally profitable franchises will be worth extraordinary prices. Simultaneously, new equity issues are soaking up investor demand and limiting interest in old issues.

Banking on the Asian consumer

The Scylla and Charybdis of Hong Kong banking are unemployment and negative equity mortgages. With both of these measures moving consistently in the right direction, we believe that the banking sector has successfully navigated its worst difficulties[2], although above-normal costs related to past mistakes remain to be taken over the next 18 months.

Unemployment peaked in July at 8.76%, and has since fallen back to 7.3% with the potential to hit 6% by YE2004. With unemployment the major indicator for bankruptcies and consumer charge-offs, we have thus seen a fall in insolvency filings for December that takes us back to 2001 levels (down 39% YoY), and a retreat in card losses to 9.85% for 3Q03 from a peak of 15.8% in 3Q02.

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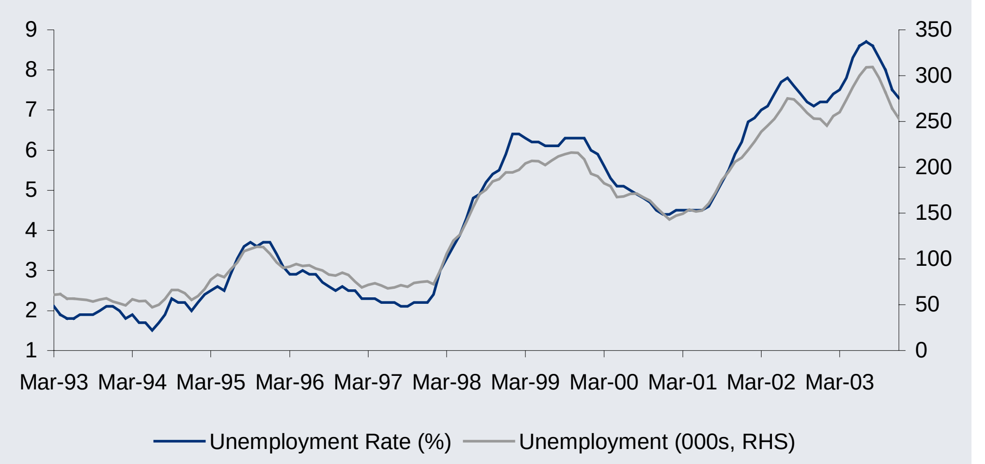
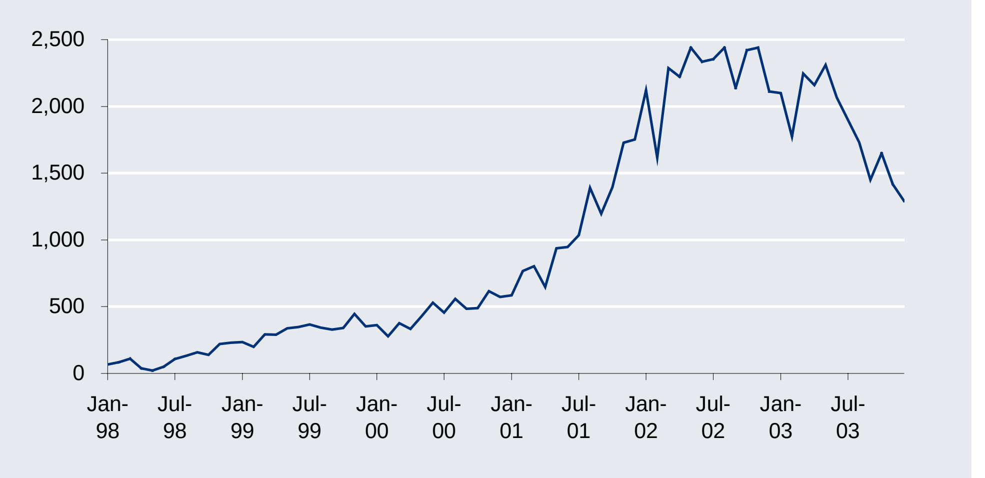
[2] Those who are tempted to carry the analogy too far will recollect that the passing of these obstacles was only the beginning of difficulties for the Ulysses' crew, who proceeded on to ruin on Thrinakia.

Fig 18 Hong Kong unemployment: 1993-present



Source: Hong Kong Census and Statistics Department

Fig 19 Hong Kong bankruptcy petitions: 1998-present



Source: Hong Kong Official Receiver's Office

Remember that we see four main factors as drivers of falling bankruptcy:

- **Improved credit quality.** The two serious issues for consumer credit quality in Hong Kong are unemployment and negative equity. As described above, both unemployment and negative equity are declining, and our analysis of the residential property market[3] strongly suggests that negative equity will be substantially lower by YE2005 – putting banks out of the danger zone. In short, the consumer is becoming increasingly likely to be able to pay her debts, and thus less likely to have to declare bankruptcy.

- **Burnout.** Simply put, the segment of the population with a disproportionate propensity to default (either through over-leverage or temperament) has already done so, meaning that even moderate rises in unemployment would not have equivalent effects on the bankruptcy rate.

- **Tighter standards.** Banks have significantly improved their credit standards since a year ago, with Aeon Credit reporting to us recently that its credit card approval rate had gone from 70% to 30% over that period. In addition, the initiation of

[3] Please refer to ING property analyst Eva Lee's recent report "*Hong Kong Property: 2004 – The rising sun*" for full details.

positive credit reporting in August means that banks have more tools to manage their credit exposure and cut off problem borrowers early.

- **IVA as a bankruptcy substitute.** Hong Kong's 1998 Bankruptcy Ordinance also introduced the Individual Voluntary Arrangement (IVA) as an alternative to bankruptcy. Of late, IVAs have become more popular – we suspect due to their intensive promotion by creditors who would prefer debt restructuring to write-offs.

Negative equity experiences negative growth

Our greatest systemic fear for the Hong Kong banks in 2002 and early 2003 was that the problem of consumer defaults on unsecured loans, which was largely limited to the lower-middle-class customer and below, would spread to the home-owning segment of the population – which is where the majority of Hong Kong banks' personal credit risk lies.

The risk of loss was driven by the vast number of borrowers (31% by volume at the peak) who were in negative equity positions despite initial loan-to-values of 70% or less. We know from our review of academic literature and practical studies that negative equity is a very strong predictor of default and loss – much more so than unemployment or household gearing.

The good news is that negative equity has begun to decline, with the overall uncollateralised balance declining by HK$58bn to HK$107bn at end-December, and negative equity loans falling from 31% to 20% of total outstandings. Although this is still far too high for comfort, current market prices would indicate that negative equity mortgages are already below 17% of outstandings.

With our appreciation forecast for mass residential properties (which account for most of the underlying property loans in negative equity) strong at 10% in 2004 and 15% in 2005, the problem of negative equity looks to be going away.

Fig 20 Negative equity mortgage statistics

	Sep-01	Mar-02	Jun-02	Sep-02	Dec-02	Mar-03	Jun-03	Sep-03	Dec-03
# of mortgages in negative equity	65,000	67,500	68,252	71,296	77,935	83,177	105,697	99,805	67,600
% of total mortgages	14%	14%	14%	15%	16%	17%	22%	20%	15%
Principal amount of negative equity loans (HK$bn)	127	115	118	120	129	135	165	155	107
As % of total outstanding value	23%	21%	21%	22%	24%	25%	31%	29%	20%
Loan-to-value ratio	NA	125%	127%	128%	127%	128%	128%	127%	126%
Weighted average interest rate	BLR - 0.27%	BLR-0.60%	BLR-0.70%	BLR-0.76%	BLR-0.83%	BLR-0.88%	BLR-1.07%	BLR-1.09%	NA

December 2003 data are ING estimates based on preliminary HKMA figures.
Source: HKMA, ING estimates

Which banks were exposed – and will now benefit?

Naturally, almost all banks are exposed to the mortgage market, with HSBC, Hang Seng, Standard Chartered and Bank of China (Hong Kong) leading the way – as would be expected given their large size. On a percentage basis, Standard Chartered, Hang Seng, HSBC and Wing Lung Bank head the list of mortgage exposure, with ICBC (Asia), Liu Chong Hing and Wing Hang Bank having the lowest investment in the sector among the banks. Consumer finance companies such as JCG and Aeon Credit have essentially no mortgage risk.

Fig 21 Mortgage and credit card exposure by bank

HK$m	Total loans	Mortgages	Credit cards	Reserves
HSBC*	539,401	242,015	19,696	8,882
HSB	227,475	113,568	5,578	2,935
STAN*	166,241	101,751	16,056**	3,336**
BOCHK	321,339	105,809	3,554	15,042
BEA	109,497	42,138	1,692	1,760
DSF	28,139	10,422	2,624	540
WHB	34,417	10,203	311	626
WLB	30,042	13,231	374	712
IBA	15,162	6,159	541	200
CKW	41,942	13,277	336	938
ICBC (Asia)	32,410	6,456	-	544
LCH	19,651	4,099	96	475
AEON	2,886	-	1,586	237
JCG	3,466	45	7	331

* Hong Kong books only. ** ING estimate
Source: Company reports, ING estimates

Obviously, looking at gross risk without considering credit reserves would be a mistake. Some banks that have very high mortgage risk have the lowest reserves (Hang Seng, IBA) while others (Wing Lung, among them) have high reserves to offset mortgage risks.

Note that BOCHK, commonly assumed to be among the most exposed banks due to its aggressive entry into the mortgage market, has only 33% of its portfolio in residential mortgages (versus 50% for Hang Seng Bank), and has reserves/loans of 4.7% (against 1.3% for HSB), a differential only partially explained by BOCHK's poor asset quality.

Fig 22 Mortgage and credit card exposure by bank relative to total loans (%)

	As a percentage of total loan		Reserves as a percentage of:		
	Mortgages	Credit cards	Loans	Mortgages	Credit cards
HSBC*	44.9	3.7	1.65	3.67	45.1
HSB	49.9	2.5	1.29	2.58	52.6
STAN*	61.2	9.7**	2.01**	3.28**	20.8**
BOCHK	32.9	1.1	4.68	14.22	423.2
BEA	38.5	1.5	1.61	4.18	104.0
DSF	37.0	9.3	1.92	5.18	20.6
WHB	29.6	0.9	1.82	6.13	201.3
WLB	44.0	1.2	2.37	5.38	190.5
IBA	40.6	3.6	1.32	3.25	37.0
CKW	31.7	0.8	2.24	7.06	279.4
ICBC (Asia)	19.9	0.0	1.68	8.42	NM
LCH	20.9	0.5	2.42	11.59	493.9
AEON	0.0	55.0	8.20	NM	14.9
JCG	1.3	0.2	9.56	739.73	5052.2

* Hong Kong books only. ** ING estimate
Source: Company reports, ING estimates

Direct property exposure

Although banks are by and large not as leveraged to the property market via direct holdings as they once were, real estate does retain a major chunk of their collective balance sheet. In 1H03, this came through as a negative, as banks were forced to take large write-downs and provisions against highly-valued property holdings – in general comprising bank premises, investment properties and foreclosed assets that once secured customer loans.

This drag on profitability should become a booster in 2H03 and 1H04 as buoyant prices begin to lift valuations once again. In addition to rising capital values, banks will find it easier to dispose of their property in a timely fashion and so be able to manage capital more effectively.

Among the banks most exposed to the property market through direct holdings are IBA, Liu Chong Hing, Wing Lung and Bank of China HK. It should be noted that banks have valued their property at different times and using different methods (some of which we find rather dubious), so that these figures represent only a rough estimate of comparative gearing to property.

By way of example, we note that IBA's large ORE portfolio has been on the books for some time, and management has indicated that there is difficulty selling the property at the booking value of HK$722m. To us, this means that the value has likely been overstated; however, a rising market and transaction volume mean that we think such a position will be steadily easier to escape without loss.

Fig 23 Property holdings of Hong Kong banks

HK$m	Total property	Investment property	Other foreclosed	Bank premises	Property/ mkt cap
HSBC	36,591	3,481	1,670	31,440	3.2%
HSB	10,600	3,279	638	6,683	5.4%
STAN	3,939			3,939	2.7%
BOCHK	19,200	5,757		13,443	12.5%
BEA	4,278	319		3,959	12.2%
DSF	891	218		673	6.1%
WHB	1,264	150		1,114	8.5%
WLB	1,490	909		581	12.8%
IBA	1,903		722	1,181	44.6%
CKW	1,645	152		1,493	12.9%
ICBC (Asia)	707			707	9.4%
LCH	1,062			1,062	19.8%
Total	72,971	10,987	2,392	59,592	4.2%

* Hong Kong banks only.

Source: Company data, ING estimates

China play

In June 2003, the governments of mainland China and the Hong Kong SAR signed the Closer Economic Partnership Arrangement (CEPA), which could potentially have a transformational effect on the Hong Kong banking sector. The market responded to this news with a surge of interest in banks with China exposure or potential, including BEA, BOCHK and even WHB.

We – like so many investors – have a long-run positive view of the potential of the China market as it relates to Hong Kong banks. However, we do not see any substantial revenue accruing to the banks over the next three years, with only minimal effects from offshore RMB deposit taking and clearing likely to show up in the P&L over this period. We therefore believe that there will be several rounds of successive euphoria and disillusionment over CEPA before it becomes a fundamental growth story.

Supporting our thesis on the profitability of the Hong Kong banks' China business is the failure of long-time entrants such as Bank of East Asia to report superior (or even acceptable) returns on capital that could be attributed to their mainland operations.

In addition, recent steps by mainland banks (including China Construction Bank, Bank of Communications, Bank of China and Minsheng Bank) reinforce our conviction that the government's incentive is to keep the market as closed as possible while sales are ongoing, so as not to dilute investors' interest with Hong Kong or foreign-based China-oriented banks from which it can reap no returns.

One potential way that we do see to access the China market through non-A share listed companies is through the Taiwanese banks, which we believe are much more plausible mainland plays than are most of the Hong Kong banks (*please turn to the Taiwan section of this report for further details*).

CEPA

Key provisions of CEPA relating to banking and our summary of the projected impact are as follows:

- **Cross-border M&A encouraged.** China will "[support] Mainland banks in developing network and business activities in Hong Kong through acquisition". (Article 13)

  Effect: This is clearly a boon to the current M&A environment among the smaller Hong Kong banks. Major state banks with locally-incorporated Hong Kong presence now include Bank of China (BOCHK), ICBC (ICBC Asia), and we believe that China Agricultural Bank, China Construction Bank and Bank of Communications are good candidates to purchase Hong Kong banks.

  We believe that the distressed nature of the Chinese state banking system makes it very likely that the government will seek to monetise the assets of the major banks, in many cases by injecting them into existing (or new) Hong Kong-listed vehicles. ICBC (Asia), given the extremely stressed nature of its parent's balance sheet, is a perfect candidate to receive asset injections – money received in return for these (or shares received which can then be sold) can be used to clean up additional operations, which can then be injected and so forth.

- **China branching asset threshold reduced.** "The asset requirement for both Hong Kong banks and Hong Kong finance companies wishing to enter the Mainland market is reduced to US$6bn" (from US$20bn). (Annex 4, sec. 3.XV)

  Effect: This will open up China branch opportunities for DBS Hong Kong (the parent group already has its own entrée), Citic Ka Wah, Shanghai Commercial, Wing Lung, ICBC (Asia), Dah Sing and Wing Hang. Banks still below the line in asset size include Liu Chong Hing, IBA, Bank of America (Asia) and Asia Commercial Bank. A major loser under this new scheme is BEA, which bought First Pacific Bank primarily to get over the US$20bn asset threshold and is now not only stuck with the ensuing low-quality portfolio but with a host of new competitors.

  Remember that this expanded access of right applies only to Hong Kong incorporated banks with a majority of their operations and employees based in Hong Kong. This clause eliminates both Standard Chartered (incorporated in the UK and operating in Hong Kong as a branch) and Citibank (incorporated in the US), despite their top-five asset size and StanChart's status as a clearing bank in Hong Kong.

  In StanChart's case, management has taken the option of seeking incorporation of its Hong Kong branch as a local bank using the company's existing banking licence (the HKMA has told us that it will absolutely approve such a move), instead of buying a locally-incorporated bank. There are still issues to be addressed in this incorporation, among them what to do with the corporation's existing mainland branches, which cannot be injected into a new entity without the approval of the PBOC.

Fig 24 Hong Kong banks: CEPA qualification summary

Bank	HK branches	Assets HK$m	Assets US$bn		Local incorporation?	CEPA eligible?
HSBC	161	1,987,562	254.8	**	Yes	**Yes**
Bank of China HK	246	735,494	94.3		Yes	**Yes**
Hang Seng Bank	139	482,308	61.8		Yes	**Yes**
StanChart	72	292,478	37.5	**,***	No	No
Citibank	21	250,060	32.1	*, **	No	No
Bank of East Asia	102	189,323	24.3		Yes	**Yes**
DBS Bank	70	131,802	16.9		Yes	**Yes**
ICBC/Fortis Pro-forma	45	95,539	12.2		Yes	**Yes**
WHB/Chekiang Pro-forma	43	88,234	11.3		Yes	**Yes**
Citic Ka Wah	34	79,253	10.2		Yes	**Yes**
Shanghai Commercial Bank	40	71,938	9.2		Yes	**Yes**
Wing Lung Bank	34	67,099	8.6		Yes	**Yes**
ICBC (Asia)	21	66,247	8.5		Yes	**Yes**
Dah Sing Financial	40	64,862	8.3		Yes	**Yes**
Wing Hang Bank	27	60,434	7.7		Yes	**Yes**
Liu Chong Hing Bank	35	38,337	4.9		Yes	No
Bank of America (Asia)	13	34,491	4.4	*	Yes	No
IBA	24	30,688	3.9		Yes	No
Fortis Bank Asia	24	29,292	3.8	*	No	No
Chekiang First Bank	16	27,800	3.6	*	Yes	No
Asia Commercial Bank	11	14,732	1.9	*	Yes	No
JCG Finance	39	5,035	0.6		Yes	No
Jian Sing Bank	3	2,736	0.4	*	Yes	No

* End-2002 data. ** Hong Kong assets only. ***Plans to incorporate locally.

Source: Company data, KPMG, ING estimates

- **Faster expansion.** "The existing requirement for a Hong Kong bank [or finance company] to set up a representative office before establishing a joint venture…company…is removed." (Annex 4, sec. 3.XV)

  "The requirement for conducting RMB business by Mainland branches of Hong Kong banks is lowered as follows: (1) The minimum requirement of prior business operation in the Mainland is reduced from 3 years to 2 years; (2) Profitability assessment is made on basis of the overall profitability position of all branches instead of the profitability position of individual branch." (Annex 4, sec. 3.XV)

  Effect: Both provisions are moderately positive for the faster expansion of mainland businesses, with the best returns going to larger banks that can afford the capital outlay for additional China branches.

- **Hong Kong as treasury centre.** China will encourage its state banks to locate their international treasury and forex dealing operations in Hong Kong. (Article 13)

  Effect: Not much direct impact on Hong Kong banks, although the strengthening of Hong Kong as a financial centre will benefit the more sophisticated institutions (HSBC, STAN, DBS) at the margin. In addition, increased currency and interbank business will generate more clearing business for HSBC (HKD/USD) and StanChart (HKD/EUR) – but margins here are very slim.

- **Hong Kong capital markets access enhanced.** China will "…support eligible Mainland insurance companies and other companies…in listing in Hong Kong." (Article 13)

  "Hong Kong Exchanges and Clearing Limited is permitted to set up a representative office in Beijing…" (Annex 4, sec. 3.XVI)

  Effect: Both provisions will spur the inflow of new mainland listings into Hong Kong, a boon for HKEx.

Renminbi business in Hong Kong

Deposits

Although the ability of Hong Kong banks to take offshore renminbi deposits was not an explicit part of the CEPA agreement, we felt that it was likely to take place – in no small part due to the worries of the PBOC about keeping tabs on the estimated Rmb65bn in cash that circulates in the SAR.

As at the end of February 2004, banks are permitted to offer personal banking services – mainly deposit accounts and remittances – in renminbi. So far, only the Bank of China (Hong Kong) has detailed its prospective services, but we expect HSBC, BEA, Hang Seng and other major banks will be close behind.

However, renminbi deposited in Hong Kong must be recycled into the interbank market via a clearing mechanism (run by designated agent, BOCHK) and cannot be used to make RMB-denominated loans through the banks' mainland branches. This is a critical point as foreign banks typically have no source of cheap core deposits on the mainland, and do most of their lending based on long-term interbank lines negotiated with domestic banks.

The PBOC has offered to absorb Hong Kong's renminbi deposits at an interest rate of 0.99% pa; after BOCHK's intermediation fee, the net interest paid to banks will be 0.865%. We anticipate that banks will offer consumers a rate very close to this due to intense competition, which will incidentally make renminbi deposits considerably more attractive than their low-yielding Hong Kong dollar counterparts.

Credit cards

With renminbi clearing approved for Hong Kong, we will also see the issuance of renminbi-denominated credit cards for Hong Kong residents. BOCHK has already announced the release of its card in 1H04, and as with renminbi banking, we expect other banks to follow suit.

Chinese renminbi cards issued through the China UnionPay programme have also been available for acceptance in Hong Kong since February 2004, with the PBOC permitting charges of up to Rmb5,000 per day. Although the number of accepting merchants is still small, charge volume is already running at over HK$1bn per year, with some merchants reporting that renminbi charges accounted for over half of their total credit card sales volume during the critical Lunar New Year period.

China UnionPay is a credit and debit card association with over 500m cards issued by 88 mainland banks. Press reports have it that the association has met with local Hong Kong banks to discuss giving them the ability to issue cards in the UnionPay network for Hong Kong residents who travel to the mainland frequently.

Such a move would also make it easier for Chinese citizens to bank offshore, as they will be able to keep their money in Hong Kong and still access it via a locally accepted credit card.

Loan growth

Total loan growth in Hong Kong continues to be negative, dropping at a 3.2% annual rate in 3Q03 and at a 2.0% rate in the most recently released figures. However, important trends have surfaced in recent months that bear watching.

Chief among these is the strong recovery in manufacturing lending, which has built upon a rising trend throughout the year to finish 3Q 12% above the comparable period of 2002. Note also that trade finance has recovered from its August lows and is once again adding to overall balance growth at an annual run rate of 6.5%.

Fig 25 HK loan growth

Source: HKMA

Loan growth has been climbing back towards zero on almost a monthly basis; although November was slightly weaker than October, December showed renewed progress. We are confident that Hong Kong will break into positive territory by the end of 1Q04. In fact, we may already be growing and not yet know it, although recent conferences with local banks do not show quite this level of optimism yet.

Negatives remain the battered consumer sector and residential property development, despite a brisk tailwind for property prices and resumed marketing of credit cards.

Although mortgage balances are still declining at about 2.3% YoY, new originations and approvals continue at a rate more than 30% above that of the year-earlier period. This should help us break the negative balance trend before mid-year 2004 and finish the year up 3.4% – this despite the continuing run-off in the HOS pool and increased sales to the HKMC.

Fig 26 Loans by sector (HK$m)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	3Q03
Manufacturing	63,731	73,720	85,845	100,137	107,530	110,675	94,609	80,169	73,726	71,227	70,668	77,636
Agriculture and fisheries	500	532	569	847	979	982	1,617	1,312	1,687	1,025	412	340
Transport and transport equipment	58,076	62,701	71,813	68,992	82,860	96,208	106,272	103,333	105,156	101,720	104,129	106,156
Electricity, gas and telephone	9,952	12,984	19,805	21,974	24,996	27,186	28,712	25,855	75,855	57,762	56,233	42,366
Property development and investment	144,533	180,439	249,112	262,199	333,032	440,296	416,226	384,127	398,365	388,833	378,945	364,805
Industrial	11,856	13,633	13,653	14,885	12,437	11,151	9,505	7,141	6,596	6,550	7,229	6,164
Residential	34,511	42,840	72,534	78,918	118,965	194,821	179,499	173,416	179,136	172,594	168,975	157,622
Commercial	58,174	72,115	94,711	102,214	113,364	122,711	111,974	100,533	105,031	103,470	111,430	114,669
Other	39,992	51,851	68,214	66,182	88,266	111,613	115,249	103,037	107,602	106,218	91,312	86,350
Wholesale and retail trade	88,152	99,405	137,472	166,281	176,497	205,679	179,668	144,075	120,155	101,184	100,367	96,590
Mining and quarrying	563	627	719	525	372	281	98	84	158	123	182	166
Consumer	279,448	337,674	372,431	429,985	518,950	662,787	708,877	727,080	758,930	783,647	773,059	741,287
Mortgages	224,258	268,031	298,496	349,209	421,890	540,800	589,658	608,559	626,387	646,910	641,645	617,918
HOS	21,628	34,886	39,939	47,494	50,620	60,399	74,227	76,189	90,524	107,187	99,214	89,811
Private	202,630	233,145	258,557	301,715	371,270	480,401	515,431	532,370	535,863	539,723	542,431	528,107
Credit cards	10,104	14,079	15,683	20,216	23,707	30,573	34,846	37,344	48,602	54,829	51,361	47,260
Other personal lending	45,086	55,564	58,252	60,560	73,353	91,414	84,373	81,177	83,941	81,908	80,053	76,109
Miscellaneous	264,958	307,696	320,824	347,254	391,975	493,184	424,292	353,756	327,434	284,579	258,912	261,249
Loans and advances for use in Hong Kong	909,913	1,075,778	1,258,590	1,398,194	1,637,191	2,037,278	1,960,371	1,819,791	1,861,466	1,790,100	1,742,907	1,690,595

Source: HKMA

Fig 27 Loans by sector (% Chg YoY)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	3Q03
Manufacturing	16.9	15.7	16.4	16.6	7.4	2.9	(14.5)	(15.3)	(8.0)	(3.4)	(0.8)	12.0
Agriculture and fisheries	16.6	6.4	7.0	48.9	15.6	0.3	64.7	(18.9)	28.6	(39.2)	(59.8)	(21.9)
Transport and transport equipment	13.3	8.0	14.5	(3.9)	20.1	16.1	10.5	(2.8)	1.8	(3.3)	2.4	4.1
Electricity, gas and telephone	0.1	30.5	52.5	11.0	13.8	8.8	5.6	(10.0)	193.4	(23.9)	(2.6)	(24.4)
Property development and investment	15.0	24.8	38.1	5.3	27.0	32.2	(5.5)	(7.7)	3.7	(2.4)	(2.5)	(1.7)
Industrial	10.7	15.0	0.1	9.0	(16.4)	(10.3)	(14.8)	(24.9)	(7.6)	(0.7)	10.4	(17.8)
Residential	15.0	24.1	69.3	8.8	50.7	63.8	(7.9)	(3.4)	3.3	(3.7)	(2.1)	(5.3)
Commercial	18.1	24.0	31.3	7.9	10.9	8.2	(8.7)	(10.2)	4.5	(1.5)	7.7	10.9
Other	12.0	29.7	31.6	(3.0)	33.4	26.5	3.3	(10.6)	4.4	(1.3)	(14.0)	(8.0)
Wholesale and retail trade	9.3	12.8	38.3	21.0	6.1	16.5	(12.6)	(19.8)	(16.6)	(15.8)	(0.8)	(4.8)
Mining and quarrying	(30.2)	11.4	14.7	(27.0)	(29.1)	(24.5)	(65.1)	(14.3)	88.1	(22.2)	48.0	17.6
Consumer	13.3	20.8	10.3	15.5	20.7	27.7	7.0	2.6	4.4	3.3	(1.4)	(5.0)
Mortgages	12.6	19.5	11.4	17.0	20.8	28.2	9.0	3.2	2.9	3.3	(0.8)	(4.4)
HOS	13.4	61.3	14.5	18.9	6.6	19.3	22.9	2.6	18.8	18.4	(7.4)	(10.3)
Private	12.5	15.1	10.9	16.7	23.1	29.4	7.3	3.3	0.7	0.7	0.5	(3.3)
Credit cards	45.4	39.3	11.4	28.9	17.3	29.0	14.0	7.2	30.1	12.8	(6.3)	(8.5)
Other personal lending	11.2	23.2	4.8	4.0	21.1	24.6	(7.7)	(3.8)	3.4	(2.4)	(2.3)	(7.3)
Miscellaneous	7.2	16.1	4.3	8.2	12.9	25.8	(14.0)	(16.6)	(7.4)	(13.1)	(9.0)	(2.0)
Loans and advances for use in Hong Kong	11.4	18.2	17.0	11.1	17.1	24.4	(3.8)	(7.2)	2.3	(3.8)	(2.6)	(3.2)

Source: HKMA

Forward estimates

We have substantially higher loan growth estimates for 2004-06. In effect, we are calling for a turn in lending dynamics. Key factors in our loan growth model are real GDP growth (positively correlated), CPI (positively correlated) and real interest rates (negatively correlated).

Fig 28 Key Hong Kong economic forecasts

	01	02	03F	04F	05F
GDP (% chg YoY)	0.6	2.3	2.3	5.0	4.5
CPI (% chg YoY)	-1.6	-3.0	-2.6	-1.0	1.0
3m interbank rate (%)	2.1	1.5	0.8	2.5	4.0

Source: CEIC, Reuters, Bloomberg, ING

The correction of Hong Kong's deflationary environment means that all three of these variables are moving in the right direction, although in the case of GDP growth there is generally a lag of at least 12 months before changes are reflected in lending. On ING's estimates, these variables equate to a sector forecast of 2.2% loan growth for 2004, 4.9% for 2005 and 5.4% for 2006 for loans for use in Hong Kong.

Do not confuse credit creation with loan growth. However, new moves to securitise more mortgages and the increasing dominance of the fixed income markets in financing large corporate capex will hold down balance sheet asset increases in this cycle to well below those of the heyday.

Fig 29 Loans by sector with 2003-06 forecasts (% Chg YoY)

	1999	2000	2001	2002	2003	2004	2005	2006
Manufacturing	**(15.3)**	**(8.0)**	**(3.4)**	**(0.8)**	**(0.5)**	**4.5**	**8.0**	**7.5**
Agriculture and fisheries	**(18.9)**	**28.6**	**(39.2)**	**(59.8)**	**(12.0)**	**(4.0)**	**(4.0)**	**(4.0)**
Transport & transport equipment	**(2.8)**	**1.8**	**(3.3)**	**2.4**	**(9.0)**	**1.0**	**3.6**	**4.8**
Electricity, gas & telephone	**(10.0)**	**193.4**	**(23.9)**	**(2.6)**	**1.5**	**2.0**	**2.5**	**3.1**
Property development and investment	**(7.7)**	**3.7**	**(2.4)**	**(2.5)**	**(2.4)**	**(0.5)**	**2.7**	**5.3**
Industrial	(24.9)	(7.6)	(0.7)	10.4	4.0	(3.0)	1.3	6.0
Residential	(3.4)	3.3	(3.7)	(2.1)	(4.0)	1.0	4.5	7.2
Commercial	(10.2)	4.5	(1.5)	7.7	(0.7)	(1.2)	1.0	5.4
Other	(10.6)	4.4	(1.3)	(14.0)	(2.0)	(2.0)	1.5	1.5
Wholesale and retail trade	**(19.8)**	**(16.6)**	**(15.8)**	**(0.8)**	**(4.0)**	**4.2**	**7.2**	**8.0**
Mining and quarrying	**(14.3)**	**88.1**	**(22.2)**	**48.0**	**1.5**	**4.0**	**5.5**	**5.7**
Consumer	**2.6**	**4.4**	**3.3**	**(1.4)**	**(3.3)**	**3.2**	**5.4**	**4.9**
Mortgages	3.2	2.9	3.3	(0.8)	(3.1)	3.4	5.6	4.5
HOS	2.6	18.8	18.4	(7.4)	(11.0)	(7.0)	(5.0)	(5.0)
Private	3.3	0.7	0.7	0.5	(1.6)	5.1	7.1	5.8
Credit cards	7.2	30.1	12.8	(6.3)	(5.0)	2.0	6.2	9.3
Other personal lending	(3.8)	3.4	(2.4)	(2.3)	(4.0)	2.2	3.8	5.0
Miscellaneous	**(16.6)**	**(7.4)**	**(13.1)**	**(9.0)**	**(2.5)**	**2.0**	**6.0**	**6.0**
Loans and advances for use in Hong Kong	**(7.2)**	**2.3**	**(3.8)**	**(2.6)**	**(3.1)**	**2.2**	**4.9**	**5.4**

Source: HKMA, ING estimates

In addition, a new (and difficult-to-quantify) factor to the model is the potential effect of additional lending in China under CEPA and, eventually, WTO. Although we foresee China's GDP growth rate falling from a peak of 10% in 4Q03 to 7.5% in FY05, there is clearly still demand for additional funding from borrowers.

There are certainly a plethora of domestic banks eager to service this demand, but the Hong Kong banks do retain certain advantages in security and sophistication that will permit them to find a niche. Remember also that the banks have many existing customers who do business (and borrow) on the mainland and who would presumably be amenable to being serviced by their primary bankers in both markets.

We estimate that new regulations will permit and the amount of capital investment planned would support approximately US$10bn of additional lending by Hong Kong banks by YE2006. This would add 0.5-1% to total sector growth, with most of the spoils going to the largest banks – HSBC, Standard Chartered and Bank of China (Hong Kong) – and to Bank of East Asia.

Note that the added profitability from this mainland loan expansion – which as described above is being margin-limited by the lack of stable core renminbi funding sources – is rather paltry compared to the market impact that its expectation has had.

M&A: Was that it?

Consolidation of the Hong Kong banking sector is an evergreen story, but one that looked as though it was finally coming to pass in 2003. In August, Wing Hang Bank announced the acquisition of unlisted Chekiang First Bank from parent Mizuho, followed closely by ICBC (Asia)'s announcement that it would acquire Fortis Bank Asia HK. In addition, Taiwan's Fubon FHC purchased 75% of International Bank of Asia via a general offer, and majority-owner Public Bank made an unsuccessful privatisation bid for JCG Holdings.

We point out first of all that the use of the term 'consolidation' to describe events in Hong Kong is slightly overwrought given that Hong Kong is already one of the most highly concentrated banking markets in the world, with the leading player (HSBC, of course) holding 41% market share and the top five collectively taking 71%.

We do think that the small banks in Hong Kong will continue to disappear, due to a combination of poor economics and pressure from the HKMA to sell out. Likely to exit or transform themselves in some way are Bank of America (Asia), Liu Chong Hing, JCG and potentially even Wing Hang.

However, in contrast to the heady days of 2000-01, when foreign banks prowled the banking district of Hong Kong looking for targets at immense prices – DBS' 2001 purchase of Dao Heng Bank for 3.3x book value is a landmark in misplaced optimism – bidders seem much more subdued at this point, with both the CFB and IBA transactions priced at around 1.2x book value and the Fortis asset acquisition at 1.05x.

Wing Hang placement signals limited M&A gains

Bank of New York placed 14.45m shares of WHB on 27 January at HK$50.615 per share, a 4.5% discount to the previous close – which was an all-time high for the company since its 1993 listing. BONY owned 25% of WHB before the placement and will continue to own 20% afterwards.

Valuation for the transaction was 2.34x trailing BV and 20x 2003 (16x 2004) forecast EPS per I/B/E/S consensus. WHB last traded at these multiples in October 1997... certainly a blast from the past.

We assume based on the sale and management's statement about "reallocating capital" towards priorities that BONY is no longer committed to its remaining 20% stake in WHB as there is no real strategic relationship between the two.

Interestingly, a market placement likely means that BONY was not able to sell its WHB stake to another Hong Kong (or foreign) bank looking to acquire the institution, or it would presumably have received a premium and not a discount, and would in addition have been able to dispose of the entire block in one go.

This is negative for sector valuations as it means that potential buyers of small Hong Kong banks may no longer be interested; certainly WHB was one of the best available franchises. It is also possible that no potential strategic buyers of WHB were able to work out an acceptable deal with the Fung family, which would be a bad long-term sign for the bank but perhaps not the sector.

Such a transaction confirms our view that the Hong Kong banks are trading at peak valuations.

Other thoughts on the WHB placement:

- We expect the rest of BONY's stake is now an overhang and will be sold in the next year or two.
- Other minority Hong Kong bank stakes include UFJ's 15% stake in DSF. WLB has agreed to buy back the 10% stake in the bank owned by DBS.

We think a DSF placement is likely, especially given the similar all-time high price and distressed nature of the parent. It remains to be seen how this will fit in with Dah Sing's move to a two-tier holding company structure.

Valuations reached peak levels

Hong Kong bank valuations approached historic highs on an earnings basis in January, with the sector average[4] reaching 21x trailing EPS – a level only reached in recent memory in late 1999 and 1993. Note that HSBC's multiple development (we look at it separately as it would otherwise overwhelm the market-cap-weighted average) has been even more phenomenal.

In our January Hong Kong banks review[5], we noted that this elevated level was associated with poor performance. A combination of the market pullback and fiscal year rollover has brought the trailing EPS multiple for the sector down to 18.5x – still well above the long-run average of 13.7x.

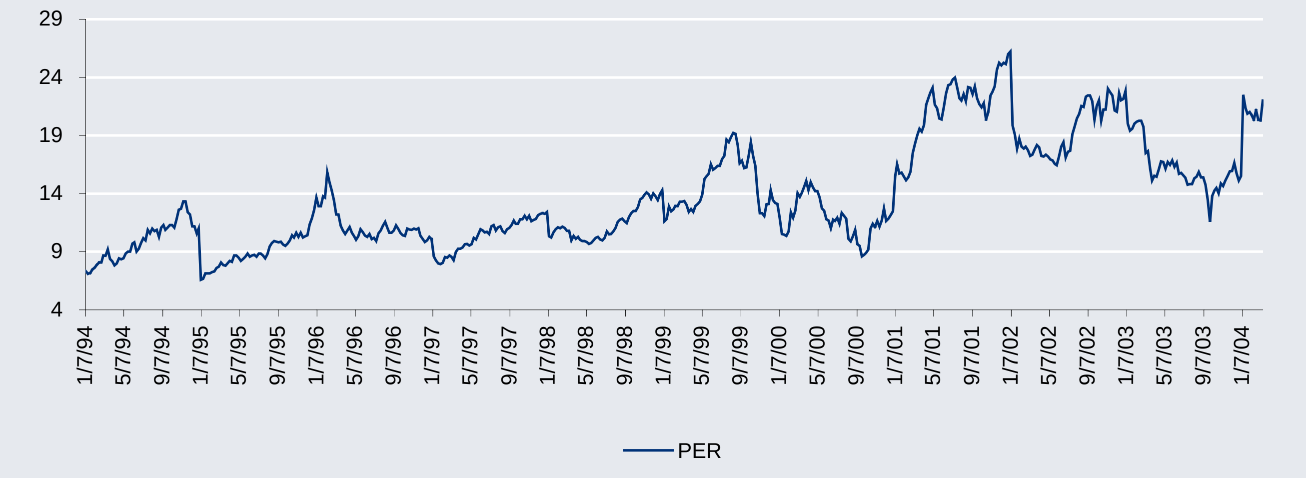
Fig 30 Average Hong Kong bank trailing PER (ex-HSBC): 1994-present

Source: Company data, Datastream, ING estimates

[4] Our average includes HSB, BEA, DSF, WHB and WLB. We exclude HSBC and STAN from our pure Hong Kong bank average because of their changing geographic mix over the applicable time period, and BOCHK as it was not listed until 2002.

[5] *Hong Kong Banks: January update – the slippery slope*, dated 28 January 2004.

Fig 31 HSBC trailing PER: 1994-present

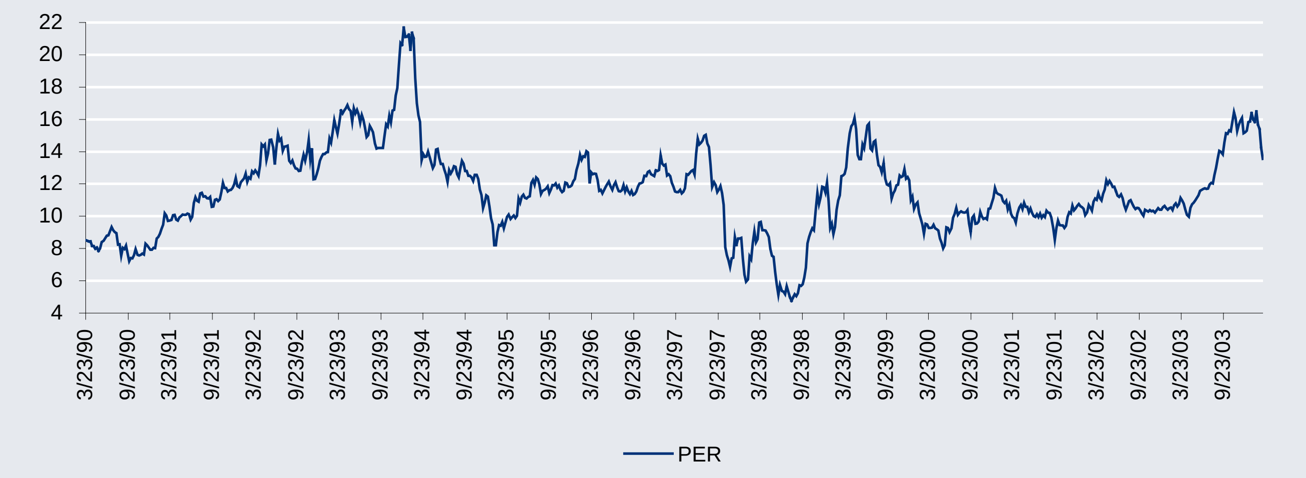


Source: Company data, Datastream, ING estimates

Why look at trailing earnings? Our rationale was that actual reported EPS is the hardest number to fake (although some have tried) and less sensitive to over-optimism (or pessimism) about the future.

However, the case can be made that Hong Kong banks are traded up to high trailing multiples due to depressed earnings during a period of falling real estate prices, sky-high consumer bankruptcies and SARS – none of which currently applies. Although this could also be said of other periods within our historical analysis (with late 1999 being the best example), we have also gone on to look at PER on a historical forecast basis using I/B/E/S data.

Fig 32 Average Hong Kong bank forward PER (ex-HSBC): 1994-present



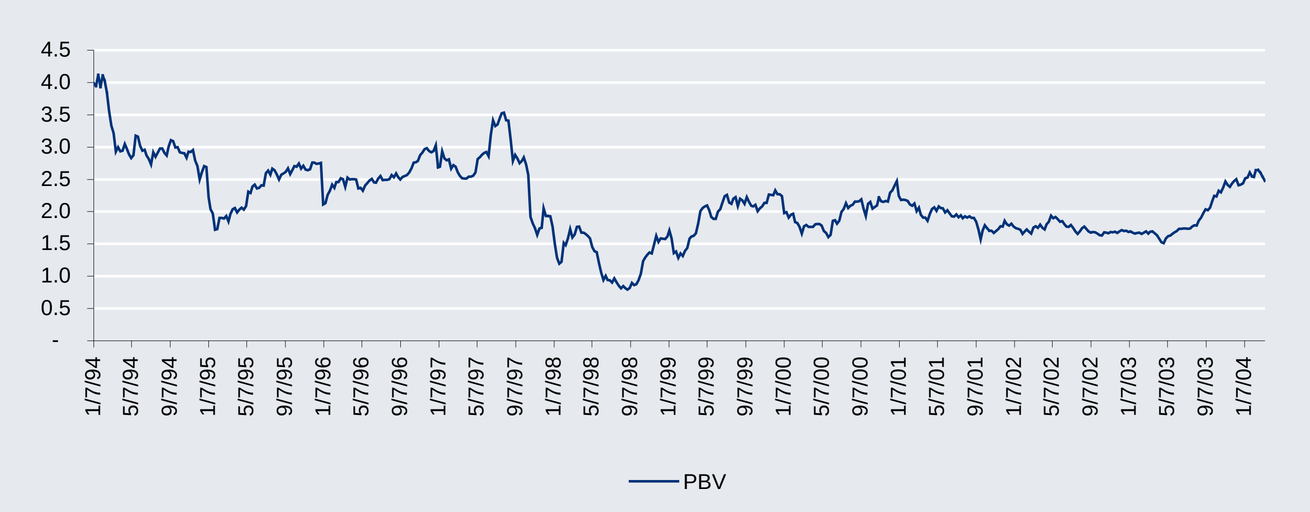
Source: Company data, Datastream, ING estimates

On a forward EPS basis (next fiscal year), Hong Kong banks currently trade at an average PER of 14.7x, well above the 11.5x long-run average but down from the 16x peak reached in February – again in part due to the roll-over to FY04 estimates.

Our analysis reveals that the sector has traded at over 15x forward EPS on only six occasions (a few of them quite brief) since 1990, for an aggregate 56 weeks of 671 (8% of the time). On average, the sector return over the following 12 months has been -8.7%.

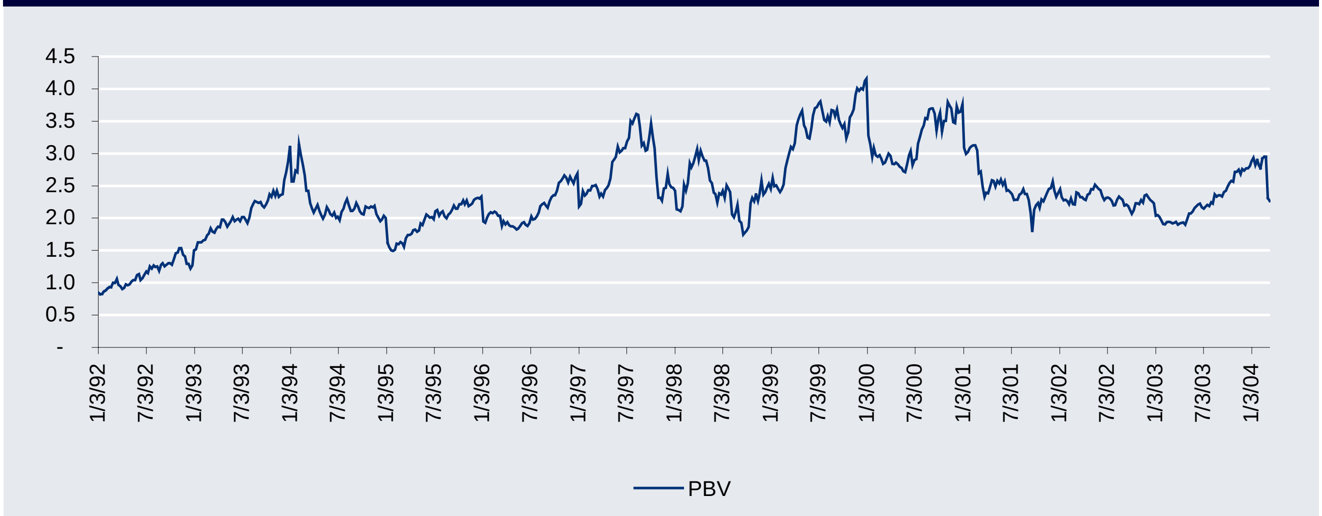
In contrast, banks have traded at single-digit forward multiples 27% of the time, with average market returns over the next 12 months of +50%. At current PERs, banks have historically eked out a positive return of 3.8% over the next 12 months.

Fig 33 Average Hong Kong bank trailing P/BV (ex-HSBC): 1994-present



Source: Company data, Datastream, ING estimates

Fig 34 HSBC trailing P/BV: 1994-present



Source: Company data, Datastream, ING estimates

Price-to-book multiple analysis is less revealing, although it still shows banks at a post-crisis resistance level of 2x stated book. On a projected sector ROE of under 15% for 2004, this is difficult to justify without projecting further transformational gains.

Fig 35 Hong Kong bank valuations

	BBG code	Price (HK$)	Mkt cap (US$m)	ING rating	Target price (HK$)	BVPS (HK$)	End-2003 P/BV (x)	PER (x) 2002	2003	2004F
HSBC	5 HK	115.00	162,005.41	HOLD	115.00	53.00	2.17	22.4	18.4	15.9
HSB	11 HK	98.25	24,143.78	SELL	90.00	20.73	4.74	18.9	19.7	18.9
STAN	2888 HK	123.50	18,567.78	BUY	160.00	47.21	2.62	25.0	19.2	14.9
BOCHK	2388 HK	13.95	18,957.62	HOLD	12.35	5.70	2.45	22.1	18.5	15.1
BEA	23 HK	22.80	4,251.81	SELL	20.00	13.83	1.65	25.7	17.2	16.3
DSF	440 HK	55.25	1,751.80	SELL	54.00	27.51	2.01	16.4	13.7	12.5
WHB	302 HK	50.25	1,897.49	NR	N/A	22.76	2.21	21.7	17.1	13.1
WLB	96 HK	58.00	1,730.98	NR	N/A	37.08	1.56	17.8	15.7	13.3
IBA	636 HK	3.28	494.18	SELL	2.66	3.23	1.02	17.1	27.8	19.1
CKW	183 HK	3.33	1,365.32	NR	N/A	2.45	1.36	16.4	15.9	12.8
ICBC (Asia)	349 HK	9.85	790.50	NR	N/A	9.48	1.04	14.1	13.9	11.8
LCH	1111 HK	11.25	629.02	NR	N/A	13.67	0.82	15.8	15.6	14.8
HKEx	388 HK	15.20	2,038.89	BUY	19.50	5.35	2.84	26.7	23.0	17.5
AEON	900 HK	5.85	314.88	BUY	6.00	2.83	2.07	11.7	20.5	11.5
JCG	626 HK	6.30	573.12	SELL	5.20	4.78	1.32	18.5	19.5	12.6
Average							1.99	19.4	18.4	14.7

Note that forward earnings estimates for non-covered companies are consensus forecasts per I/B/E/S.
Source: Company data, ING estimates, I/B/E/S.

HSBC

The Asian multinational

Rating: HOLD

The global footprint

Despite its roots in China and the still-lucrative monopoly franchise HSBC enjoys in Hong Kong, the modern HSBC is essentially a developed market bank, with 55% of net income coming from Europe and the US.

The challenge for the bank is that on an ROA basis these are the two least profitable markets for HSBC—entirely as befits developed markets with low growth and entrenched competitors.

Fig 36 Pre-tax contribution by market: 1996-2003

	1996	1997	1998	1999	2000	2001	2002	2003
Europe	2,368	3,201	2,884	3,322	3,658	3,542	3,500	3,969
Hong Kong	2,775	3,246	2,427	3,054	3,691	3,883	3,710	3,728
Rest of Asia-Pacific	1,101	651	39	329	1,265	1,088	1,260	1,391
North America	792	950	987	959	850	481	1,928	3,072
Latin America	16	82	234	318	311	(994)	(748)	656
Total	7,052	8,130	6,571	7,982	9,775	8,000	9,650	12,816

Source: Company data, ING estimates

Fig 37 Pre-tax contribution by market (% of total): 1996-2003

	1996	1997	1998	1999	2000	2001	2002	2003
Europe	33.6%	39.4%	43.9%	41.6%	37.4%	44.3%	36.3%	31.0%
Hong Kong	39.4%	39.9%	36.9%	38.3%	37.8%	48.5%	38.4%	29.1%
Rest of Asia-Pacific	15.6%	8.0%	0.6%	4.1%	12.9%	13.6%	13.1%	10.9%
North America	11.2%	11.7%	15.0%	12.0%	8.7%	6.0%	20.0%	24.0%
Latin America	0.2%	1.0%	3.6%	4.0%	3.2%	-12.4%	-7.7%	5.1%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Company data, ING estimates

Fig 38 Average assets by market: 1996-2003

US$m	1996	1997	1998	1999	2000	2001	2002	2003	% Chg YoY
Europe	129,757	156,020	178,073	201,023	253,248	296,483	319,905	383,441	20%
Hong Kong	119,572	148,591	166,615	157,274	170,983	176,145	178,135	188,960	6%
Rest of Asia-Pacific	45,641	52,007	52,515	56,272	55,984	59,507	69,487	87,358	26%
North America	50,168	67,740	72,566	87,012	114,087	127,335	130,884	398,439	204%
Latin America	-	9,178	11,458	15,898	18,127	17,146	20,295	54,433	168%
Total	377,200	437,032	477,407	517,477	612,428	676,615	718,705	1,112,631	55%

Source: Company data, ING estimates

Fig 39 Pre-tax ROAA by market: 1996-2003

	1996	1997	1998	1999	2000	2001	2002	2003
Europe	1.82%	2.05%	1.62%	1.65%	1.44%	1.19%	1.09%	1.04%
Hong Kong	2.32%	2.18%	1.46%	1.94%	2.16%	2.20%	2.08%	1.97%
Rest of Asia-Pacific	2.41%	1.25%	0.07%	0.58%	2.26%	1.83%	1.81%	1.59%
North America	1.58%	1.40%	1.36%	1.10%	0.75%	0.38%	1.47%	0.77%
Latin America	NA	0.89%	2.04%	2.00%	1.72%	-5.80%	-3.69%	1.21%
Total	1.87%	1.86%	1.38%	1.54%	1.60%	1.18%	1.34%	1.15%

Source: Company data, ING estimates

Growing by acquisition

Many of HSBC's core businesses have been reasonably stagnant over the past three years, with its Hong Kong franchises (Hongkong Bank and 63%-owned Hang Seng Bank) unable to transcend a fundamentally poor market despite superior operations, US assets not making much progress, Latin America experiencing a series of disasters, and most of the rest of the world too small to make an appreciable difference. The European (mainly UK + CCF) business has been the only major area to grow its book, averaging high single digits since YE2000.

Instead, HSBC has maintained its growth and changed the bank's geographic profile and ambitions through a series of acquisitions. We briefly discuss some of the most significant below.

Household International

HSBC completed its acquisition of Household International at the end of March 2003, issuing 14.8% new shares in payment for a 100% stake in the company.

Household offers a variety of consumer finance products to its customer base in the US, Canada, and the UK. The company's loans are primarily mortgage and home equity loans (43%) and outstanding credit card receivables (32%), although auto lending and unsecured personal loans are also significant contributors to the overall business.

Fig 40 Household loan book by product

	YE 2002		YE 1998	
	Balances	% of Total	Balances	% of Total
Mortgage and HELOAN	46,275	43.0%	22,486	35.2%
Auto finance	7,442	6.9%	1,765	2.8%
MasterCard/Visa	18,953	17.6%	16,611	26.0%
Private label credit cards	14,917	13.9%	10,378	16.2%
Personal loans	19,446	18.1%	11,971	18.7%
Commercial and other	463	0.4%	697	1.1%

Source: Company data, ING

HI is also the eighth-largest issuer of credit cards in the US with approximately 20 million customer accounts, roughly the same relative position the company has held since 1995. HI's main products in the credit card sector are the GM Card, a co-branded card which allows clients to earn discounts on General Motors cars, and the AFL-CIO Union Plus card, which is marketed to union members. In addition to these Mastercard and VISA products, the company issues private-label credit cards for retailers including Best Buy, Costco, Microsoft, CompUSA, and Sony.

Branch network

Household's branch network is widespread and covers almost every major US population centre, with over 1,300 branches in 45 of the 50 United States, as well as over 100 in Canada and 224 branches in the United Kingdom. In addition, the company sources loans through 4,500 auto dealers and 14,000 tax preparation outlets (representing largely 9,900 H&R Block and 546 Jackson Hewitt locations).

By comparison, HSBC's 442 US bank branches are almost all located in New York State, products of the group's acquisition of Marine Midland Bank and Republic Bank. Within New York, most offices are either in the metro New York City area (old Republic

Bank territory) or in Buffalo and Rochester (the former Marine Midland network). The company also has approximately 120 banking offices in Canada.

Household makes most of its US loans in California, the Midwest, and the Southeast, with a relatively even national credit card portfolio evening out some of the regional skew away from the Northeast and Mid-Atlantic states. Note as per our analysis above that HI has relatively little overlap with HSBC geographically.

Fig 41 Household International geographic distribution by product

	Northeast	Mid-Atlantic	Southeast	Southwest	Midwest	California	West	Total
Mortgage	7%	10%	24%	11%	21%	17%	10%	100%
Consumer	12%	17%	15%	8%	22%	16%	10%	100%
MasterCard/Visa	16%	14%	12%	11%	26%	14%	7%	100%
Private label cards	9%	12%	25%	16%	19%	13%	6%	100%
Auto	3%	15%	29%	18%	17%	14%	4%	100%
Total	10%	13%	21%	12%	22%	16%	8%	100%

Source: Company data, ING

Returns

Household was an extremely profitable business prior to its acquisition despite legal turmoil, and has remained so since the HSBC acquisition. For this reason, the purchase was very accretive from an earnings standpoint, with the purchase price equivalent to 9.7x depressed 2002 reported net income versus HSBC's own 18x multiple on 2002 earnings at the time of purchase.

Fig 42 Household International key earnings components: 1997-2002

US$m	1997	1998	1999	2000	2001	2002
Net interest income	2,979	3,291	3,937	4,887	5,941	6,774
Non-interest income	3,041	2,885	2,670	3,010	3,651	4,342
Non-interest expenses	2,982	2,740	2,621	3,123	3,718	4,233
Loan loss provisions	1,493	1,517	1,716	2,117	2,913	3,732
Core income	923	1,320	1,419	1,621	1,833	2,398
Net income	923	509	1,419	1,621	1,833	1,495
EPS	1.90	1.05	3.03	3.44	4.01	3.15

Source: Company data, ING

Fig 43 Household International key earnings ratios: 1997-2002

	1997	1998	1999	2000	2001	2002
ROA	2.42%	1.02%	2.50%	2.36%	2.21%	1.60%
Core ROA	2.42%	2.65%	2.50%	2.36%	2.21%	2.57%
ROE	20.26%	8.21%	22.40%	22.52%	23.21%	17.52%
Core ROE	20.26%	21.29%	22.40%	22.52%	23.21%	28.11%
NIM	8.69%	7.36%	7.63%	7.73%	7.70%	7.71%
Cost/income	49.55%	44.37%	39.67%	39.55%	38.76%	38.08%
Overhead	8.70%	6.13%	5.08%	4.94%	4.82%	4.82%
Effective tax rate	29.94%	22.34%	30.87%	32.71%	32.78%	22.06%

Source: Company data, ING

Bank of Bermuda

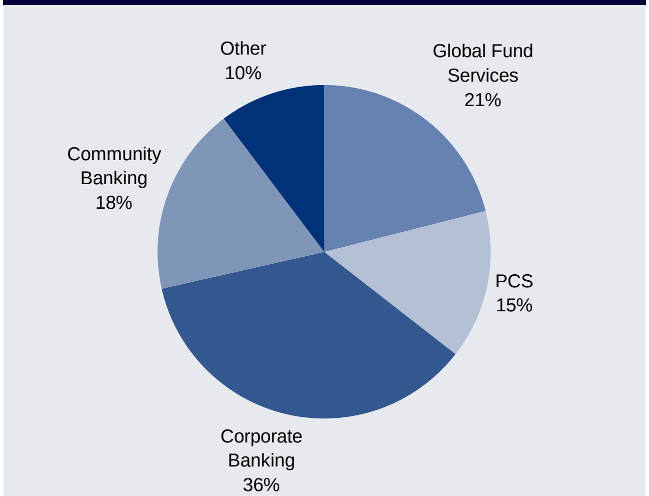
HSBC management announced in late October 2003 that the bank had concluded an agreement to buy 100% of Bank of Bermuda (BoB). The transaction, which was concluded in February despite some grumbling from BoB shareholders, was valued at

US$45 per BoB share, a 12.5% premium to the last closing price of BoB's thinly-traded stock, for a total of US$1.3bn.

BoB is not mainly a traditional commercial bank (although it does have some corporate lending and retail functions), but rather derives most of its revenues from mutual fund and hedge fund custody and other services. In addition, the institution is a respectable competitor in private banking.

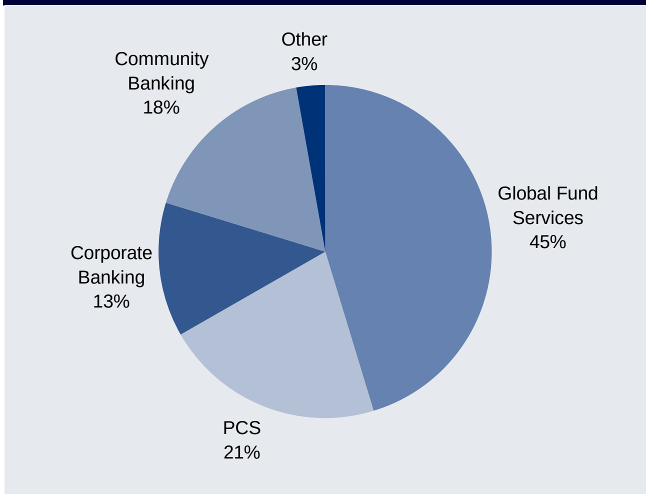
BoB has four major business lines, with fund management accounting for the major chunk of revenues and profits. Key points on each business area:

Fig 44 BoB profits by business line: FY02



Source: Company data

Fig 45 BoB revenues by business line: FY02



Source: Company data

Fund services

BoB provides back-office and management services to both traditional asset managers and hedge funds, with the bank's client list including major fund houses such as Fidelity, Alliance, and Axa. Fund services encompasses a wide variety of business lines including clearing, custody, settlement, and compliance reporting, registrar and transfer agency services for fund shares, and independent pricing, valuation, and accounting on behalf of fund clients.

The last has become particularly important after a series of recent scandals at hedge and mutual funds over inaccurate pricing of exotic and/or illiquid securities held within the book which resulted in faulty NAVs being given to clients and used in transactions. Hedge funds in particular tend to be secretive about their strategies and actions, so that investors can be wary of leaving money in a pool which leaves reporting of the performance up to the managers themselves.

Note that the largest proportion of BoB's fund administration revenues actually come from Asia-Pacific, including a 24% share of administration for the Hong Kong MPF market, representing efforts on behalf of more than 60 of the 220 approved MPF investment funds. BoB has been handling retirement scheme administration in Hong Kong since the opening of its office in 1974, and the SCMP reports that the bank still administers approximately 170 legacy plans covered by the Occupational Retirement Scheme Ordinance ("ORSO"), with more than 100 thousand members.

As HSBC has approximately 50% share of MPF funds, we can expect that the back office at least will be efficiently combined.

Private client services

The bank is a relative niche player in the private banking market, with some US$22bn in assets under management serviced primarily through offshore centres (Bermuda, Jersey, Caymans, Channel Islands, and Luxembourg) and Asian offices in Hong Kong and Singapore. Based on last available data, this portfolio would add about 16% to HSBC's private banking assets—which are distinct from overall assets under management.

Cash management

BoB's corporate treasury operation specialises in offshore cash management, investment, and f/x for multinational clients, with a significant concentration in insurance companies and captive reinsurers—many of whom are located in Bermuda for its favourable legal and tax environment. BoB management has commented in the past that the bank does well with this client base due to its status as the highest-rated local bank; clearly the merger with HSBC will only enhance this as ratings agencies have already put BoB on the action list for potential upgrade.

In addition, our understanding is that as new reinsurers have entered the market post September 11, 2001, more of the Bermudian reinsurers are part of larger organisations with established global banking relationships. We believe that an amalgamation of BoB with HSBC will help stave off an increase in the flight of customers to the Citibanks and Chases of the world.

Retail banking

BoB does have local retail operations, and is in fact required to maintain a Bermudian retail presence under the terms of its bank and deposit-taking company charters. Retail operations appear to be pretty plain-vanilla, with mortgage lending predominating. The bank has a reported market share of 41% on a deposit basis and 37% on a lending basis as of YE2002. All retail deposit-taking and lending occurs in Bermuda.

Bank of Bermuda has had several years of sub-par returns, with ROE for the 2001-2003 period mainly in the 10-13% range despite a reasonable CAR of ~15% across the period and a single-digit overall tax rate.

In part this has been due to a series of one-time mishaps, including the settlement of a class action suit against the bank on the part of investors in a Ponzi scheme and losses from credit card fraud related to the bank's online merchant servicing, which has since been stopped. However, it does seem that the bank has been in a bit of a revenue rut—one reason it may have welcomed the HSBC bid despite poison pill provisions which would have made an unsolicited offer difficult.

Fig 46 Key earnings components

US$m	2000	2001	2002	3Q02	4Q02	1Q03	2Q03	3Q03
Net interest income	205	198	176	45	44	40	41	42
Non-interest income	239	249	243	54	66	68	73	76
Non-interest expenses	320	377	337	84	93	84	91	93
Loan loss provisions	3	3	(2)	(1)	0	1	1	1
Core income	122	67	97	25	18	21	19	23
Net income	116	60	78	14	17	22	21	22
EPS	3.77	1.91	2.53	0.46	0.56	0.73	0.71	0.75

Source: Company data, ING estimates

Fig 47 Key earnings ratios

	2000	2001	2002	3Q02	4Q02	1Q03	2Q03	3Q03
ROA	1.02%	0.54%	0.71%	0.54%	0.62%	0.81%	0.78%	0.78%
Core ROA	1.07%	0.61%	0.89%	0.98%	0.68%	0.78%	0.73%	0.80%
ROE	18.48%	9.57%	12.03%	8.56%	10.04%	13.15%	12.38%	12.97%
Core ROE	19.48%	10.74%	15.04%	15.44%	10.93%	12.60%	11.56%	13.25%
NIM	1.84%	1.82%	1.64%	1.79%	1.68%	1.57%	1.61%	1.50%
Cost/income	72.05%	84.43%	80.45%	85.06%	84.62%	77.84%	79.46%	79.02%
Overhead	2.87%	3.48%	3.15%	3.32%	3.56%	3.28%	3.58%	3.36%
Effective tax rate	5.92%	10.13%	7.43%	13.16%	1.00%	6.68%	7.30%	7.63%

Source: Company data, ING estimates

Grupo Financiero Bital

HSBC completed its tender for and acquisition of the then-troubled Grupo Financiero Bital ("Bital") in November 2002, acquiring 99.6% of the company for $1.14 billion. Bital had little choice but to sell, as the group was operating under an agreement with Mexican regulators to raise its Tier 1 capital ratio to 8% by October 2002 and to 10% by that year-end (from 6.32% at 30 June 2002), which did not appear possible without outside assistance.

Subsequently, management of HSBC injected an additional $800 million into Bital to restore the bank's capital adequacy and allow for expansion of its operations. This brings the total purchase price to $1.94 billion, or some 2.38x pre-injection book value.

Post the take-over, HSBC now owns all of Mexico's fifth-largest bank. Note that this is HSBC's second foray into the market; the group purchased the rights to Banco Serfin from the government in 1997, only to return the bank to government hands (and receive a return of the purchase price) three years later due to persistent asset quality issues.

We are somewhat puzzled over the volte-face on Serfin, especially when coupled with the subsequent bid for Bital. Serfin is in our opinion a much more high-quality franchise than Bital, both operationally and in terms of credit and customer quality. However, it would appear that HSBC is aiming at a lower stratum of society for its customer base, targeting a similar style of lending to Household's sub-prime US business. This would have Bital competing more with small local lenders like Banco Azteca rather than with Banamex.

Fig 48 Key earnings components - Grupo Bital

US$m**	1998A	1999A	2000A	2001A	1H02A	2H02A	2002A	1H03A
Net interest income	N/A	1,020	946	937	410	412	821	455
Non-interest income	N/A	460	427	550	232	303	538	308
Non-interest expenses	N/A	1,112	1,087	1,055	524	874	1,412	474
Goodwill amortisation	N/A	NA	NA	NA	NA	NA	NA	NA
Provisions	N/A	280	242	354	88	532	638	158
Disposals and other	N/A	NA	NA	NA	NA	NA	NA	NA
Pre-tax profit	N/A	89	43	79	30	(692)	(691)	132

**Based on conversion of MXN in constant currency terms.

Source: Company data, ING estimates

An expensive transaction

It seems very safe to say that HSBC did not paid a bargain price for Bital either—particularly in the light of the following Bank of America/Serfin transaction. Calculating the purchase price against Bital's fairly low historic earnings, as illustrated by the company's 3Q02 ROE of 0.33% and ROA of 5.8%, yields a valuation of almost 60x annualised 3Q02 earnings and 41x FY2001 net profit. Even assuming that the injected capital earns an incremental 8% return—by no means a safe assumption if it is meant to write off bad assets—HSBC still paid 20x trailing earnings for Bital.

Expensive compared to Banamex and Serfin

Comparing the HSBC/Bital deal to Citibank/Banamex and BofA/Serfin, it appears that HSBC has paid a substantially higher multiple on an earnings basis. Citibank paid 17x trailing earnings (based on the last reporting period before consolidation), and BofA paid 12.5x FY2001 profit for Serfin, although admittedly not for a controlling stake.

Fig 49 Comparative Mexican bank acquisition valuations

	Bital	Serfin	Banamex
Acquiror	HSBC	BofA	Citi
Purchase date	Nov-02	Feb-03	Aug-02
Purchase price (US$bn)	1.94	1.60	12.50
Percentage stake	100%	25%	100%
P/BV	2.38x	3.21x	2.82x
PER	47.14x	12.47x	17.34x

Source: Company data, ING estimates

Losango

Along with China, India, and Mexico, HSBC's senior management has identified Brazil as one of the group's four focus markets for future growth. The market opportunity exists in their view because of a rapidly-expanding middle class, the majority of whom do not have existing banking relationships; we agree with this assessment but also believe that spreads in Brazil are wider than they will be at equilibrium, and tend to think that Mexico offers better growth potential.

HSBC's existing Brazilian operations are based on the former Bamerindus, which was acquired in 1997 for US$1bn. The HSBC Bank Brazil platform now consists of approximately 1600 branches servicing 3.75 million customers, making HSBC the 10th-largest retail bank and 3rd-largest foreign bank. Existing Brazilian assets are split relatively evenly between consumer and corporate lending, and aggregate US$3.1bn as of 1H03.

In addition to banking, HSBC has substantial interests in insurance (#7 in Brazil), asset management (#5), and investment and private banking (via Banco Múltiplo, the former Banco CCF Brasil).

Lloyds and Losango

HSBC has placed a successful bid (beating out Bradesco, among others) to purchase the Brazilian banking operations of Lloyds TSB in October 2003. Lloyds reports total Brazilian exposure of GBP1.5bn (US$2.5bn) as of 1H03—a sharp contraction from YE2002 despite favourable exchange rates. The Lloyds Brazil assets are mainly retail based, with the Losango consumer finance unit making up the majority of the bank's assets in-country.

Losango's main businesses are auto finance and retail hire-purchase. Most of the company's business is originated through a network of 15 thousand merchants, although Losango does operate more than 100 of its own offices and "mega-stores" as well. The company also offers credit cards (both proprietary and Visa/MC), with over 2.5m cards outstanding in mid-2002.

Another popular product is payroll loans, which offer salaried employees small loans with the monthly repayments deducted directly from their salaries. With more corporate customers and hence greater access to payroll accounts, we would expect HSBC to add to Losango's business in this area.

Losango's competitors include consumer lender Fininvest, a subsidiary of Unibanco, and BNP's Cetelem unit.

Pricing looks good

The reported price for these assets is US$815m, which would be approximately 5.3x Lloyds' annualised pre-tax profit of GBP46m on the Brazil book, based on 1H03 figures. Using HSBC's consolidated effective tax rate of 24%, this would value the deal at 7.0x earnings.

Minority stakes

HSBC has also picked up smaller stakes in several Asian institutions to broaden its reach out of the moribund Hong Kong market.

These include 10% of Chinese life insurer Ping An, 8% of Bank of Shanghai, 15% of Indian lender UTI Bank, and 50% of tiny mainland bank Fujian Asia Bank in cooperation with Ping An. In addition, affiliate Hang Seng has bought 16% of Fuzhou-based Industrial Bank, one of China's 10 national joint-stock banks.

Who's next?

HSBC has an avowed ambition of becoming one of the top five banking groups in the US, but is still far away, with its main US banking subsidiary currently ranked #12 with approximately 1/10th the asset size of Citigroup or the merged JPMC-ONE or BOA-Fleet. Even with the inclusion of additional Household assets (which are held not through the US bank but rather by a different arm of the top-tier holding company, HSBC USA would be roughly the same size as FleetBoston before its acquisition, and significantly smaller than Bank One.

In essence, HSBC is the size of the banks that are being bought, rather than the banks that are doing the buying.

Additionally, HSBC is very geographically concentrated and dependent on wholesale businesses—although again the Household purchase addresses both of these issues in part—which means that the bank has less presence at the critical retail banking level than other institutions of comparable size.

Finally, there is a sense (true or not) that the time is nigh for a final consolidation of the American banking sector which will cap a decade and a half of M&A activity. This last gasp will leave the US with a "barbell" shaped banking sector that has super-large banks on one end and thousands of small community banks on the other, but very little middle ground—the historic home of regional and super-regional banks which would be the best targets for HSBC.

We don't consider Household's network a substitute for that of a bank—its branches are not generally suitable for transactional business nor do they attract the clientele that HSBC services elsewhere.

Although these items don't add up of themselves to a dangerous future for HSBC in America, they do represent a cusp of activity where we believe that the group must actively and quickly consider its future strategy. Further contributing to the sense of timeliness is that the Euro (and HSBC's GBP-denominated shares) are strong against the US dollar, making it potentially a good time to buy more US assets.

Who are the potential targets?

If HSBC is not to achieve its goals through organic growth, the question then becomes, "who might they buy?" We have identified 12 potential US banking targets in four geographic groups, but feel that the best fits for HSBC would be US Bancorp, Wamu, or Wells Fargo.

Best fit: California dreamin'

We see the most compelling reasons for HSBC to be in the California market. First, the high proportion of Asian consumers and Pacific Rim-related businesses is a natural way for HSBC to leverage its existing Asian franchise and name recognition, and secondly, the group's focus on the Latin American market (Mexico and Brazil being two of HSBC's four focus markets for the years ahead) makes control of the cross-border remittance business (also a factor in Texas, among other states) a potentially lucrative add-on.

With BOA having bought a stake in Serfin to pursue the same goals, and Citi busy trying to connect subsidiary Banamex with the recently-acquired Golden West Financial platform, it would seem to be a spur to HSBC's management not to fall behind.

WAMU could be an easier deal to accomplish due to its lower valuation amid fears of a slowdown in mortgage refinancing, but WFC also offers significant promise as not only a premium franchise but a renowned innovator in retail banking techniques and a potential source of technology transfer to HSBC's businesses elsewhere.

Fig 50 Wells Fargo branch network

Source: FDIC

Fig 51 WAMU branch network

Source: FDIC

Valuation

HSBC is currently trading at 18.4x 2003 net income and at 15.8x our forecast for 2004. On a price to book basis, the group is valued at 2.2x YE2003 BVPS and 2.1x YE2004 BVPS, both of those values before deduction of whopping goodwill balances.

Fig 52 Valuation at current price

	2001	2002	2003	2004F
Share price (£)	830			
PER (x)	27.62x	22.40x	18.41x	15.82x
Core PER (x)	22.21x	18.41x	14.90x	12.63x
PUP (x)	11.39x	11.38x	7.86x	7.20x
P/BV (x)	2.97x	2.67x	2.17x	2.08x
P/ABV (x)	4.85x	4.35x	3.91x	3.30x

Source: Company data, ING estimates

Our fair value price target for HSBC is some 4% lower, at GBp795, which is based on our standard cost of capital methodology using a cost of equity of 8.1% and sustainable ROE of 16.2%.

Fig 53 Valuation at target price

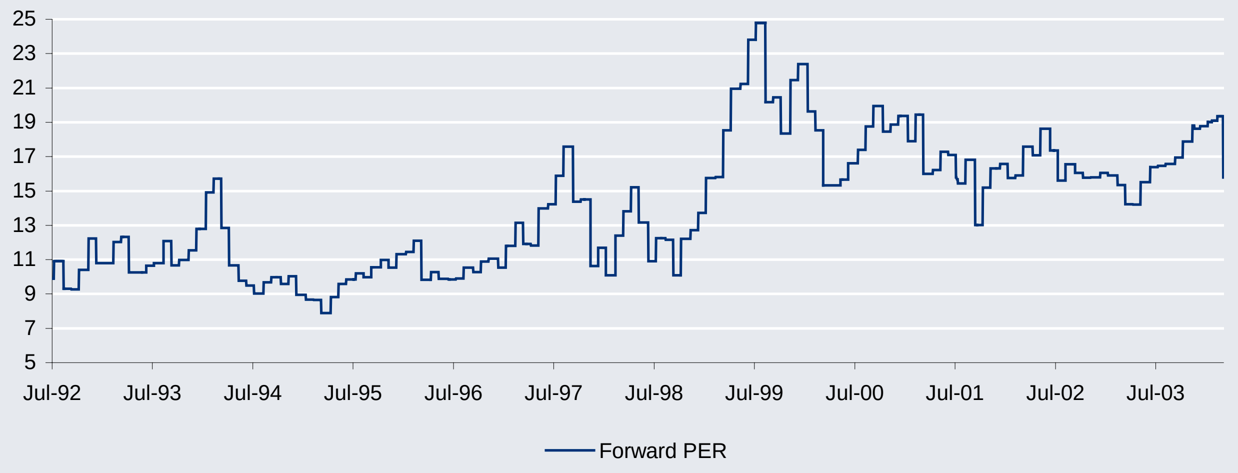
	2001	2002	2003	2004F
Share price (£)	795			
PER (x)	27.06x	21.94x	18.04x	15.50x
Core PER (x)	21.76x	18.04x	14.59x	12.37x
PUP (x)	11.15x	11.15x	7.70x	7.05x
P/BV (x)	2.91x	2.61x	2.13x	2.04x
P/ABV (x)	4.75x	4.26x	3.83x	3.23x

Source: Company data, ING estimates

Fig 54 HSBC trailing PER: 1992-present

Source: Datastream

Fig 55 HSBC forward PER: 1992-present



Source: Datastream, I/B/E/S

HSBC

Hong Kong

Share Price:	115.00	**Reuters Code:**	HSBA.L / 0005.HK
52 Week Price Range:	81.50 - 128.50	**Bloomberg Code:**	HSBA LN / 5 HK
Shares Outstanding	10,960	**Market Cap (US$m)**	161,590

INCOME STATEMENT (US$m)	01	02	03	04	05
Interest income	35,261	28,595	39,968	47,472	54,810
Interest expense	20,536	13,135	14,370	19,790	25,190
Net interest income	**14,725**	**15,460**	**25,598**	**27,682**	**29,619**
Non-interest income	11,990	11,774	16,030	16,576	17,505
Total operating income	**26,715**	**27,234**	**41,628**	**44,258**	**47,125**
Non-interest expense	14,605	14,954	21,067	21,825	22,677
Pre provision profit	**12,110**	**12,280**	**20,561**	**22,433**	**24,448**
Loan loss provisions	3,331	1,752	6,243	5,750	5,500
Non-operating income	-1,839	-1,707	-2,350	-2,583	-2,670
Pre tax profit	**6,940**	**8,821**	**11,968**	**14,100**	**16,278**
Tax	1,988	2,534	3,120	3,887	4,453
Net profit	**4,992**	**6,239**	**8,774**	**10,213**	**11,825**

BALANCE SHEET (US$m)	01	02	03	04	05
Gross loans	421,473	456,980	646,150	701,919	758,073
Loan loss reserves	*8,183*	*9,140*	*13,715*	*13,078*	*13,920*
Net loans	413,290	447,840	632,435	688,841	744,152
Total earning assets	608,534	659,369	896,129	961,474	1,050,192
Other assets	87,711	99,877	138,087	131,110	129,799
Total Assets	**696,245**	**759,246**	**1,034,216**	**1,092,585**	**1,179,991**
Deposits	503,631	548,371	643,556	645,013	670,814
Other paying liabilities	145,934	158,469	316,187	369,810	427,207
Other liabilities	NM	NM	NM	NM	NM
Total Liabilities	649,857	706,840	959,743	1,014,823	1,098,021
Total Equity	**46,388**	**52,406**	**74,473**	**77,762**	**81,970**

ASSET QUALITY	01	02	03	04	05
Nonperforming assets	10,567	12,030	18,457	18,199	17,034
NPAs/total loans	2.5%	2.6%	2.9%	2.6%	2.2%
Reserve coverage of NPAs	77.4%	76.0%	74.3%	71.9%	81.7%

PER SHARE DATA (US$)	01	02	03	04	05
EPS	0.53	0.66	0.80	0.93	1.07
DPS	0.48	0.53	0.60	0.63	0.69
Effective payout ratio (%)	*89%*	*80%*	*74%*	*68%*	*64%*
BVPS	4.96	5.53	6.79	7.10	7.40

BALANCE SHEET RATIOS	01	02	03	04	05
Loan-to-deposit	83.7%	83.3%	100.4%	108.8%	113.0%
Equity to assets	6.7%	6.9%	7.2%	7.1%	6.9%
Tier 1 CAR	9.0%	9.0%	12.8%	13.4%	14.1%
Total CAR	13.0%	13.3%	16.8%	17.4%	18.1%

VALUATION	01	02	03	04	05
Price to book value	3.0x	2.7x	2.2x	2.1x	2.0x
Price to earnings	27.6x	22.4x	18.4x	15.8x	13.8x
Price to underlying profit	11.4x	11.4x	7.9x	7.2x	6.7x
Yield at current price (%)	3.2	3.6	4.0	4.3	4.7

LOAN MIX	01	02	03	04	05
Consumer (%)	12.3%	13.4%	21.0%	23.0%	25.0%
Mortgage (%)	27.3%	28.9%	36.0%	36.5%	37.2%
Corporate (%)	48.4%	47.8%	35.0%	33.0%	30.3%
Other (%)	12.0%	9.9%	8.0%	7.5%	7.5%

PROFITABILITY RATIOS (%)	01	02	03	04	05
Net interest margin	2.46%	2.44%	3.29%	2.98%	2.94%
Yield on assets	5.79%	4.34%	4.46%	4.94%	5.22%
Cost of liabilities	3.21%	1.94%	1.72%	2.00%	2.38%
Non-int. inc (% Op income)	44.88%	43.23%	38.51%	37.45%	37.15%
Cost to income	54.67%	54.91%	50.61%	49.31%	48.12%
Overhead	2.44%	2.36%	2.71%	2.35%	2.25%
ROA	0.73%	0.86%	0.98%	0.96%	1.04%
ROE	10.76%	11.91%	11.78%	13.13%	14.43%

GROWTH RATES (%,YoY)	01	02	03	04	05
Pre-provision earnings	7%	1%	67%	9%	9%
Net profit	-23%	25%	41%	16%	16%
EPS	-23%	23%	22%	16%	15%
DPS	10%	10%	13%	6%	9%
Net Loans	-1%	8%	41%	9%	8%
Assets	3%	9%	36%	6%	8%
Deposits	3%	9%	17%	0%	4%

Standard Chartered Growth and diversity

Rating: BUY

The emerging market bank

Standard Chartered has steadily transformed itself into a broad-based emerging market bank, with commensurately high growth prospects which are unique among the bank's large peers. The proposition that STAN offers to investors can be described as diversified positions in high growth markets with efficient scale, Western-standard management, and investable liquidity.

At a time when our enthusiasm for Asian banks is high—and economic drivers in other emerging markets seem to be following suit—Standard is one of the only ways to gain big-cap leverage into the sector recovery. Cheap it isn't, but it's still a long way below historical peak valuations.

Standard's near-term earnings performance will be driven by low hanging fruit—simply returning the Hong Kong credit card portfolio to its equilibrium charge-off rate of 5% will add 35% to bottom-line EPS over the 2003-04 period.

The exciting characteristic of the company, however, is its portfolio of markets with strong prospects for growth. With Asian reflation taking off, Standard offers a broad warrant on the healthiest and most undervalued economies in Asia, now including Korea. In addition, extremely robust growth in India, Africa, and MESA will boost returns over the next three years.

Standard Chartered's business mix gives investors concentrated access to the consumer consumption sector and to commodity-driven economies and currencies—exactly the sweet spot for this point in the cycle.

Fig 56 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	0.99	0.77	0.51	0.92	0.56	0.63	0.82	1.06	1.41

Source: Company data, ING estimates

Fig 57 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

Wholesale driving revenue

Overall, the wholesale business continues to provide the majority (56%) of operating profits, although it is doing so with 73% of book assets. Management's strategy to "trade revenues for risk" doesn't seem to be constraining the business overly; note that wholesale revenues were up 6.5% YoY versus a 3.1% rise for consumer revenues.

Provisions have peaked

The fall-off in provisions (although they remain high) seen in 1H03 has continued through year-end, largely driven by receding charge-offs in the Hong Kong credit card portfolio. Overall, provisions were down 25% YoY, despite SARS and losses on the bank's exposure to SK Global in 1H03.

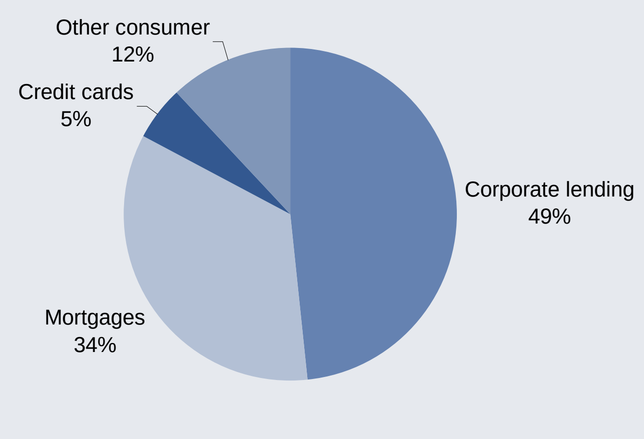
Stubbornly high costs

StanChart's overhead and cost/income ratios remain high, in the latter case actually increasing from a year ago. Although some progress has been made, we are expecting more from the centralised processing and standardised product initiatives which have been touted.

Shift towards consumer lending

SCB has progressively shifted its portfolio towards consumer lending since the Asian crisis, with retail assets now comprising a slight majority of the balance sheet. Within this book, mortgage assets are the largest category by far, and their share is increasing as Standard move into countries like India (which has an underdeveloped mortgage market) and Korea (where management highlights that fixed rate mortgages of over three years contractual duration are almost impossible to obtain.

Fig 58 Loan portfolio breakdown: YE03

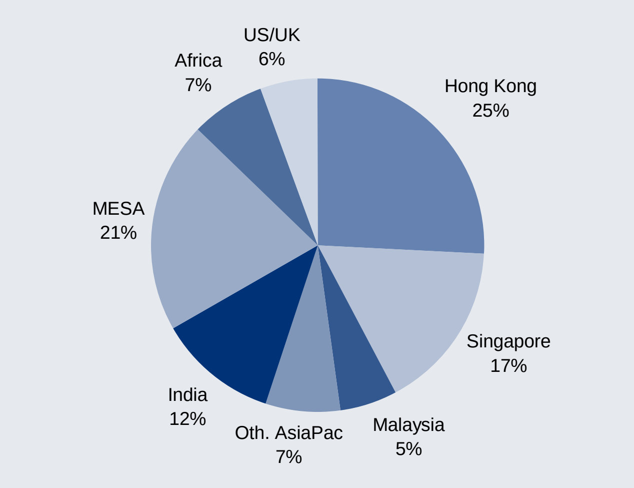


Source: Company data, ING estimates

Geographic breakdown

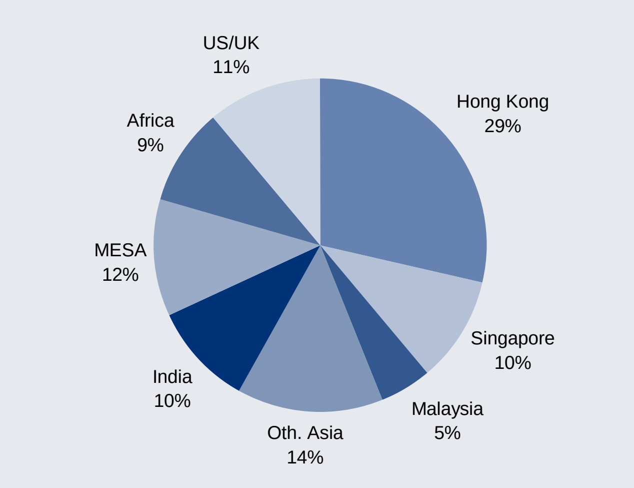
Hong Kong and Singapore—StanChart's developed markets—have declined in their proportional contribution of operating profits, from a combined 48% in FY02 to 43% in 2003. Africa, India, and non-developed Asia have filled the gap with strong results to take additional share.

Fig 59 Operating profit by market: FY2002



Source: Company data

Fig 60 Operating profit by market: FY2003



Source: Company data

Fig 61 Operating results breakdown by business line

US$m, 2003	Hong Kong	Singapore	Malaysia	Other 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 62 Operating results breakdown by business line (% Chg YoY)

% Chg YoY	Hong Kong	Singapore	Malaysia	Other 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

Revenue growth by market

Among the major divisions, Hong Kong's revenue was strongly negative, with a 6% fall in consumer revenue helping to pull the consolidated entity's consumer growth down globally. India's growth has been explosive on the wholesale side, with not much activity in consumer revenues visible so far, while Africa posted strong and balanced growth of 33% in total.

We believe that Hong Kong will regain some of its former importance to the group when 2004 is all tallied up, even though we don't forecast much growth in top line growth or loan balances. However, the appeal of StanChart from a revenue perspective is clearly coming from India, Africa, and MESA of the established markets.

In addition, we believe that despite the lost battle for KorAm, Standard's own newly-opened Korean operations, as well as a potential acquisition in Indonesia, will begin to rebuild the "Other Asia-Pacific" category as the bank takes advantage of reflation in ASEAN.

Finally, the restructuring of STAN's offshore deposit and investment facilities in Jersey should begin to pay dividends beginning in 2005.

Growth areas

Standard Chartered's historic core markets of Hong Kong and Singapore are mature, and even Malaysia and Thailand should not be looked-to to offer double-digit balance sheet growth over the long run. We do expect some return of pricing power over the next year, however, as excess liquidity begins to run off.

China is a market with tremendous potential, and STAN is one of the leading foreign banks in the country, but nevertheless we do not see any major earnings contribution looking out through 2006—even though we assume that the group will find a way to benefit from CEPA.

Markets that will generate increased top-line growth within this time frame in our view include India, Nigeria, South Africa, Korea, and potentially Indonesia. Brief comments on fast-growing areas:

Africa

Africa remains disproportionately profitable. StanChart's frequently overlooked African franchise has been turning in high-margin results with improving consistency. The (sub-Saharan) Africa franchise accounted for 10% of group pre-tax profits in 2003 (US$151m), but used only 2% of the group's risk-weighted assets, mainly due to high market share (15-25% across the group's African markets) and wide interest spreads of 7%.

Geographic diversification lowers risk

STAN's African business does take place within higher-risk markets, but the African countries appear to be less correlated with each other than are the group's Asian markets. The most recent example: despite sustaining a loss on currency depreciation (and general chaos of the Mugabe regime) of approximately $25m in Zimbabwe during 2002, Standard was able to post decent results for the year, with trading profit of $101m. Management reports that next exposure in Zimbabwe is now only $5-6m.

Overlooked growth markets

We have long been convinced of Africa's status as a high-margin legacy business for StanChart, but are surprised to see such a robust outlook for growth—which was masked in 2002 by extraordinary losses. GDP growth in Standard's primary markets of Botswana, Ghana, and Kenya will accelerate to an average of 5.1% in 2004 (based on the company's economics estimates) from 4.1% in 2003.

New opportunities add revenue potential

Although STAN is a big name in African banking in general, the company has had a negligible presence in the two largest markets—South Africa and Nigeria—but is now making a concerted effort in both. Although Standard gave up its banking licence in South Africa in 1987 (forming what is now Standard Bank of SA), the group was recently awarded a new full bank charter and plans to recommence operations in both consumer banking (primarily through its just acquired Internet bank, Twenty20) and corporate lending. In Nigeria, management highlighted plans to double the branch network this year.

Consumer banking is undeveloped

The largest untapped market for future growth for Standard in Africa would seem to be the consumer banking sector. To date, STAN's consumer operations, which are focused on acquiring liabilities instead of lending, and which carry a punitively high 91% cost/income ratio (FY2002), make very little money. We are convinced given StanChart's experience in India, Malaysia, Indonesia, and other emerging markets, that management has the ability to change this by importing successful products and leadership from elsewhere in the group.

Korea

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

This made SCB the second-largest shareholder in Koram Bank after the JP Morgan/Carlyle consortium, which holds a 34% stake. JPM/C acquired its stake in Koram in November 2000 (after a protracted negotiation process) at an average price of Won6,800 per share. Although we believed that Standard's intention was to take 100% of Koram in relatively short order, management was overtaken by events.

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, they have been effectively trumped by the Citibank bid.

Citi's offer was to be effective if at least 80% of the shares are tendered, so that StanChart's 10% stake alone was not enough to scuttle a merger. Based on preliminary reports, Citibank has been overwhelmingly successful in acquiring and Koram, and we expect the bank to be eventually de-listed. SCB tendered its shares into the offer and walked away, consoled by a gain of approximately US$106m on its investment of US$154m in August of 2003.

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. A possible rival for KFB, however, is HSBC, which is reported to be looking over the bank but has not yet entered into any formal negotiations.

Additionally, we believe that Lone Star would be a seller of its controlling stake in Korea Exchange Bank (004940 KS, Won7,390, 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, Won26,950, BUY).

India

GDP growth in 2003 is projected to be very strong, reaching 5% for the full year. Although wholesale business has already shown the effects of the expanding economy (and of SCB's rapidly growing branch network), consumer revenues have yet to reflect the increased scope of business now on offer—note that consumer revenues were only up 10% on asset growth of 51%—we believe that this is only a timing issue and will come on stream over the next 12 months.

Management has commented, however, that a reduction of STAN India's reliance on credit cards and greater origination of mortgages will depress spreads going forward, so that we do not expect revenue growth commensurate with asset growth.

STAN wants to be the largest bank in India. Currently, management reports market share among foreign banks of 26%, but only 2% overall.

MESA

The Gulf war did not seem to affect SCB's MESA business during the first half, per management's assurances at year-end, as revenue grew 10%. STAN is now capturing a 7% slice of its estimate of consumer revenue across the region, and believes that 10-15% share is a realistic goal.

Khoo shareholding up for grabs

Legendary Malaysian investor Khoo Teck Puat in late February at age 89, leaving behind control of a 13.5% stake in STAN, which he acquired as a "white knight[6]" in the mid-1980s when the bank was under siege by Lloyds.

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

[6] Along with Y.K. Pao and Robert Holmes à Court.

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.

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[7], 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:

  Standard

  - 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.

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[7] *Standard Chartered: Believe and Prosper*, dated February 19, 2004.

Singapore/Temasek/DBS

- 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$10bn 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.

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 63 Potential bidders for StanChart

Company	Ticker	Price (lcy)	Mkt cap (US$bn)	ING rating
Citigroup	C US	49.66	248.7	NR
JP Morgan Chase	JPM US	38.38	78.3	NR
Bank of America	BAC US	81.39	164.4	NR
HSBC	HSBA LN	843.50	179.5	HOLD
Royal Bank of Scotland	RBS LN	1,724.00	88.4	BUY
Barclays PLC	BARC LN	508.00	59.3	HOLD
Lloyds TSB	LLOY LN	427.00	42.3	SELL

Price data as of 22 April 2004.
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 material 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$88bn 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

Valuation

Standard Chartered is trading on 2.6x trailing and 2.4x YE2004F book value per share. However, swiftly rising ROE's mean that the group's PER declines from a trailing 19.2x to a more reasonable 14.9x on 2004 and 11.2x on 2005 estimated EPS. We maintain our BUY recommendation and HK$160 price target, which is based on a 23% sustainable core ROE and 3.2x forward BVPS.

Fig 64 Valuation at current price

	2002	2003	2004F	2005F
Share price (US$)	15.83			
Share price (HK$)	123.50			
Share price (£)	889			
PER (x)	25.04x	19.19x	14.91x	11.26x
Core PER (x)	21.59x	17.07x	13.35x	10.23x
PUP (x)	9.34x	8.53x	7.33x	6.01x
P/BV (x)	2.75x	2.62x	2.44x	2.25x
P/ABV (x)	4.03x	3.64x	3.22x	2.81x

Source: Company data, ING estimates

Fig 65 Valuation at target price

	2002	2003	2004F	2005F
Share price (US$)	20.51			
Share price (HK$)	160			
Share price (£)	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

Standard Chartered

Hong Kong

Share Price:	123.50	**Reuters Code:**	STAN.L / 2888.HK
52 Week Price Range:	82.50 - 138.50	**Bloomberg Code:**	STAN LN / 2888 HK
Shares Outstanding	1,167	**Market Cap (US$m)**	18,483

INCOME STATEMENT (US$m)	**01**	**02**	**03**	**04**	**05**
Interest income	6,419	5,231	4,790	5,271	6,033
Interest expense	3,587	2,333	1,877	1,910	2,121
Net interest income	**2,832**	**2,898**	**2,913**	**3,362**	**3,912**
Non-interest income	1,505	1,476	1,785	1,764	1,875
Total operating income	**4,337**	**4,374**	**4,698**	**5,126**	**5,787**
Non-interest expense	2,585	2,401	2,530	2,605	2,713
Pre provision profit	**1,752**	**1,973**	**2,168**	**2,520**	**3,074**
Loan loss provisions	731	720	547	440	455
Non-operating income	-12	-244	-163	-165	-166
Pre tax profit	**1,009**	**1,009**	**1,458**	**1,916**	**2,453**
Tax	378	387	495	676	812
Net profit	**631**	**736**	**963**	**1,240**	**1,641**

BALANCE SHEET (US$m)	**01**	**02**	**03**	**04**	**05**
Gross loans	54,387	58,165	62,383	66,651	72,090
Loan loss reserves	*1,382*	*2,292*	*2,027*	*2,009*	*2,111*
Net loans	53,005	57,009	59,744	64,641	69,979
Total earning assets	93,768	98,497	102,287	110,182	121,250
Other assets	13,611	14,513	17,995	17,878	17,259
Total Assets	**107,379**	**113,010**	**120,282**	**128,060**	**138,510**
Deposits	79,543	82,476	84,691	89,060	94,936
Other paying liabilities	9,446	10,964	12,678	12,304	11,611
Other liabilities	NM	NM	NM	NM	NM
Total Liabilities	101,256	106,315	113,216	120,498	130,291
Total Equity	**6,123**	**6,695**	**7,066**	**7,562**	**8,218**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	2,279	2,811	2,464	2,369	2,274
NPAs/total loans	4.2%	4.8%	4.0%	3.6%	3.2%
Reserve coverage of NPAs	60.6%	81.5%	82.3%	84.8%	92.8%

PER SHARE DATA (US$)	**01**	**02**	**03**	**04**	**05**
EPS	0.56	0.63	0.82	1.06	1.41
DPS	0.42	0.47	0.52	0.64	0.84
Effective payout ratio (%)	*75%*	*74%*	*63%*	*60%*	*60%*
BVPS	5.42	5.75	6.05	6.48	7.04

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	68.4%	70.5%	72.9%	74.8%	75.9%
Equity to assets	5.7%	5.9%	5.9%	5.9%	5.9%
Tier 1 CAR	9.0%	8.6%	8.8%	8.9%	9.1%
Total CAR	16.2%	14.5%	14.6%	14.4%	13.8%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	2.9x	2.8x	2.6x	2.4x	2.2x
Price to earnings	28.4x	25.0x	19.2x	14.9x	11.3x
Price to underlying profit	10.2x	9.3x	8.5x	7.3x	6.0x
Yield at current price (%)	2.6	3.0	3.3	4.0	5.3

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	15.6%	16.0%	17.3%	18.5%	21.8%
Mortgage (%)	36.2%	35.5%	34.4%	34.0%	36.2%
Corporate (%)	48.1%	48.5%	48.2%	47.5%	42.0%
Other (%)	NM	NM	NM	NM	NM

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	3.09%	3.01%	2.90%	3.16%	3.38%
Yield on assets	6.85%	5.31%	4.68%	4.78%	4.98%
Cost of liabilities	4.12%	2.56%	1.97%	1.92%	2.04%
Non-int. inc (% Op income)	34.70%	33.74%	37.99%	34.42%	32.39%
Cost to income	59.60%	54.89%	53.85%	50.83%	46.89%
Overhead	2.82%	2.50%	2.52%	2.45%	2.34%
ROA	0.60%	0.67%	0.83%	1.00%	1.23%
ROE	10.36%	11.48%	14.00%	16.95%	20.80%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	32%	13%	10%	16%	22%
Net profit	-37%	17%	31%	29%	32%
EPS	-39%	13%	30%	29%	32%
DPS	7%	12%	12%	22%	32%
Net Loans	2%	8%	5%	8%	8%
Assets	5%	5%	6%	6%	8%
Deposits	4%	4%	3%	5%	7%

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Hang Seng Bank

High quality, high price

Rating: SELL

Hang Seng Bank is without a doubt the best-managed, best-performing bank in Hong Kong—and perhaps in all of Asia. It regularly outstrips its corporate parent in ROE, ROA, cost-cutting, and general efficiency. As much as we love the company, everyone else already loves the stock too much for us to find it a good value.

In addition, we think that the quality of HSB's earnings has deteriorated over the past few years, giving rise to a worry that the bank may not reap all the benefits of Hong Kong's economic recovery and expansion. For the second year in a row, HSB's net profit and core earnings both declined in absolute terms, down 4% and 3%, respectively, although ROE has continued to advance as the bank pays out more than 100% of its capital accretion.

HSB has paid out 98% of FY2003's earnings, and after charges taken directly to the balance sheet book value is actually declining, as are the equity/assets and CAR ratios. The lack of retained earnings will hamper HSB's ability to loan-up its book as and when the market recovers, meaning that the bank could become capital constrained in a rapid expansion, despite its low LDR.

Margins continue to drop as HSB's large free funds book is hurt by low rates. Management has reacted by moving more heavily into securities and farther out on the yield curve. The average maturity of the bank's securities portfolio was approximately 3 years at interim reporting but shortened somewhat by year-end.

The biggest change in HSB's portfolio over the past few years has been the decline in importance of mortgages, in part due to the indefinite suspension of sales under the government housing program (HOS) and a resultant lack of new loans and in part due to the bank's unwillingness to chase mortgages at prevailing rates of prime-260bp or lower.

Even after a 39% rise in provisions during the period, Hang Seng continues to provision less than the bank charges-off, this despite bad loans that are increasing based on our measurements. The bank's reserves have reached a—to our minds alarmingly—low level of 110bp on average loans. Although it is true that by the standards of historic levels of charge-off in Hong Kong this is reasonably safe, we believe that as the SAR has become a mature market credit losses will converge somewhat with global levels; note that this has already happened (and then some) in credit cards.

Hang Seng has long been the most expensive stock in our universe on a P/BV basis, and now at over 4.7x YE2003 book it has widened its lead over challengers. Although the bank's returns are excellent, its price of 20x earnings with limited growth is too high for us.

We maintain our SELL rating and HK$90 price target, based on 15x 2005 EPS, commensurate with the bank's anticipated single-digit growth over the 2003-2005 period. At our target price of HK$90, HSB would be trading at a multiple of 4.3x YE 2003 BVPS and at 4.1x YE 2005 BVPS—still very generous.

Hang Seng Bank

Hong Kong

Share Price:	98.25	**Reuters Code:**	0011.HK	**Shares Outstanding**	1,912
52 Week Price Range:	75.50 - 110.50	**Bloomberg Code:**	11 HK	**Market Cap (US$m)**	24,082

INCOME STATEMENT (HK$m)	**01**	**02**	**03**	**04**	**05**
Interest income	24,509	14,960	12,846	14,525	16,673
Interest expense	12,849	4,155	2,667	3,206	4,057
Net interest income	**11,660**	**10,805**	**10,179**	**11,008**	**11,801**
Non-interest income	4,391	4,875	5,686	5,313	5,599
Total operating income	**16,051**	**15,680**	**15,865**	**16,321**	**17,400**
Non-interest expense	4,104	3,832	3,902	3,749	3,769
Pre provision profit	**11,947**	**11,848**	**11,963**	**12,884**	**14,345**
Loan loss provisions	424	571	792	1,134	1,227
Non-operating income	9	20	-141	-36	-43
Pre tax profit	**11,532**	**11,297**	**11,030**	**11,715**	**13,075**
Tax	1,400	1,266	1,423	1,903	2,133
Net profit	**10,114**	**9,961**	**9,539**	**9,573**	**10,377**

BALANCE SHEET (HK$m)	**01**	**02**	**03**	**04**	**05**
Gross loans	225,926	227,475	231,999	241,651	255,123
Loan loss reserves	*3,490*	*2,913*	*2,533*	*2,739*	*2,788*
Net loans	222,436	224,562	229,466	238,911	252,335
Total earning assets	450,048	447,273	470,834	466,310	480,959
Other assets	24,739	27,329	32,125	18,349	18,349
Total Assets	**474,787**	**474,602**	**502,959**	**484,659**	**499,308**
Deposits	416,950	414,679	441,100	420,453	428,097
Paying liabilities	383,476	378,941	393,609	380,886	387,811
Other liabilities	46,240	51,653	69,065	63,502	69,440
Total Liabilities	429,716	430,594	462,674	444,388	457,252
Total Equity	**45,071**	**43,564**	**39,641**	**40,271**	**42,057**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	7,649	7,867	6,857	5,874	5,533
NPAs/total loans	3.4%	3.5%	3.0%	2.4%	2.2%
Reserve coverage of NPAs	45.6%	37.0%	36.9%	46.6%	50.4%

PER SHARE DATA (HK$)	**01**	**02**	**03**	**04**	**05**
EPS	5.29	5.21	4.99	5.01	5.43
DPS	4.90	5.40	4.90	4.90	4.90
Effective payout ratio (%)	*93%*	*104%*	*98%*	*94%*	*84%*
BVPS	23.57	22.79	20.73	20.83	22.00

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	54.2%	54.9%	52.6%	57.5%	59.6%
Equity to assets	9.5%	9.2%	7.9%	8.3%	8.4%
Tier 1 CAR	12.3%	11.9%	10.8%	11.0%	11.5%
Total CAR	15.3%	14.2%	14.2%	14.3%	14.7%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	4.2x	4.3x	4.7x	4.7x	4.5x
Price to earnings	18.6x	18.9x	19.7x	19.6x	18.1x
Price to underlying profit	15.7x	15.9x	15.7x	14.6x	13.1x
Yield at current price (%)	5.0	5.5	5.0	5.0	5.0

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	5.0%	5.2%	5.4%	6.0%	7.9%
Mortgage (%)	51.7%	49.9%	49.6%	50.0%	52.0%
Corporate (%)	41.3%	42.9%	42.6%	41.0%	37.1%
Other (%)	1.9%	2.0%	2.4%	3.0%	3.0%

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	2.53%	2.41%	2.22%	2.45%	2.49%
Yield on assets	5.45%	3.34%	2.73%	3.11%	3.47%
Cost of liabilities	3.25%	1.09%	0.69%	0.85%	1.06%
Non-int. inc (% Op income)	27.36%	31.09%	35.84%	31.94%	30.74%
Cost to income	25.57%	24.44%	24.60%	22.97%	21.66%
Overhead	0.89%	0.85%	0.85%	0.81%	0.80%
ROA	2.07%	2.10%	1.95%	1.98%	2.11%
ROE	22.23%	22.48%	22.93%	24.10%	25.73%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	1%	-1%	1%	7%	11%
Net profit	1%	-2%	-4%	5%	12%
EPS	1%	-2%	-4%	5%	12%
DPS	2%	10%	-9%	0%	0%
Net Loans	2%	1%	2%	4%	6%
Assets	-5%	0%	6%	1%	3%
Deposits	-4%	-1%	6%	1%	2%

Bank of East Asia

All sizzle, no steak

Rating: SELL

The differentiating factor for BEA has long been its China business. The bank has the largest branch network in China, and is able to go up against HSBC and Citibank for penetration despite its far inferior size.

In recent days BEA has won approval to conduct RMB business—both deposit-taking and lending—with domestic firms out of the bank's Shanghai branch, as opposed to its current MNC and JV franchise. Only four banks have to date received this permission, with the others being Citibank, HSBC, and Mizuho.

No foreign banks will be permitted to do RMB business with Chinese consumers until 2006, so this is the ultimate prize on offer at this point.

Despite the good news and torrid loan expansion, BEA's self-reported China profits actually fell year on year, from HK$160m in 2002 to HK$129m in 2003. We estimate that this means an ROE for the China business of approximately 6-7%.

BEA continues to lose net interest margin, primarily because the size of the bank's balance sheet is controlled by depositors. A 9.8% rise in deposits during 2003 added HK$15bn to the liability book, matched by a HK$13bn rise in assets. Loans, however, were shrinking, so the excess funds wound up swelling the interbank and securities accounts—an unrewarding business in a low-rate environment. BEA needs a turnaround in interest rates to begin increasing margins again.

The bank's loan book continues to run off overall (customer loans were down 5.1% during 2003), despite healthy growth outside its main Hong Kong business. One of the major decisions that BEA has made with regard to the loan book is to let the mortgage portfolio run down and to sell portfolios to the Hong Kong Mortgage Corporation.

An area of clear outperformance is the bank's mainland China portfolio, which continues to grow by leaps and bounds as new offices are opened and mature. The mainland book increased by 22% *half-on-half* in 2H03, actually accelerating its rate of growth. Profitability, however, has been distinctly elusive.

BEA's asset quality is definitely getting better, with gross NPLs down by 16% YoY to 2.9% of total loans. Our NPL migration analysis shows that loans have started to be upgraded to performing on a net basis in the second half of 2003; this is strong evidence of a broad-based economic recovery.

The core of BEA's remaining bad loan problem remains the mainland book—on average a whopping 13.4% NPL—which makes us wonder how BEA reports a profit at all in the mainland given thin regulated spreads.

BEA is simply too expensive for us to recommend given its limited overall growth and poor ROE. At its closing price of HK$22.80 BEA is trading on 17.3x the just-announced 2003 EPS, and at 1.7x book value per share (1.9x tangible BVPS). Even projecting steady earnings growth for next year and looking at core earnings instead of net (adding back the goodwill amortisation as we should properly do when valuing the company) brings us to over 15x.

We maintain our SELL rating and HK$20 price target.

Bank of East Asia

Hong Kong

Share Price:	22.80	**Reuters Code:**	0023.HK	**Shares Outstanding**	1,453,702
52 Week Price Range:	13.70 - 25.95	**Bloomberg Code:**	23 HK	**Market Cap (US$m)**	4,249

INCOME STATEMENT (HK$m)	**01**	**02**	**03**	**04**	**05**
Interest income	9,743	6,553	5,764	6,997	8,134
Interest expense	5,765	2,727	2,168	2,891	3,691
Net interest income	**3,977**	**3,826**	**3,596**	**4,107**	**4,442**
Non-interest income	1,198	1,576	1,915	1,723	1,826
Total operating income	**5,176**	**5,401**	**5,511**	**5,829**	**6,268**
Non-interest expense	2,763	2,769	2,385	2,548	2,677
Pre provision profit	**2,413**	**2,632**	**3,125**	**3,281**	**3,591**
Loan loss provisions	432	811	499	642	644
Non-operating income	78	215	233	100	100
Pre tax profit	**2,058**	**2,036**	**2,860**	**2,740**	**3,048**
Tax	279	266	433	462	516
Net profit	**1,600**	**1,288**	**1,922**	**2,033**	**2,287**

BALANCE SHEET (HK$m)	**01**	**02**	**03**	**04**	**05**
Gross loans	108,735	109,497	105,611	118,818	131,386
Loan loss reserves	*1,921*	*1,760*	*1,640*	*1,767*	*1,786*
Net loans	106,814	107,737	102,833	117,051	129,600
Total earning assets	172,917	173,124	191,312	196,763	207,695
Other assets	8,848	12,119	7,165	7,876	8,314
Total Assets	**181,765**	**185,243**	**198,476**	**204,640**	**216,008**
Deposits	154,571	153,196	168,224	174,026	184,165
Paying liabilities	159,159	161,970	172,725	179,622	190,088
Other liabilities	69	77	5,625	5,527	5,849
Total Liabilities	159,227	162,047	178,350	185,149	195,936
Total Equity	**18,248**	**18,875**	**20,102**	**20,464**	**21,693**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	4,038	3,816	3,049	2,888	2,633
NPAs/total loans	3.7%	3.5%	2.9%	2.4%	2.0%
Reserve coverage of NPAs	47.6%	46.1%	53.8%	61.2%	67.8%

PER SHARE DATA (HK$)	**01**	**02**	**03**	**04**	**05**
EPS	1.12	0.89	1.32	1.40	1.58
DPS	0.54	0.56	0.85	0.70	0.73
Effective payout ratio (%)	*48%*	*63%*	*64%*	*50%*	*46%*
BVPS	12.75	13.00	13.83	14.12	14.97

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	70.3%	71.5%	62.1%	68.3%	71.3%
Equity to assets	10.0%	10.2%	10.1%	10.0%	10.0%
Tier 1 CAR	12.5%	12.4%	13.0%	13.2%	14.0%
Total CAR	17.5%	17.0%	17.2%	16.7%	17.5%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	1.8x	1.8x	1.6x	1.6x	1.5x
Price to earnings	20.4x	25.7x	17.2x	16.3x	14.4x
Price to underlying profit	13.5x	12.6x	10.6x	10.1x	9.2x
Yield at current price (%)	2.4	2.4	3.7	3.1	3.2

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	5.3%	4.6%	4.2%	4.5%	6.0%
Mortgage (%)	41.2%	38.5%	34.9%	31.0%	36.0%
Corporate (%)	34.5%	34.0%	33.2%	38.9%	33.2%
Other (%)	19.0%	23.0%	27.8%	25.6%	24.8%

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	2.32%	2.21%	1.97%	2.14%	2.20%
Yield on assets	5.63%	3.79%	3.01%	3.56%	3.92%
Cost of liabilities	3.65%	1.70%	1.30%	1.66%	2.00%
Non-int. inc (% Op income)	23.15%	29.17%	34.74%	29.55%	29.13%
Cost to income	53.38%	51.27%	43.29%	43.71%	42.70%
Overhead	1.61%	1.60%	1.31%	1.33%	1.32%
ROA	0.89%	0.70%	1.00%	1.02%	1.09%
ROE	9.00%	6.94%	9.86%	10.19%	10.85%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	-16%	9%	19%	10%	9%
Net profit	-15%	-19%	49%	19%	12%
EPS	-17%	-21%	49%	19%	12%
DPS	-17%	3%	52%	4%	4%
Net Loans	4%	1%	-5%	6%	11%
Assets	1%	2%	7%	5%	6%
Deposits	2%	-1%	10%	6%	6%

Dah Sing Financial

Cash and consumption

Rating: SELL

Dah Sing is an atypical Hong Kong bank in that it has relatively low property exposure, with corporate loans to developers and investors accounting for only 9% of the loan portfolio and mortgages a further 37% (comparable figures for Hang Seng are 22% and 49%, respectively). The bank is highly leveraged to consumer assets, with credit cards and other personal lending accounting for 19% of total loans—the highest concentration for any Hong Kong bank including Standard Chartered.

Dah Sing's strategy has been differentiated over the past few quarters by the bank's eagerness to attract additional deposits, even at a point in the rate cycle where most banks eschew them—in particular the more expensive time deposits and CDs—due to the lack of high-spread reinvestment opportunities. These excess deposits have made the balance sheet very liquid.

It should be noted that on a hefty ROA of 1.6%, Dah Sing could easily have a considerably higher ROE than its current 15.4% if capital management were strictly imposed. If the company were to reduce its 21% (consolidated) CAR to a figure closer to the regulatory minimum of 12%, ROE would have considerable upside.

However, management has indicated that they will continue to retain excess capital in the near term, dismissing any immediate idea of a large special dividend or share buyback from the public float. This is consistent with building a “war chest” of excess capital so that DSF can participate in any available M&A. In fact, 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 will raise funds for potential M&A, but will depress ROE.

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.

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 which will create such a discount and dilute EPS and ROE in order to favour the controlling shareholder, and downgraded from BUY to SELL on its announcement[8].

Major Japanese financial group UFJ owns a 15% stake in DSF. As UFJ is financially troubled and in need of capital, we believe that it makes sense for the company to unload its non-core overseas assets, which include the DSF stake.

Although DSF would indeed make a tempting takeover target, any buyer of the UFJ stake would also need to make arrangements to buy the Wong family's 37% interest in DSF—and the family is a much less motivated seller than is the moribund Japanese lender.

Dah Sing is currently trading on 2.0x trailing book value and 1.9x our estimate of YE2004 BVPS, with earnings multiples of 13.7x 2003 and 12.5x 2004 EPS respectively. We maintain our SELL rating with a price target of HK$54.

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[8] Please refer to our recent report: *Dah Sing Financial: Looking out for #1*, dated March 18, 2004 for additional details.

Dah Sing Financial

Hong Kong

Share Price:	55.25	**Reuters Code:**	0440.HK	**Shares Outstanding**	246,747
52 Week Price Range:	31.80 - 66.00	**Bloomberg Code:**	440 HK	**Market Cap (US$m)**	1,748

INCOME STATEMENT (HK$m)	**01**	**02**	**03**	**04**	**05**
Interest income	3,183	2,569	2,361	2,702	3,237
Interest expense	1,503	741	675	862	1,130
Net interest income	**1,681**	**1,829**	**1,687**	**1,840**	**2,107**
Non-interest income	726	723	834	709	796
Total operating income	**2,407**	**2,551**	**2,521**	**2,548**	**2,903**
Non-interest expense	928	881	794	794	826
Pre provision profit	**1,479**	**1,670**	**1,728**	**1,754**	**2,077**
Loan loss provisions	425	704	535	441	424
Non-operating income	72	38	62	0	0
Pre tax profit	**1,127**	**1,004**	**1,255**	**1,313**	**1,653**
Tax	118	92	123	223	281
Net profit	**868**	**829**	**993**	**1,090**	**1,372**

BALANCE SHEET (HK$m)	**01**	**02**	**03**	**04**	**05**
Gross loans	29,643	28,543	28,340	30,363	32,604
Loan loss reserves	*608*	*540*	*510*	*663*	*711*
Net loans	28,998	28,003	27,829	29,700	31,893
Total earning assets	50,644	56,810	61,058	62,815	64,785
Other assets	3,788	3,320	2,698	2,363	2,363
Total Assets	**54,432**	**60,129**	**63,756**	**65,178**	**67,148**
Deposits	38,976	44,237	48,030	49,021	50,000
Paying liabilities	33,192	37,378	49,000	50,191	51,193
Other liabilities	14,769	15,634	6,941	7,826	8,042
Total Liabilities	47,961	53,012	55,942	58,017	59,235
Total Equity	**5,417**	**6,094**	**6,789**	**7,161**	**7,913**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	761	771	677	827	882
NPAs/total loans	2.6%	2.7%	2.4%	2.7%	2.7%
Reserve coverage of NPAs	79.9%	70.0%	75.4%	80.2%	80.6%

PER SHARE DATA (HK$)	**01**	**02**	**03**	**04**	**05**
EPS	3.52	3.36	4.02	4.42	5.56
DPS	1.12	1.12	1.33	1.98	2.49
Effective payout ratio (%)	*32%*	*33%*	*33%*	*45%*	*45%*
BVPS	21.96	24.70	27.51	29.02	32.07

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	75.1%	63.6%	58.1%	61.9%	65.2%
Equity to assets	10.0%	10.1%	10.6%	11.0%	11.8%
Tier 1 CAR	14.2%	15.0%	19.0%	19.6%	20.4%
Total CAR	18.6%	19.7%	21.3%	21.9%	23.2%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	2.5x	2.2x	2.0x	1.9x	1.7x
Price to earnings	15.7x	16.4x	13.7x	12.5x	9.9x
Price to underlying profit	9.2x	8.2x	7.9x	7.8x	6.6x
Yield at current price (%)	2.0	2.0	2.4	3.6	4.5

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	22.0%	20.6%	18.2%	19.0%	24.5%
Mortgage (%)	37.3%	37.0%	39.0%	40.3%	40.1%
Corporate (%)	39.1%	40.3%	40.6%	38.7%	33.5%
Other (%)	1.6%	2.0%	2.2%	2.0%	1.9%

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	3.46%	3.40%	2.86%	2.94%	3.30%
Yield on assets	6.29%	4.52%	3.87%	4.30%	5.00%
Cost of liabilities	4.58%	2.10%	1.56%	1.73%	2.23%
Non-int. inc (% Op income)	30.17%	28.32%	33.10%	27.81%	27.42%
Cost to income	38.54%	34.54%	31.48%	31.16%	28.45%
Overhead	1.91%	1.64%	1.35%	1.27%	1.29%
ROA	1.67%	1.45%	1.60%	1.68%	2.07%
ROE	16.95%	14.40%	15.41%	15.89%	18.20%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	20%	13%	3%	0%	18%
Net profit	7%	-5%	20%	11%	26%
EPS	7%	-5%	20%	11%	26%
DPS	4%	0%	19%	55%	26%
Net Loans	-1%	-3%	-1%	6%	7%
Assets	10%	10%	6%	1%	3%
Deposits	3%	13%	9%	1%	2%

Bank of China (HK)

Something to prove

Rating: HOLD

Bank of China (Hong Kong) has a unique status among Hong Kong banks as simultaneously the franchise with the greatest potential and that with the most egregious downside.

BOCHK is still reaping the benefits of its integration of the Hong Kong operations of 13 separate Bank of China-owned entities and of steadily diminishing—but still very real—asset quality problems, which give the bank tremendous potential earnings leverage in an improving economy.

In addition, the bank's relationship with its mainland parent has allowed for use of BOC's branch network in China, joint ventures to develop cross-border credit cards for both Hong Kong and mainland residents, and most recently the appointment of BOCHK as the clearing bank for offshore RMB deposits in Hong Kong.

However, BOCHK does still have inferior corporate governance and internal controls when compared with Asian institutions of comparable size (*viz.*, Hang Seng Bank, DBS, Standard Chartered). Although its aftermath has been handled extremely well, the 2003 Shanghai Land scandal highlighted the weaknesses of BOCHK's legacy culture.

Not only were executives forced to leave the bank under circumstances which call into severe question their judgement, but the bank's lending practices—even right up to the period of its 2002 listing—were revealed to be primitive. Perhaps most alarmingly, an independent review of the bank's credit resulted in substantial downgrades to reported classified assets.

Although it will be some time before we will conclusively know whether or not BOCHK has made a fresh start, we are beginning to believe that it has. In particular, we think management has been generally forthcoming about the bank's issues and shortcomings—always unusual in our universe.

Also in BOCHK's favour in the current reflationary environment is the bank's large exposure to real estate. The bank's premises and investment property holdings account for over 12% of market capitalisation, the highest among its large bank peers. This has been a drag over the past two years, as BOCHK took a HK1.2bn charge to the P&L for real estate revaluation in 1H03, following on the heels of a HK$1.0bn hit in 2H02.

With prices now on the upswing, Bank of China HK should not only eliminate a negative but even potentially book some gains as these properties are gradually divested.

At 2.5x trailing and 2.3x forward BVPS, BOCHK is not inexpensive (although it is the cheapest of the HK large-cap banks), but its earnings multiple of 18.5x 2003 declines to 15.5x in 2004. We maintain our HOLD rating with a price target of HK$13.50.

Bank of China (Hong Kong)

Hong Kong

Share Price:	13.95	**Reuters Code:**	2388.HK	**Shares Outstanding**	10,573
52 Week Price Range:	7.60 - 15.90	**Bloomberg Code:**	2388 HK	**Market Cap (US$m)**	18,909

INCOME STATEMENT (HK$000)	**01**	**02**	**03**	**04**	**05**
Interest income	38,307	21,463	17,759	23,165	27,433
Interest expense	23,320	7,521	4,885	7,776	10,511
Net interest income	**14,987**	**13,942**	**12,874**	**15,389**	**16,921**
Non-interest income	4,147	4,065	4,400	4,514	4,750
Total operating income	**19,134**	**18,007**	**17,274**	**19,903**	**21,671**
Non-interest expense	5,847	6,025	5,658	5,533	5,757
Pre provision profit	**13,287**	**11,982**	**11,616**	**14,370**	**15,915**
Loan loss provisions	7,412	2,855	1,671	3,100	3,000
Non-operating income	2,009	932	1,115	-132	-132
Pre tax profit	**7,884**	**10,059**	**11,060**	**11,138**	**12,782**
Tax	832	1,268	589	1,634	1,873
Net profit	**2,768**	**6,673**	**7,963**	**9,504**	**10,910**

BALANCE SHEET (HK$000)	**01**	**02**	**03**	**04**	**05**
Gross loans	325,222	323,345	311,007	329,691	343,514
Loan loss reserves	*17,156*	*15,042*	*10,913*	*16,516*	*17,010*
Net loans	305,886	306,297	298,189	310,721	323,947
Total earning assets	678,221	704,905	753,745	693,431	703,431
Other assets	87,919	30,584	8,842	30,086	30,520
Total Assets	**766,140**	**735,489**	**762,587**	**723,517**	**733,951**
Deposits	666,723	630,934	644,421	620,664	629,614
Paying liabilities	666,723	630,934	644,421	620,664	629,614
Other liabilities	46,181	46,500	56,749	39,744	37,409
Total Liabilities	712,904	677,434	701,170	660,408	667,023
Total Equity	**52,170**	**56,941**	**60,261**	**63,063**	**66,881**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	40,657	28,310	19,660	31,968	29,935
NPAs/total loans	12.6%	8.8%	6.4%	9.8%	8.8%
Reserve coverage of NPAs	42.2%	53.1%	55.5%	51.7%	56.8%

PER SHARE DATA (HK$)	**01**	**02**	**03**	**04**	**05**
EPS	0.26	0.63	0.75	0.90	1.03
DPS	0.13	0.40	0.52	0.58	0.67
Effective payout ratio (%)	*50%*	*63%*	*68%*	*65%*	*65%*
BVPS	4.93	5.39	5.70	5.96	6.33

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	48.5%	50.9%	48.0%	52.7%	54.2%
Equity to assets	6.8%	7.7%	7.9%	8.7%	9.1%
Tier 1 CAR	13.4%	13.1%	13.9%	14.5%	15.4%
Total CAR	14.4%	14.0%	14.7%	15.2%	16.1%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	2.8x	2.6x	2.4x	2.3x	2.2x
Price to earnings	53.3x	22.1x	18.5x	15.5x	13.5x
Price to underlying profit	11.1x	12.3x	12.7x	10.3x	9.3x
Yield at current price (%)	0.9	2.9	3.7	4.2	4.8

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	4.0%	4.0%	3.9%	4.2%	4.5%
Mortgage (%)	32.1%	35.1%	36.0%	37.2%	39.0%
Corporate (%)	63.9%	60.9%	60.1%	58.6%	56.5%
Other (%)	0.0%	0.0%	0.0%	0.0%	0.0%

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	2.12%	2.02%	1.77%	2.21%	2.42%
Yield on assets	5.65%	3.04%	2.43%	3.34%	3.90%
Cost of liabilities	3.26%	1.16%	0.77%	1.25%	1.68%
Non-int. inc (% Op income)	21.67%	22.57%	25.47%	22.68%	21.92%
Cost to income	30.56%	33.46%	32.75%	27.80%	26.56%
Overhead	0.83%	0.87%	0.78%	0.79%	0.82%
ROA	0.34%	0.89%	1.06%	1.31%	1.50%
ROE	6.47%	12.23%	13.59%	15.48%	16.79%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	-12%	-10%	-3%	11%	11%
Net profit	-47%	141%	19%	36%	15%
EPS	-47%	141%	19%	36%	15%
DPS	43%	206%	29%	47%	15%
Net Loans	-5%	0%	-3%	2%	4%
Assets	-9%	-4%	4%	-1%	1%
Deposits	-13%	-5%	2%	-1%	1%

IBA

Going, going...

Rating: SELL

Fubon Bank agreed to purchase the 55% of IBA held by Arab Bank in September 2003 for a net price of HK$3.68 (not including the dividend which was paid to investors of record as of January 8th), and on February 16th made a general offer for the remainder of the bank, comprising a 20% stake held by China Everbright and 25% public float.

The general offer failed to attract material support other than from China Everbright, which tendered its full stake. Only 0.8% of the public shares were tendered and purchased, which same amount will now have to be resold into the market in order to meet the 25% public float requirement.

In our July 2003 report on IBA[9] we predicted that the bank—which had by then been for sale for over a year—would find a bidder at HK$3.50-3.75, and even highlighted Fubon as a likely buyer. We continue to believe that IBA has considerably less value as a standalone entity than it does as an M&A target; remember that our formal recommendations and target prices are never based on M&A.

However, IBA shares traded through the Fubon offer price post the approval of the transaction and remained above HK$3.68 for some time after before falling victim to the general decline in the Hong Kong market. We believe that this optimism was related to the recent history of failed privatisation candidates trading higher after the failure of their offers, as happened most recently with JCG.

While we believe that there is clearly some room for catch-up, given that the sector fundamentals and valuation have been very strong since Fubon's original agreement with ABC in September 2003, we don't see much chance of a permanent re-rating of the stock at this point.

IBA has not earned its cost of capital in over five years, with current ROE coming in at 2.8% and a projected full-year 2005 peak only reaching 6.93%. The bank's troubles are operational and not gearing-related; although CAR of 20% is high a low ROA of 0.33% means that even a highly levered IBA would have difficulty achieving investors' required returns.

IBA is also carrying a heavy load of NPLs and foreclosed property, with very little (18%) reserve coverage against these assets and a net reserve level similar to that of Hang Seng Bank, despite much softer asset quality.

Remember that the IBA situation is distinct from that of JCG in that Public Bank was looking to fully privatise JCG in order to upstream its huge excess capital. In contrast, Fubon is only looking for a position in Hong Kong, and potentially (IBA is not currently eligible under CEPA) a way into China.

With a 75% stake already won, Fubon has undisputed control of IBA and can use it in whatever way it likes. Furthermore, ample opportunities exist to take cash out of the company through management contracts, service agreements, and cherry-picking of IBA customers into Fubon's existing full-license Hong Kong branch.

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[9] *IBA: Selling off the family silver*, dated July 31, 2003

IBA

Hong Kong

Share Price:	3.28	**Reuters Code:**	0636.HK	**Shares Outstanding**	1,172,160
52 Week Price Range:	2.55 - 4.03	**Bloomberg Code:**	636 HK	**Market Cap (US$m)**	493

INCOME STATEMENT (HK$m)	**01**	**02**	**03**	**04**	**05**
Interest income	1,708	1,130	1,012	1,146	1,254
Interest expense	950	402	371	381	400
Net interest income	**758**	**728**	**641**	**766**	**854**
Non-interest income	274	325	229	166	173
Total operating income	**1,032**	**1,053**	**871**	**931**	**1,026**
Non-interest expense	487	457	467	469	474
Pre provision profit	**545**	**597**	**403**	**462**	**552**
Loan loss provisions	238	375	289	220	190
Non-operating income	0	0	0	0	0
Pre tax profit	**307**	**222**	**114**	**242**	**362**
Tax	12	-3	12	41	62
Net profit	**295**	**225**	**103**	**201**	**301**

BALANCE SHEET (HK$m)	**01**	**02**	**03**	**04**	**05**
Gross loans	16,730	15,162	15,413	15,487	15,778
Loan loss reserves	*346*	*200*	*214*	*206*	*243*
Net loans	16,384	14,961	15,199	15,280	15,536
Total earning assets	26,724	30,802	29,041	29,180	29,730
Other assets	1,889	1,511	1,667	1,905	2,003
Total Assets	**28,612**	**32,312**	**30,707**	**31,085**	**31,733**
Deposits	23,861	23,881	26,457	26,596	26,862
Paying liabilities	21,819	24,073	20,863	21,002	21,270
Other liabilities	3,137	4,473	6,171	6,348	6,568
Total Liabilities	24,957	28,547	27,034	27,351	27,839
Total Equity	**3,655**	**3,766**	**3,674**	**3,734**	**3,894**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	1,659	1,183	1,023	837	711
NPAs/total loans	9.9%	7.8%	6.6%	5.4%	4.5%
Reserve coverage of NPAs	20.9%	16.9%	20.9%	24.6%	34.1%

PER SHARE DATA (HK$)	**01**	**02**	**03**	**04**	**05**
EPS	0.25	0.19	0.09	0.17	0.26
DPS	0.11	0.12	0.12	0.12	0.12
Effective payout ratio (%)	*44%*	*62%*	*137%*	*70%*	*47%*
BVPS	3.12	3.21	3.13	3.19	3.32

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	70.1%	63.5%	58.3%	58.2%	58.7%
Equity to assets	12.8%	11.7%	12.0%	12.0%	12.3%
Tier 1 CAR	NA	NA	NA	NA	NA
Total CAR	19.7%	21.4%	20.8%	21.2%	22.1%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	1.1x	1.0x	1.0x	1.0x	1.0x
Price to earnings	13.0x	17.1x	37.5x	19.1x	12.8x
Price to underlying profit	7.1x	6.4x	9.5x	8.3x	7.0x
Yield at current price (%)	3.4	3.7	3.7	3.7	3.7

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	9.7%	7.8%	6.4%	7.0%	8.2%
Mortgage (%)	41.8%	40.6%	40.9%	40.1%	41.0%
Corporate (%)	47.7%	51.3%	52.2%	52.4%	50.3%
Other (%)	0.8%	0.3%	0.5%	0.5%	0.5%

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	2.80%	2.53%	2.14%	2.63%	2.90%
Yield on assets	6.39%	3.67%	3.48%	3.93%	4.22%
Cost of liabilities	4.29%	1.75%	1.65%	1.82%	1.89%
Non-int. inc (% Op income)	26.55%	30.86%	26.35%	17.81%	16.83%
Cost to income	47.20%	43.37%	53.67%	50.40%	46.20%
Overhead	1.80%	1.59%	1.56%	1.61%	1.61%
ROA	1.02%	0.74%	0.33%	0.65%	0.96%
ROE	8.28%	6.07%	2.76%	5.42%	7.88%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	21%	9%	-32%	15%	20%
Net profit	21%	-24%	-54%	96%	50%
EPS	21%	-24%	-54%	96%	50%
DPS	37%	9%	0%	0%	0%
Net Loans	-6%	-9%	2%	1%	2%
Assets	-2%	13%	-5%	1%	2%
Deposits	-3%	0%	11%	1%	1%

JCG Holdings

Capital strangulation

Rating: SELL

The bulk of JCG's loan portfolio is consumer finance and personal lending, generally at rates of 16% and above. The typical loan tenor is 24 months with a range of 6 to 36 months. JCG historically has targeted the lower and middle-income brackets, although in recent years the company has made some efforts to move upstream. Its existing customer base consists of 20% civil servants, 30% domestic helpers and 50% others.

JCG is majority (65.3%) owned by Malaysia's Public Bank, which tried and failed to fully privatize the company in September 2003, as minority shareholders spurned the offer of HK$4.61 per share. While the JCG franchise is a valuable and well-managed one, we question how shareholders can unlock that value.

Faced with an unyielding minority shareholder base, Public Bank maintained its HK$4.61 bid for JCG to the last; it was rejected by 58% of minority shareholders. In the meantime, Public bought an additional 3.6% of JCG in the open market, further reducing float.

What you pay depends on where you sit: JCG is worth a high price to Public Bank—but much less to minority investors as a standalone company. PBK has made it clear that JCG will not manage capital; combined with reduced float, this means that shareholders can only wait for another privatisation bid to monetise their holdings—not a possibility until at least September 2004.

We still do expect Public Bank to eventually take over JCG and merge it into PBK's Hong Kong full bank, but in the meantime management has every incentive to hold down results and make the company look weak, in order to drive down the price.

JCG's year-end 2003 equity base exceeded 68% of total assets, an utterly ridiculous level for a finance company of any sort. This is the key reason for JCG's inability to deliver ROE above its cost of capital, despite a very profitable underlying business (ROAA of 4.7%) and an upswing in Hong Kong consumer spending.

The downside of Public Bank's failed bid is that JCG has few opportunities to manage capital on its own aside from returning it to shareholders—a path that management has clearly pooh-poohed. In fact, JCG actually cut the interim dividend for 2003 from the prior year, despite overcapitalisation. We believe that it is Public Bank's intention to retain as much capital as possible within JCG (and take a commensurately lower ROE) in order to drive minority holders to sell.

Needless to say, this is not a dynamic which makes us want to hold JCG shares. We maintain our SELL rating and HK$5.20 price target.

JCG Holdings

Hong Kong

Share Price:	6.30	**Reuters Code:**	0440.HK	**Shares Outstanding**	707,662
52 Week Price Range:	3.18 - 7.25	**Bloomberg Code:**	440 HK	**Market Cap (US$m)**	572

INCOME STATEMENT (HK$m)	**01**	**02**	**03**	**04**	**05**
Interest income	929	800	723	813	868
Interest expense	90	29	32	47	67
Net interest income	**839**	**771**	**691**	**766**	**801**
Non-interest income	194	168	170	168	177
Total operating income	**1,033**	**939**	**861**	**934**	**978**
Non-interest expense	214	200	186	201	210
Pre provision profit	**819**	**739**	**675**	**733**	**768**
Loan loss provisions	313	477	415	320	280
Non-operating income	-16	-3	0	0	0
Pre tax profit	**491**	**259**	**260**	**413**	**488**
Tax	62	28	27	62	73
Net profit	**429**	**237**	**232**	**351**	**415**

BALANCE SHEET (HK$m)	**01**	**02**	**03**	**04**	**05**
Gross loans	3,795	3,556	3,191	3,608	3,804
Loan loss reserves	*334*	*331*	*308*	*342*	*348*
Net loans	3,341	3,135	3,103	3,192	3,355
Total earning assets	4,424	4,895	4,565	4,959	5,183
Other assets	391	457	288	412	455
Total Assets	**4,815**	**5,352**	**4,853**	**5,370**	**5,638**
Deposits	1,034	1,774	1,309	2,147	2,362
Paying liabilities	1,234	1,774	1,309	2,339	2,683
Other liabilities	110	85	239	105	116
Total Liabilities	1,343	1,859	1,549	2,444	2,799
Total Equity	**3,266**	**3,277**	**3,304**	**3,528**	**3,810**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	280	236	216	216	190
NPAs/total loans	7.6%	6.8%	6.3%	6.1%	5.1%
Reserve coverage of NPAs	119.4%	140.4%	142.5%	158.2%	183.2%

PER SHARE DATA (HK$)	**01**	**02**	**03**	**04**	**05**
EPS	0.61	0.34	0.33	0.50	0.59
DPS	0.32	0.18	0.24	0.18	0.19
Effective payout ratio (%)	*53%*	*54%*	*73%*	*60%*	*60%*
BVPS	4.62	4.63	4.67	4.98	5.38

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	355.6%	195.4%	260.5%	164.6%	156.8%
Equity to assets	67.8%	61.2%	68.1%	65.7%	67.6%
Tier 1 CAR	NM	NM	NM	NM	NM
Total CAR	NM	NM	NM	NM	NM

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	1.4x	1.4x	1.3x	1.3x	1.2x
Price to earnings	10.4x	18.8x	19.2x	12.7x	10.8x
Price to underlying profit	5.4x	6.0x	6.6x	6.1x	5.8x
Yield at current price (%)	5.1	2.9	3.8	2.9	3.0

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	74.2%	73.2%	75.1%	77.2%	79.2%
Mortgage (%)	1.9%	1.3%	1.2%	1.2%	1.2%
Corporate (%)	23.9%	25.5%	23.7%	21.6%	19.6%
Other (%)	0.0%	0.0%	0.0%	0.0%	0.0%

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	17.99%	16.55%	14.61%	16.09%	15.79%
Yield on assets	20.99%	16.35%	15.84%	16.39%	16.74%
Cost of liabilities	5.40%	1.94%	2.10%	2.56%	2.66%
Non-int. inc (% Op income)	18.77%	17.88%	19.74%	17.96%	18.09%
Cost to income	20.67%	21.32%	21.64%	21.51%	21.47%
Overhead	4.58%	4.30%	3.94%	4.22%	4.14%
ROA	8.31%	4.67%	4.55%	6.87%	7.53%
ROE	13.53%	7.25%	7.05%	10.28%	11.30%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	8%	-10%	-9%	9%	5%
Net profit	-4%	-45%	-2%	51%	18%
EPS	-4%	-45%	-2%	51%	18%
DPS	0%	-44%	33%	-25%	4%
Net Loans	-11%	-6%	-1%	3%	5%
Assets	-12%	11%	-9%	11%	5%
Deposits	-22%	72%	-26%	64%	10%

Aeon Credit HK

Consumption leverage

Rating: BUY

Aeon is the #3 card issuer in Hong Kong, behind Standard Chartered and HSBC/Hang Seng. All of the company's other business is consumer-related as well, consisting primarily of hire purchase and instalment lending. Although consumer finance in Hong Kong has been hit hard by economic weakness and changes in the Bankruptcy Act, it is important to bear in mind that the business is sustainable in the long term for players with sufficient scale, especially as consumers shift from defensive savings to consumption.

Aeon HK is controlled by its top tier parent, Aeon Co. (8267 JP), through Aeon Credit Service Co., Ltd (8570 JP). Together, Aeon Co. and its affiliates own 66.2% of Aeon HK, with the remainder being free float.

The majority of Aeon's HP business (and the clear focus area going forward) is appliance financing, which the company does in conjunction with its retail partners, in particular corporate sibling Jusco Stores. The retailers want the added sales that financing makes possible, but do not want to operate the collection and servicing business – or take on the credit risk; hence, their outsourcing of this to Aeon. From Aeon's perspective, store chain tie-ups are an efficient marketing tool, as the retailer promotes the product.

Aeon management have changed the company's recruitment strategy for new customers in general, sourcing them through affiliates (such as merchant partners) rather than through branches. Aeon has closed 14 of its branches and merged several others, leaving the company with a network of 16 offices.

This reorganisation has yielded significant cost savings as well as better credit quality. Management targets at least a 10% reduction in overall expenses in FY2004, with advertising set to fall by 40%, staff costs by 15%, and premises by a further 10% as leases are renegotiated.

Management has been using securitisation and renegotiating its long-term funding lines to reduce its cost of liabilities (~7.4% for FY2003). The company's funding rate in 4Q03 was down to 5.6%, and the maturation of HK$900m of additional debt in FY2004 will result in a cost of funds projected at 5.4% for the full year.

Aeon is increasing fees as competition slackens, imposing an HK$20 fee for cash payments made at its branches or counters and increasing the cash advance handling charge to HK$40 from HK$30. In addition, the company has imposed a 1% fee on new personal loans.

The company is following its affiliate Jusco Stores into the mainland market, and will earn fees by handling instalment loan servicing without taking credit risk, pending Aeon's approval for a licence. This is a low-risk entry into a potentially large market.

We maintain our BUY rating and HK$6.00 price target.

Aeon Credit (Hong Kong) — Hong Kong

Share Price:	5.85	**Reuters Code:**	0900.HK	**Shares Outstanding**	418,766
52 Week Price Range:	2.38 - 6.20	**Bloomberg Code:**	900 HK	**Market Cap (US$m)**	314

INCOME STATEMENT (HK$m)	**01**	**02**	**03**	**04**	**05**
FY ended February					
Interest income	770	804	659	562	586
Interest expense	192	171	144	124	115
Net interest income	**578**	**633**	**515**	**438**	**470**
Non-interest income	72	78	302	278	349
Total operating income	**650**	**712**	**817**	**716**	**819**
Non-interest expense	273	296	274	263	259
Pre provision profit	**377**	**415**	**543**	**453**	**560**
Loan loss provisions	135	235	403	200	190
Non-operating income	0	-68	2	0	0
Pre tax profit	**242**	**112**	**141**	**253**	**370**
Tax	32	37	21	40	59
Net profit	**210**	**211**	**117**	**212**	**311**

BALANCE SHEET (HK$m)	**01**	**02**	**03**	**04**	**05**
Gross loans	2,650	2,776	2,886	2,981	3,162
Loan loss reserves	*90*	*149*	*237*	*354*	*468*
Net loans	2,560	2,627	2,649	2,626	2,694
Total earning assets	2,998	3,051	2,726	2,815	2,987
Other assets	157	245	221	228	242
Total Assets	**3,155**	**3,295**	**2,947**	**3,043**	**3,229**
Deposits	NM	NM	NM	NM	NM
Paying liabilities	2,135	2,134	1,759	1,758	1,736
Other liabilities	121	106	69	30	4
Total Liabilities	2,256	2,240	1,828	1,788	1,741
Total Equity	**899**	**1,056**	**1,106**	**1,256**	**1,488**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	192	276	340	61	56
NPAs/total loans	7.3%	10.0%	11.8%	2.0%	1.8%
Reserve coverage of NPAs	47.1%	53.8%	69.6%	582.9%	835.5%

PER SHARE DATA (HK$)	**01**	**02**	**03**	**04**	**05**
EPS	0.50	0.50	0.28	0.51	0.74
DPS	0.13	0.13	0.13	0.15	0.19
Effective payout ratio (%)	*25%*	*26%*	*46%*	*30%*	*25%*
BVPS	2.15	2.52	2.64	3.00	3.55

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	NM	NM	NM	NM	NM
Equity to assets	28.5%	32.0%	37.5%	41.3%	46.1%
Tier 1 CAR	NM	NM	NM	NM	NM
Total CAR	NM	NM	NM	NM	NM

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	2.7x	2.3x	2.2x	2.0x	1.6x
Price to earnings	11.7x	11.6x	20.9x	11.5x	7.9x
Price to underlying profit	6.5x	5.9x	4.5x	5.4x	4.4x
Yield at current price (%)	2.1	2.2	2.2	2.6	3.2

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	100.0	100.0	100.0	100.0	100.0
Mortgage (%)	-	-	-	-	-
Corporate (%)	-	-	-	-	-
Other (%)	-	-	-	-	-

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	20.30%	20.94%	17.84%	15.80%	16.21%
Yield on assets	25.68%	26.36%	24.17%	19.95%	19.61%
Cost of liabilities	9.02%	8.00%	7.39%	7.04%	6.60%
Non-int. inc (% Op income)	11.10%	11.02%	36.96%	38.87%	42.59%
Cost to income	42.00%	41.65%	33.54%	36.75%	31.63%
Overhead	9.59%	9.80%	9.49%	9.50%	8.93%
ROA	7.03%	6.54%	3.76%	7.09%	9.91%
ROE	23.35%	19.98%	10.60%	16.92%	20.89%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	3%	10%	31%	-17%	24%
Net profit	17%	0%	-44%	81%	46%
EPS	17%	0%	-44%	81%	46%
DPS	20%	4%	0%	15%	25%
Net Loans	12%	3%	1%	-1%	3%
Assets	12%	4%	-11%	3%	6%
Deposits	1%	0%	-18%	-100%	NM

Japan banks

Recovering

Rating: Overweight

We remain positive on the banking sector. Although much of the recovery is discounted in the share prices, in our opinion, there is further upside potential in some of the major banks. We believe a recovery in core profitability from next FY is likely to drive the shares higher.

Loan growth is likely to remain weak next FY, although we expect it to recover from FY3/06. We also expect asset yields to decline this FY on declining securities yields, but for next FY, we expect modest gains in asset yields.

In our report "*Japan's Bad Debt Burden: Getting Lighter",* published on 16 October 2003, we offered what we believe is one of the most comprehensive studies of Japan's bad debt problem. We found that while it is premature to say that the NPL problem has disappeared, there has been a material YoY improvement.

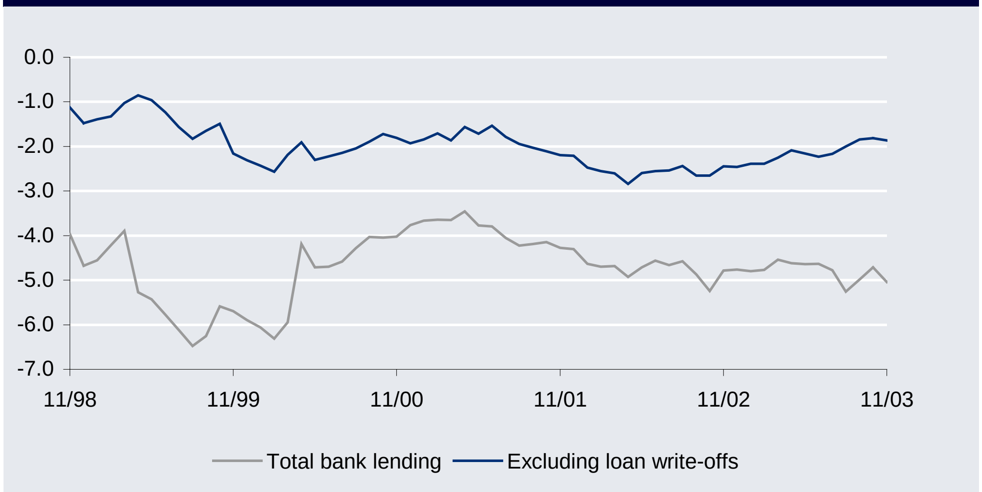
Any investment in the Japanese banks remains risky. However, we believe these risks have declined considerably over the past few months.

Loan growth

Loan volumes seem certain to continue their decline this FY. While the major banks proceed with non-performing loan disposal, corporate demand for credit remains weak and headline data points to a 4.5%-5.0% YoY decline. Furthermore, loan/deposit ratios continue to decline as deposits rise steadily, particularly at the major banks.

However, adjusted for loan write-offs, loan volumes are falling at sub-2% rates. An encouraging sign is that the rate of decline on an adjusted basis is decelerating steadily (see chart below).

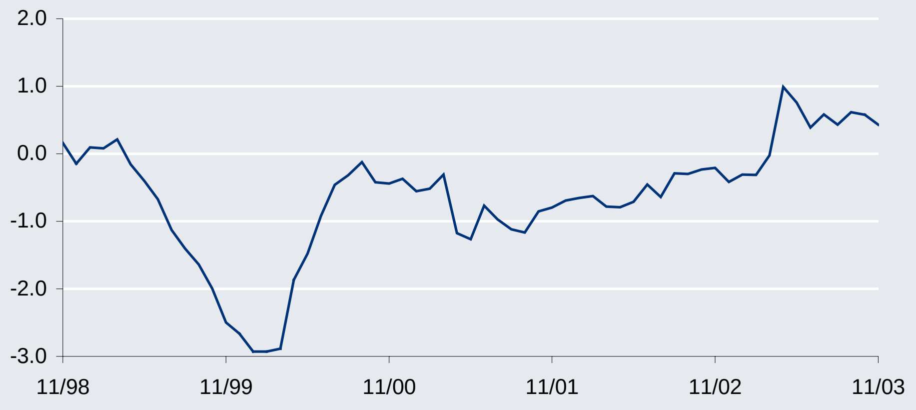
Fig 66 Bank lending YoY (%)



Source: BOJ

Furthermore, the overwhelming portion of the decline is accounted for by the major banks, which are pressing on with aggressive NPL disposal. Meanwhile, loan growth at the Tier I regional banks is considerably higher, and since April 2003, has been in positive territory. Moreover, it is worth pointing out that the data for the regional banks is not adjusted for loan write-offs, which understates the adjusted growth rate, albeit modestly.

Fig 67 Tier I regional bank lending YoY (%)



Source: BoJ

Is there demand for credit?

The large difference between the major banks and the regional banks' loan growth could have important implications. While many bank officials claim there is little demand for credit, as it turns out, regional banks have found opportunities to grow their loan books in recent months.

We believe the discrepancy between major banks and regional banks' loan growth has more to do with capital than with a lack of lending opportunities. The regional banks, on average, enjoy a substantially higher level of capital adequacy than the major banks and it can be argued that many regional banks are overcapitalised. Lacking capital constraints, regional banks are able to grow their loan books, while the major banks, pressed with low capital ratios, have been unwilling to extend credit – and in fact it could be argued that they are intentionally cutting it. It seems hard to believe that a major bank can reduce its loan book by over 15% in 12 months due to declines in demand only. Given that there has been a substantial improvement in the major banks' BIS ratios over 1H FY3/04, it can be argued that the major banks may be more willing to extend credit going forward.

An anomaly: Few high rate loans

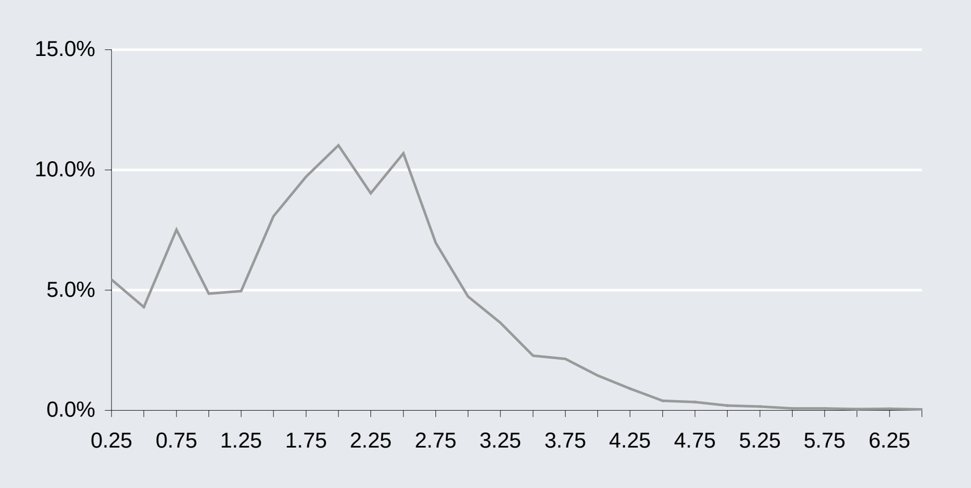
Furthermore, the distribution of loans by rate suggests the existence of an anomaly. According to the BoJ, there was virtually no bank lending above 5% at September 2003. Yet, there is lending at above 14% and it is proven by the existence of profitable sub-prime lenders who lend at interest rates above that!

It is illogical in an economic sense to argue that there is no demand for credit between 5% and 15%, as naturally someone who borrows at 15% would be willing to borrow at 10%. Rather, it suggests a gross inability by Japanese lenders (read banks) to service borrowers that may be willing to borrow in that range. This inability is likely due to a lack of appropriate credit scoring systems and reluctance to take on risk due to a capital shortage.

Yet this is perhaps the largest potential area of growth for the Japanese banks. The four Mega banks have already started offering unsecured loans to SMEs at above 3%

and, in some cases, balances are growing rapidly. We concede, though, that it will take some time before such loans produce a material contribution to earnings.

Fig 68 Loans outstanding by interest rate (%)

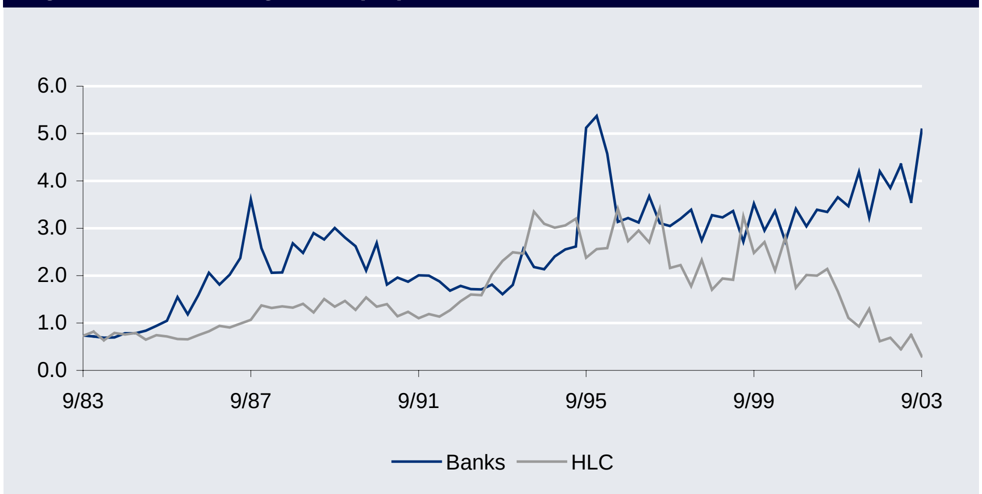


Source: BoJ

Housing loans

Housing loans offer robust growth opportunities for the Japanese banks. The scaling down of the Housing Loan Corporation (HLC) ahead of its planned dissolution in FY06 has provided banks with an opportunity to grow their housing loan books. While commercial banks control about 48% of the outstanding housing loans, they currently account for some 64% of new loans. The HLC has about 32% of the outstanding balances, but in 3Q CY03, extended less than 4% of the new housing loans.

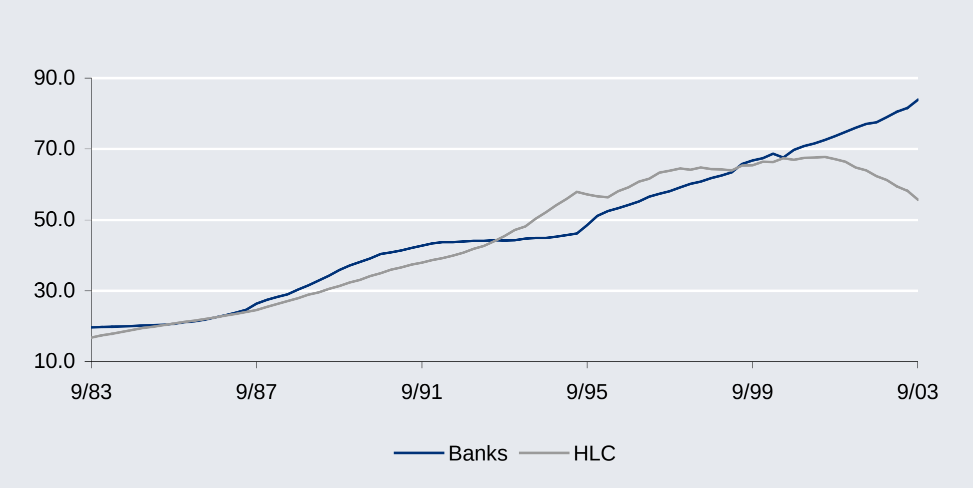
Fig 69 New housing loans (¥tr)



Source: BoJ

Furthermore, the low interest rate environment has increased demand for housing loans, while the banks have stepped up their efforts to expand their retail exposure. The relatively low charge-off rates, as well as the limited capital requirements (housing loans are 50% risk weighted), have made mortgages an attractive growth area, albeit a very competitive one.

Fig 70 Outstanding housing loans (¥tr)



Source: BoJ

While housing loans are likely to continue to grow steadily, we expect overall loan balances at the major banks to decline this FY, and in some cases, next FY as well.

Margins

Perhaps one of the most important issues that has concerned investors in Japanese banks for more than a decade is loan spreads. Net interest margin for the major banks has been substantially lower than for overseas banks over the past two decades. While this recovered marginally in the 1990s, it stood at a meagre 120bps in FY3/03. The ultra-low interest rate environment and the small consumer lending exposure of Japanese banks explain much of the gap between their NIM and that of foreign banks. Nonetheless, a major reason for the low margin is the modest corporate loan spread.

An interest rate hike will significantly improve margins, but we believe the BoJ is unlikely to change the zero interest rate policy before 2005. We nonetheless believe the banks may be able to improve loan margins by starting to charge higher interest rates on lower category borrowers. Furthermore, changes in loan portfolio mix toward higher yielding products like housing loans and SME loans are likely to result in improved average loan rates.

Fig 71 Major banks' net interest margin (%)

Source: Company data, ING

Last FY, NIM at the major banks fell as declining loan rates and securities yields failed to offset the gains made in lowering funding costs. This FY, we expect NIM to decline even further as asset yields are likely to remain under pressure.

However, the decline this FY is likely to be due to declines in securities yields rather than loan rate declines. In 1H FY3/04, NIM for the major banks fell largely due to declines in securities yields.

Fig 72 Domestic yields and rates* for 1H FY 3/04

Code	Name	Asset yield	*YoY chg bps*	Loan rates	*YoY chg bps*	Securities yield	*YoY chg bps*	Deposit rate	*YoY chg bps*
8306	MTFG	1.09	-3	1.46	-10	0.45	-1	0.03	-3
8307	UFJ	1.32	-10	1.74	-1	0.53	-24	0.02	-2
8316	SMFG	1.45	-2	1.73	1	0.58	-12	0.02	-2
8411	Mizuho	1.12	-4	1.59	1	0.52	-24	0.16	-4
8403	Sumitomo Trust	1.11	-10	1.28	-10	0.83	-11	0.21	-3

*Banking accounts only, non-consolidated

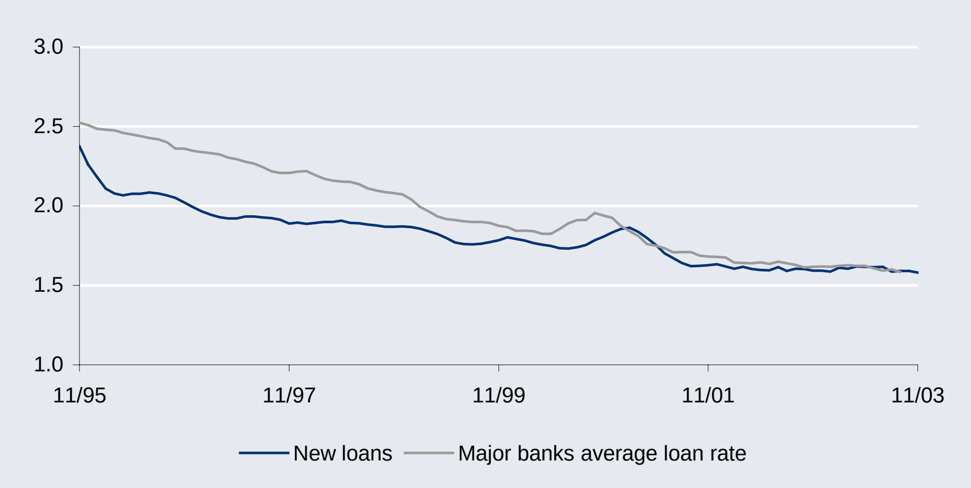
Source: Company data

It was encouraging to see that loan rates at three of the four Mega banks were flat YoY (for SMFG, UFJ and Mizuho). Despite the difficult lending environment and the pressure from refinancing at lower rates, the banks managed to prevent loan rates from declining substantially.

On the contrary, securities yields fell on average by 15bps YoY on declining long term rates and the banks shortening the duration of their bond portfolios (either through sales of longer maturity bonds or purchases of shorter maturity issues). As major banks' bond holdings at 9/03 accounted for over 12% of total assets, the declining securities yields depressed overall asset yields.

Despite the banks' efforts to increase loan spreads, headline BoJ data suggests that limited progress has been made so far. Nonetheless, it is worth pointing out that new loan rates and the banks' existing loan rates have started to converge; hence, pressure on spreads should start to ease. The new loan rate data, though, includes data for the regional banks, which tend to lend at higher rates, and as a result, understates the gap between the major banks' new lending and their existing lending. However, 1H results demonstrate that some of the major banks have managed to prevent loan rates from declining.

Fig 73 New loan rates* versus existing rates (%)



*Six-month average.
Source: BOJ, ING

We expect pressure on asset yields to continue in 2H, and while a decline is likely for the full year, we expect loan rates to rise modestly next FY, helped by banks' efforts to expand their higher rate lending and a gradual recovery in demand for credit. Furthermore, with long-term JGB yields reaching a low in June 2003, we expect pressure on securities yields to abate. As a result, we believe asset yields will hit a trough this FY before recovering next year.

Asset quality

Although there has been a substantial improvement in asset quality over the past 18 months, the size of Japan's bad debt problem remains an area of debate. The officially disclosed numbers are generally viewed as unreliable, largely due to the near-zero interest rate environment. The ultra-low lending rates have allowed weak borrowers to meet their loan obligations despite the deflationary environment, thus concealing the real extent of the problem.

Fig 74 NPLs by borrower category at 3/03 (¥tr)

Borrower category	All banks	YoY %	as % of total	Major banks*	YoY %	as % of total
Bankrupt	5.7	-22.4	1.4	2.2	-32.5	0.9
Doubtful	13.0	-32.6	3.2	6.6	-46.2	2.7
Special attention	16.6	0.6	4.1	11.5	1.3	4.7
Total NPLs	**35.3**	**-18.2**	**8.7**	**20.2**	**-24.4**	**8.3**
Watch list	*71.4*	*-11.0*	*17.5*	*40.5*	*-11.6*	*16.5*
Healthy	371.7	-5.5	91.3	224.5	-10.5	91.7
Total credit	**407.0**	**-6.8**	**100.0**	**244.7**	**-11.8**	**100.0**

*Excludes Shinsei Bank and Aozora Bank
Source: FSA, ING

In our report "*Japan's Bad Debt Burden: Getting Lighter*", published on 16 October 2003, we offered what we believe is one of the most comprehensive studies of Japan's bad debt problem. We found that while it is premature to say that the NPL problem has disappeared, there has been a substantial YoY improvement. We estimate that total potential problem loans in Japan are down 31.2% YoY to ¥95.8tr. Within that, we find loans belonging to companies that cannot afford a 50bps increase in borrowing costs from OP (we classify these as 'special attention') to be ¥43.8tr, down 4.2%YoY.

Much of the improvement is due to large corporate borrowers, where we find that only 10.9% of total bank borrowings can be considered as potential problem loans, down sharply from 23.6% a year ago. Conversely, the financial health of the SMEs has generally deteriorated YoY. While we found that loans on the broad 'watch list' have declined some 21.1% YoY, we estimate that 'special attention' loans are up 15.8% YoY. As a result, we expect lenders with larger SME exposure, such as regional banks, *shinkin* banks and credit co-operatives, to continue to face serious asset quality issues. While the improving economic environment is likely to push both large companies and SMEs' profits higher, and enhance their ability to service debt obligations, it may take longer for the SMEs to recover markedly.

However, due to their relatively high exposure to large corporates, major banks are likely to benefit substantially from the improved ability of large companies to service debt payments. We now estimate that the four Mega banks need to take ¥3.4tr, or about one year's worth of net business profits, in extra credit costs to solve the current bad debt problem.

Fig 75 Major banks' credit cost estimates

Code	Name	Credit costs (¥bn)	As % of credit
8306	MTFG	446	0.9
8307	UFJ	887	1.8
8316	SMFG	1,059	1.6
8411	Mizuho	1,048	1.5
Mega banks		3,440	1.5
8403	Sumitomo Trust	96	0.9

Source: ING

We have assumed that the banks will take two-thirds of the credit costs this FY and the remaining one-third next FY. In 1H FY3/04, the major banks continued to reduce NPLs, with MTFG and SMFG standing out as having made the most progress in the six months to September 2003.

Fig 76 NPLs at 9/03 (¥bn)

		Total NPLs		NPLs as % of credit	
Code	**Name**	**Amount**	**HoH**	**3/03**	**9/03**
8306	MTFG	1,857	-29.0	5.3	3.8
8307	UFJ	3,708	-10.9	8.7	8.1
8316	SMFG	4,453	-23.9	9.0	7.0
8411	Mizuho	4,336	-9.4	6.2	5.8
8308	Resona	3,219	10.8	9.3	11.2
8309	Mitsui Trust	671	-6.1	7.2	7.1
8403	Sumitomo Trust	373	-7.4	3.6	3.4
8404	Mizuho Trust	284	-9.8	7.5	7.4
TOTAL/AVERAGE		**18,900**	**-13.1**	**7.4**	**6.6**

Source: Company data

SMEs improving in 1H

Furthermore, 1H corporate data suggests a robust improvement in profitability at the SMEs, where we found most of the problem loans in our NPL study. According to the MOF corporate survey data, 1H OP at the SMEs, helped by a cyclical recovery, was up 7.4% YoY, in line with profit growth at large companies.

Fig 77 1H FY3/04 operating profit growth by group size, YoY (%)

	Manufacturing	Non-manufacturing	Total
Large companies	27.8	-6.1	7.5
Small companies	3.1	8.9	7.3
All companies	19.9	0.8	7.4

Note: Large defined as companies with capital in excess of ¥1bn, small with capital of less than ¥1bn.
Source: MOF, ING

OP at non-manufacturing SMEs, where we identified most of the problem loans to be, was up 8.9% YoY, faster than the 3.1% YoY at manufacturing SMEs. Furthermore, 1H OP of SMEs in sectors with a higher level of potential problem loans, like retail and services, grew 49.4% and 13.4% YoY, respectively – faster than other sectors.

The MOF series also suggested that corporates continued to cut leverage, as total debt for all companies was down 7.4% YoY. At the SMEs, total debt was down 9.4% YoY, with much of the decline accounted for by non-manufacturing companies.

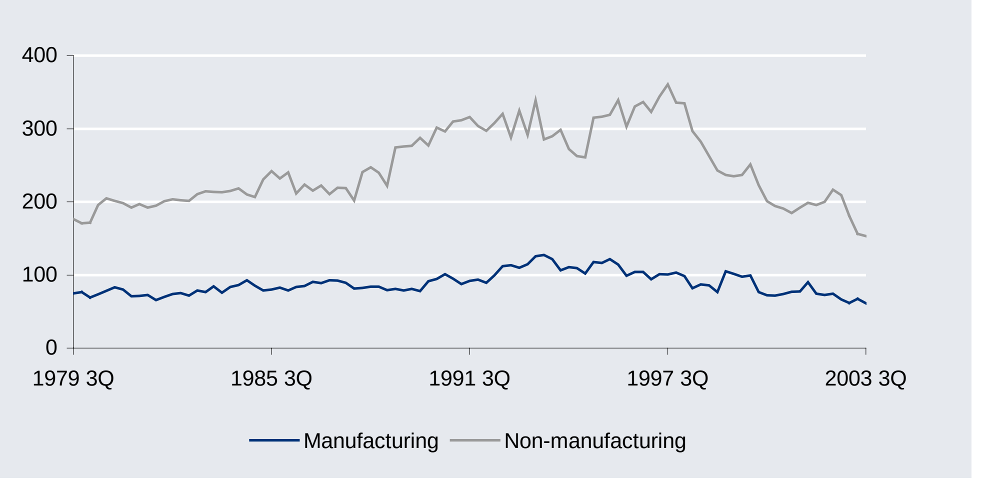
Fig 78 Total debt by size group, YoY (%)

	Manufacturing	Non-manufacturing	Total
Large companies	-2.6	-5.4	-4.6
Small companies	-5.3	-10.4	-9.4
All companies	-3.9	-8.5	-7.4

Note: Large defined as companies with capital in excess of ¥1bn, small with capital of less than ¥1bn.
Source: MOF, ING

As a result of the reduction in debt levels, SMEs' net debt to equity ratio is at its lowest level since the mid-1970s, suggesting that much of the debt overhang created during the bubble has been cut.

Fig 79 Net debt to equity at small companies (%)



Note: Large is defined as companies with capital in excess of ¥1bn, small with capital of less than ¥1bn.
Source: MOF, ING

Valuations

Despite the rally the major banks enjoyed in the second half of CY03, we believe the shares offer further room for appreciation, backed by the decline in potential problem loans and the improvement in capital adequacy. Furthermore, core profit recovery is likely to offer a further boost.

We have based our investment opinion on discounted cash flow models to arrive at the implied discount rate for each bank. In February 2003, this technique showed that UFJ was the most attractive among the Mega banks, and we remain comfortable with the methodology. We believe SMFG and UFJ offer an attractive risk-reward balance at present and we maintain our positive stance on these two stocks.

Fig 80 Implied discount rates (%)

				Treatment of public money	
Name	**Rating**	**Target price (¥)**	**Stock price* (¥)**	**Repayment**	**Conversion**
MTFG**	HOLD	933,000	1,020,000	6.0	6.0
UFJ	BUY	718,000	654,000	7.9	7.0
SMFG	BUY	908,000	781,000	8.5	7.8
Mizuho	HOLD	356,000	499,000	4.1	4.0
Sumitomo Trust**	HOLD	700	674	7.3	6.8

*As of 22 April 2004; **MTFG and Sumitomo Trust do not have public money
Source: Bloomberg, ING

Regional banks

For the regional banks, we use conventional PER and PBV multiples to identify value. The table below summarises the valuations for 12 major regional banks. We believe that relative to their profitability, Bank of Fukuoka and Bank of Yokohama offer further upside and we rate both stocks as BUY. Shizuoka Bank is fairly priced at current levels and we maintain our HOLD rating.

Fig 81 Major regional bank valuations

Code	Name	Price* ¥	PE FY3/04** x	PB x	ROE** %	Market cap ¥bn
8326	Bank of Fukuoka	606	19.3	1.2	6.2	375
8331	Chiba Bank	640	20.0	1.6	7.8	530
8332	Bank of Yokohama	652	18.0	1.7	9.0	683
8333	Joyo Bank	467	25.3	1.0	4.2	390
8334	Gunma Bank	551	25.3	0.9	3.8	272
8341	77 Bank	716	27.4	0.9	3.3	262
8355	Shizuoka Bank	997	29.7	1.2	4.3	691
8358	Suruga Bank	826	24.0	1.8	7.4	218
8359	Hachijuni Bank	707	19.3	1.0	5.5	378
8369	Bank of Kyoto	749	29.2	1.0	3.4	240
8379	Hiroshima Bank	496	20.5	1.5	7.4	305
8382	Chugoku Bank	1,174	21.4	0.9	4.3	274

*As of 22 April 2004. **ING estimates for 8326, 8332, and 8355, bank own estimates for the rest.
Source: Company data, ING estimates

Risks

Any investment in the Japanese banks remains risky, although we believe these risks have declined considerably over the few months. Foremost is regulatory risk. It could take the form of banks being pressured to take higher levels of provisioning or being forced to write down their deferred tax assets (DTA) substantially so that it may actually push the banks into capital inadequacy. While the former was a significant concern over the past two years, we believe it has declined substantially recently.

Following two rounds of special inspections and aggressive provisioning by the banks over the past couple of years, we believe there is limited scope for further pressure from the regulators to raise credit costs substantially. In September 2003, the FSA announced a significant decline in the difference between the FSA and the banks' own NPL assessment.

Capital quality, though, while improving, remains poor. DTA was over 40% of Tier I capital at the major banks. While the treatment of DTA as part of regulatory capital remains a wildcard, we do not expect material changes to the rules that would significantly affect bank capital adequacy over the next 12 months.

Fig 82 Capital quality (¥bn)

Code	Name	DTA	YoY (%)	DTA/OP (x)	DTA as % of Tier I 3/03	DTA as % of Tier I 9/03	Public pref money as % Tier I
8306	MTFG	1,055	-22.6	1.3	41.6	26.9	0.0
8307	UFJ	1,478	-2.9	1.6	58.5	51.7	49.8
8316	SMFG	1,846	-5.6	1.5	58.3	51.5	37.5
8411	Mizuho	1,672	-21.5	1.6	60.8	43.7	51.4
	Mega banks	**6,052**	**-13.2**	**1.5**	**54.9**	**42.8**	**33.8**
8308	Resona	97	-81.5	0.4	99.4	12.6	371.3
8309	Mitsui Trust	324	-6.8	1.8	99.9	72.7	97.3
8403	Sumitomo Trust	212	-24.1	1.3	39.5	27.9	13.2
8404	Mizuho Trust	106	-24.7	2.0	54.4	38.3	0.0
	Major banks*	**6,684**	**-17.7**	**1.4**	**57.9**	**42.5**	**50.9**

*Excludes Mizuho Trust
Source: Company data

The market risk remains considerable. Declining equity prices would be likely to result in substantial unrealised losses for the major banks, whose equity holdings were over ¥15tr at 9/03, roughly equivalent to Tier I capital. A collapse in bond prices may also negatively impact the Japanese banks (major banks' bond holdings at 9/03 were about 12% of total assets), but bond prices often move in the opposite direction to equities, potentially limiting the impact of market moves.

Finally, renewed recession may have a very damaging impact on banks' balance sheets as well as their core profitability.

MTFG

In integration mode

Rating: HOLD

MTFG remains the bank with the highest asset and capital quality among the four Mega banks. The bank cut NPLs by some 29.0% in 1H and at 9/03 it enjoyed a 3.8% NPL ratio, well below the average for the major banks. Furthermore, with a BIS ratio of 12.45% at 9/03, MTFG remains the most adequately capitalised Mega bank.

The bank's 3Q release had little information of value, with the bank proceeding with NPL disposal and expecting no significant changes in capital adequacy at 3/04.

With most of the capital and asset quality problems already behind it, MTFG has shifted its attention to restructuring and integrating its different business lines. On 4 February 2004, the group held a strategy conference. The key point of the event was to highlight the potential synergies of having a commercial bank (Bank of Tokyo Mitsubishi), a trust bank (Mitsubishi Trust) and a securities company (Mitsubishi Securities) under its umbrella and the group's push into the retail market. Some of the main points were as follows:

- MTFG targets an ROE of 14-15% by FY3/07. If interest rates were to remain unchanged from zero, though, the target would decline by 1-2%.
- The bank expects its retail business to contribute much of the growth going forward. It expects net business profits from retail to more than double by FY3/07 from the ¥100bn expected for this FY. It also expects net business profit from corporate business to grow by 50% and trust bank business profits to quadruple.
- The growth in revenue and some cost cuts will enable the bank to reduce its overhead ratio to about 45% from the 56% expected for this FY.
- MTFG's main aspiration is to become within three years a global financial institution with a market cap that would position it in the top 10. Currently, its market capitalisation puts it at around the 20th spot.

The bank made some bold statements about its future profitability, which we believe were somewhat aggressive. Nonetheless, it is ahead of its peers in integrating its business lines and offering services under the same brand across its customer base. It plans to enhance cross selling among the business lines to offer one-stop financial services to both retail and institutional clients. Most of the benefits will not have an impact in the immediate future, but nonetheless, the group is quickly moving in the right direction.

At current prices, the stock yields an implied discount rate of about 6.0%, which leaves limited upside for the shares when compared to its peers. We rate the shares as HOLD, with a target price of ¥933,000.

MTFG

Japan

Share Price:	1,020,000	**Reuters Code:**	8306.T	**Shares Outstanding**	6.23
52 Week Price Range:	354,000 - 1,050,000	**Bloomberg Code:**	8306 JP	**Market Cap (US$m)**	57,788

INCOME STATEMENT	**01**	**02**	**03**	**04**	**05**
Interest income	2,225	1,692	1,692	1,708	1,708
Interest expense	1,120	635	635	641	641
Net interest income	**1,105**	**1,057**	**1,058**	**1,067**	**1,067**
Non-interest income	604	689	635	599	605
Total operating income	**1,709**	**1,746**	**1,693**	**1,666**	**1,673**
Non-interest expense	967	991	971	962	952
Pre provision profit	**742**	**754**	**722**	**704**	**721**
Loan loss provisions	755	531	299	147	182
Non-operating income	-279	-586	-19	0	0
Pre tax profit	**-292**	**-362**	**404**	**557**	**539**
Tax	-163	-181	120	223	216
Net profit	**-152**	**-161**	**282**	**332**	**321**

BALANCE SHEET	**01**	**02**	**03**	**04**	**05**
Gross loans	49,063	46,950	46,528	46,417	46,318
Loan loss reserves	-1,660	-1,297	-1,103	-992	-893
Net loans	50,722	45,653	45,425	45,425	45,425
Total earning assets	88,408	85,195	85,131	84,887	84,766
Other assets	11,089	13,980	13,548	13,792	13,913
Total Assets	**99,497**	**99,175**	**98,679**	**98,679**	**98,679**
Deposits	63,108	66,670	68,670	69,700	70,397
Other paying liabilities	13,211	14,990	15,439	15,671	15,828
Other liabilities	19,655	14,146	11,266	9,697	8,547
Total Liabilities	**95,974**	**95,806**	**95,376**	**95,068**	**94,772**
Total Equity	**3,324**	**3,046**	**3,304**	**3,611**	**3,908**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	4,269	2,615	1,700	1,445	1,228
NPAs/total loans	8.7	5.6	3.7	3.1	2.7
Reserve coverage of NPAs	38.9%	49.6%	64.9%	68.7%	72.7%

PER SHARE DATA (¥)	**01**	**02**	**03**	**04**	**05**
EPS	-28,922	-30,239	45,270	53,339	51,585
DPS	6,000	4,000	6,000	6,000	6,000
Effective payout ratio (%)	*N/M*	*N/M*	*13%*	*11%*	*12%*
BVPS	516,832	417,951	530,105	579,444	627,029

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	80.4	68.5	66.1	65.2	64.5
Equity to assets	3.3	3.1	3.3	3.7	4.0
Tier 1 CAR	5.3	5.7	6.5	7.0	7.2
Total CAR	10.3	10.8	12.2	12.5	12.5

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	2.0x	2.4x	1.9x	1.8x	1.6x
Price to earnings	N/M	N/M	16.5x	18.9x	18.5x
Price to underlying profit	8.8x	8.7x	9.3x	9.0x	8.5x
Yield at current price (%)	0.59	0.39	0.59	0.59	0.59

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	2	1	2	3	3
Mortgage (%)	17	19	23	25	26
Corporate (%)	64	66	64	62	61
Other (%)	17	15	11	10	10

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	1.35	1.31	1.31	1.32	1.32
Yield on assets	2.72	2.09	2.10	2.12	2.12
Cost of liabilities	1.36	0.76	0.74	0.74	0.73
Non-int. inc (% Op income)	35.3	39.4	37.5	35.9	36.2
Cost to income	56.6	56.8	57.4	57.7	56.9
Overhead to assets	0.97	1.00	0.98	0.97	0.96
ROA	(0.2)	(0.2)	0.3	0.3	0.3
ROE	(4.6)	(5.1)	8.9	9.6	8.6

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings		2%	-4%	-2%	2%
Net profit		N/M	N/M	18%	-3%
EPS		N/M	N/M	18%	-3%
DPS		-33%	50%	0%	0%
Net Loans		-10%	-1%	0%	0%
Assets		0%	0%	0%	0%
Deposits		6%	3%	1%	1%

UFJ

The bumpy road to recovery

Rating: BUY

Despite cutting NPLs as a percentage of total credit by almost 5% points over the past 18 months, UFJ had the highest NPL ratio of 8.1% at 9/03 among the Mega banks. The bank nonetheless plans to reduce NPLs to ¥2.5tr (or under 6% of total credit) by March 2004 from ¥3.38tr at December 2003 UFJ's Tier I capital ratio as of 9/03 was 6.24%, higher than that of SMFG and Mizuho, but below MTFG's.

In January 2004, UFJ made an official announcement on its agreement to turn Nippon Shinpan, a large credit card company, into a consolidated subsidiary by March 2005. According to the agreement, UFJ will invest ¥200bn in preferred shares issued by Nippon Shinpan, which it will convert into common shares by April 2005, giving it control over two-thirds of Nippon Shinpan's common stock. The bank intends to integrate its operations with UFJ Card to form the largest credit card company by users (over 23m) and by transaction volume (over ¥4tr). The deal will enable the bank to get large exposure to the high-yielding card loan and cashing business well ahead of its main competitors.

The bank's exposure to large troubled borrowers has made it a target of media speculation In January. An article published by the *Nikkei* alleged that the FSA will inspect the bank after finding unofficial internal documents showing some borrowers' conditions to be worse than expected. Although the bank denied the report, its stock substantially underperformed its peers' over a period of time after the report was published.

The case highlights the existence of significant regulatory risk, which in previous research we have pointed out as the foremost risk when investing in banks. Regulatory action is often not transparent and not necessarily consistent and despite the recent improvements in fundamentals, it may result in material losses to shareholders.

On 5 February, the bank reported strong 3Q results. Unlike other banks, UFJ disclosed headline P&L items – non-consolidated net business profit before credit costs (OP), RP and NP and credit costs – in addition to the standard balance sheet items disclosed by banks quarterly. For the nine months to 12/04, the bank posted NP of ¥251.3bn, higher than the group's non-consolidated full-year estimate of ¥190.0bn. The bank left its full-year estimates unchanged as it expects higher credit costs in 4Q.

Credit costs for the nine months were ¥266.1bn, almost unchanged from ¥243.9bn in 1H. Interpretation of these figures, though, requires caution, since, in calculating credit cost for 3Q, the bank used the loss ratio incurred in 1H. The next round of special inspections by the FSA will be carried out in 4Q, and may have a significant impact on the bank's full-year credit costs. For the full year, the bank expects credit costs to reach ¥500bn, leaving a sizeable cushion for the 4Q. Similarly, non-consolidated NPLs at 12/03 were down 9.0% QoQ to ¥3.38tr, but most of the NPL reduction is likely to be done in the 4Q as the bank reiterated its target to reduce NPLs to ¥2.5tr by March.

At current prices, the stock yields an implied discount rate of about 8%, which we believe offers an attractive investment opportunity. We rate the shares as BUY, with a target price of ¥718,000.

UFJ — Japan

Share Price:	654,000	**Reuters Code:**	8307.T	**Shares Outstanding** 5.04
52 Week Price Range:	86,000 - 672,000	**Bloomberg Code:**	8307 JP	**Market Cap (US$m)** 29,941

INCOME STATEMENT	**01**	**02**	**03**	**04**	**05**
Interest income	1,652	1,157	1,149	1,168	1,181
Interest expense	608	289	286	291	294
Net interest income	**1,045**	**868**	**862**	**877**	**886**
Non-interest income	559	726	558	515	520
Total operating income	**1,603**	**1,595**	**1,421**	**1,392**	**1,406**
Non-interest expense	855	775	752	733	722
Pre provision profit	**748**	**820**	**669**	**659**	**684**
Loan loss provisions	2,006	791	594	293	165
Non-operating income	-346	-698	0	0	0
Pre tax profit	**-1,604**	**-669**	**75**	**366**	**519**
Tax	-435	-30	4	146	208
Net profit	**-1,227**	**-609**	**50**	**199**	**291**

BALANCE SHEET	**01**	**02**	**03**	**04**	**05**
Gross loans	46,025	44,179	42,910	42,368	42,255
Loan loss reserves	-1,671	-1,674	-1,256	-1,130	-1,017
Net loans	44,353	42,504	41,654	41,238	41,238
Total earning assets	63,877	64,939	64,547	63,902	63,809
Other assets	15,896	15,268	14,056	13,916	14,008
Total Assets	**79,773**	**80,207**	**78,603**	**77,817**	**77,817**
Deposits	57,160	56,078	57,761	58,627	59,213
Other paying liabilities	10,413	10,377	10,377	10,377	10,377
Other liabilities	9,012	11,044	8,564	6,724	5,859
Total Liabilities	**76,585**	**77,500**	**76,701**	**75,728**	**75,450**
Total Equity	**2,601**	**1,864**	**1,902**	**2,089**	**2,368**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	6,482	4,164	2,706	2,300	2,070
NPAs/total loans	14.1	9.4	6.3	5.4	4.9
Reserve coverage of NPAs	25.8%	40.2%	46.4%	49.1%	49.1%

PER SHARE DATA (HK$)	**01**	**02**	**03**	**04**	**05**
EPS	-262,851	-126,805	9,966	39,614	57,859
DPS	0	0	2,500	3,000	3,000
Effective payout ratio (%)	*N/M*	*N/M*	*25%*	*8%*	*5%*
BVPS	202,404	67,382	99,671	136,785	192,144

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	77.6	75.8	72.1	70.3	69.6
Equity to assets	3.3	2.3	2.4	2.7	3.0
Tier 1 CAR	5.8	5.5	6.0	6.5	6.5
Total CAR	11.0	10.0	11.0	11.5	11.5

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	3.2x	9.7x	5.8x	4.4x	3.2x
Price to earnings	N/M	N/M	26.7x	17.1x	11.1x
Price to underlying profit	4.4x	4.1x	4.6x	5.1x	4.8x
Yield at current price (%)	-	-	0.38	0.46	0.46

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	4	3	2	4	5
Mortgage (%)	19	21	24	25	26
Corporate (%)	70	70	69	67	65
Other (%)	7	6	5	4	4

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	1.35	1.27	1.29	1.32	1.34
Yield on assets	2.13	1.69	1.71	1.76	1.78
Cost of liabilities	0.80	0.41	0.40	0.40	0.40
Non-int. inc (% Op income)	34.8	45.5	39.3	37.0	37.0
Cost to income	53.3	48.6	52.9	52.7	51.3
Overhead to assets	1.07	0.97	0.95	0.94	0.93
ROA	-	(0.8)	0.1	0.3	0.4
ROE	-	(27.3)	2.7	10.0	13.1

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings		10%	-18%	-1%	4%
Net profit		N/M	N/M	297%	46%
EPS		N/M	N/M	297%	46%
DPS		N/M	N/M	20%	0%
Net Loans		-4%	-2%	-1%	0%
Assets		1%	-2%	-1%	0%
Deposits		-2%	3%	1%	1%

SMFG

Cleaning up

Rating: BUY

SMFG has made substantial progress in reducing bad debts this FY. During 1H only, the bank managed to cut consolidated NPLs by some 23.9%. As a result, its NPL ratio as a percentage of the total at 9/03 fell to 7.0% from 9.0% at 3/03. In 3Q, the bank continued its efforts in NPL reduction and in the three months to December 2003 managed to reduce non-consolidated NPLs by some 14.1% to ¥3.3tr.

For the full year, the bank plans to cut NPLs to ¥3.0tr, which we believe is a very achievable target given the substantial reduction in the 3Q. To facilitate the bad debt reduction, in October 2003 the bank announced a NPL workout scheme, which will consists of two tiers.

Firstly, SMFG, Goldman Sachs and Daiwa SMBC Principal Investments will form a joint-venture company with ownership stakes of 52%, 24% and 24%, respectively. This JV will aim at corporate revival of borrowers.

Secondly, a separate entity, called Japan Endeavour Fund, will be formed, which will purchase NPLs. Goldman Sachs will own 58%, Daiwa Principal Investments SMBC 29% and SMFG 13% of the fund. The fund will buy NPLs from SMBC (SMFG's banking business) and other banks and then manage the workout process. While in principal the scheme appears to be similar to those of other Mega banks, it is different in that SMFG will not be consolidating the entity that purchases the NPLs since it owns only 13% of it.

As a result, all loans that are sold to the fund will reduce the bank's total NPLs, and this could be seen as a tool to quickly cut bad loan balances. Other Mega banks consolidate the workout entities and, consequently, transfers to these subsidiaries remain intra-company with no impact on consolidated statements. This scheme is unlikely to entitle SMFG to much of the potential gains from the final workout process, but it will certainly aid the bank's NPL disposal substantially.

The bank’s 3Q release offered little more than the positive NPL data. The bank expects the Tier I ratio at 3/04 to be between 5.5% and 6.0% (vs 5.9% at 9/03), while it expects BIS to be between 10.5% and 11.0%, versus 10.9% at 9/03. Parent unrealised gains at 12/03 were ¥211.3bn, down from gains of ¥306.9bn at 9/03. The decline was largely due to decreases in the value of equity holdings, possibly sold at a gain.

At current prices, the stock yields an implied discount rate of about 8.5%, which we believe offers an attractive investment opportunity. We rate the shares as BUY, with a target price of ¥908,000.

SMFG

Japan

Share Price:	781,000	**Reuters Code:**	8316.T	**Shares Outstanding** 5.80
52 Week Price Range:	164,000 - 792,000	**Bloomberg Code:**	8316 JP	**Market Cap (US$m)** 41,152

INCOME STATEMENT	**01**	**02**	**03**	**04**	**05**
Interest income	2,177	1,817	1,727	1,710	1,710
Interest expense	727	417	397	393	393
Net interest income	**1,450**	**1,400**	**1,330**	**1,317**	**1,317**
Non-interest income	628	785	563	571	576
Total operating income	**2,078**	**2,184**	**1,894**	**1,888**	**1,893**
Non-interest expense	936	889	863	845	837
Pre provision profit	**1,142**	**1,295**	**1,031**	**1,042**	**1,056**
Loan loss provisions	1,703	1,201	710	350	226
Non-operating income	-19	-610	20	0	0
Pre tax profit	**-581**	**-516**	**341**	**693**	**830**
Tax	-187	-159	96	277	332
Net profit	**-464**	**-465**	**212**	**382**	**465**

BALANCE SHEET	**01**	**02**	**03**	**04**	**05**
Gross loans	63,646	61,083	58,981	58,315	58,225
Loan loss reserves	-2,160	-2,244	-1,907	-1,812	-1,721
Net loans	61,486	58,839	57,074	56,503	56,503
Total earning assets	87,434	88,115	86,436	85,572	85,451
Other assets	20,571	16,493	15,033	14,883	15,004
Total Assets	**108,005**	**104,607**	**101,469**	**100,455**	**100,455**
Deposits	71,648	67,784	69,140	69,831	70,529
Other paying liabilities	22,140	22,301	22,301	22,301	22,301
Other liabilities	10,321	11,102	7,422	5,364	4,531
Total Liabilities	**104,109**	**101,187**	**98,863**	**97,496**	**97,361**
Total Equity	**2,913**	**2,424**	**2,606**	**2,959**	**3,093**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	6,568	5,854	3,805	3,234	2,911
NPAs/total loans	10.3	9.6	6.5	5.5	5.0
Reserve coverage of NPAs	32.9%	38.3%	50.1%	56.0%	59.1%

PER SHARE DATA (HK$)	**01**	**02**	**03**	**04**	**05**
EPS	N/A	-84,324	36,510	65,929	80,168
DPS	0	3,000	3,000	3,000	3,000
Effective payout ratio (%)	*N/M*	*N/M*	*8%*	*5%*	*4%*
BVPS	N/A	106,577	225,192	286,037	361,119

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	85.8	86.8	82.5	80.9	80.1
Equity to assets	2.7	2.3	2.6	2.9	3.1
Tier 1 CAR	5.5	5.5	5.8	6.3	6.5
Total CAR	10.5	10.1	11.0	11.5	11.5

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	N/A	7.3x	3.3x	2.6x	2.0x
Price to earnings	N/M	N/M	16.4x	11.3x	9.1x
Price to underlying profit	4.0x	3.5x	4.2x	4.2x	4.1x
Yield at current price (%)	-	0.38	0.38	0.38	0.38

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	3	2	2	3	3
Mortgage (%)	22	23	25	26	27
Corporate (%)	68	68	69	67	66
Other (%)	7	6	4	4	4

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	1.50	1.51	1.48	1.48	1.48
Yield on assets	2.26	1.97	1.93	1.93	1.93
Cost of liabilities	0.80	0.45	0.42	0.41	0.41
Non-int. inc (% Op income)	30.2	35.9	29.8	30.2	30.4
Cost to income	45.0	40.7	45.5	44.8	44.2
Overhead to assets	0.87	0.84	0.84	0.84	0.83
ROA	-	(0.4)	0.2	0.4	0.5
ROE	-	(17.4)	8.4	13.7	15.4

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings		13%	-20%	1%	1%
Net profit		N/M	N/M	81%	22%
EPS		N/M	N/M	81%	22%
DPS		N/M	N/M	0%	0%
Net Loans		-4%	-3%	-1%	0%
Assets		-3%	-3%	-1%	0%
Deposits		-5%	2%	1%	1%

Mizuho

Profit recovery

Rating: HOLD

After taking massive cost charges, Mizuho has made a substantial profit recovery. In 1H FY3/04, the bank's RP was some ¥505.4bn, up from ¥122.2bn a year ago, while NP was ¥255.4bn, up from ¥39.0bn. A significant portion of the YoY improvement was accounted for by lower credit costs, overheads and stock losses.

The bank also raised it full-year RP estimate to ¥800bn from ¥500bn, and NP to ¥360bn from ¥220 to reflect the stronger 1H and slightly improved outlook for 2H.

Furthermore, pre-provision core profits were up 15.7% YoY as G&A costs fell 12.2% while gross operating profit (GOP) was broadly flat YoY. Mizuho reduced both personnel and other expenses substantially (overall cost savings were some 79.4bn) as the aggressive pay cuts and branch closures last FY started to pay off.

Asset quality over the past nine months has improved substantially. NPLs in 1H were down 9.4% to ¥4.3tr to account for 5.8% of total credit, from 6.3% at 3/03. In the 3Q, the bank made further progress by cutting bad debts by 14.3% for the three months to December.

The NPL disposal has been facilitated by a workout scheme, which the bank set up in the summer last year. The bank will transfer trillions of yen in loans and equity of borrowers who need to be restructured to four consolidated subsidiaries. The borrowers will be from loan categories 2 and below (ie, the broad watch list, special attention and doubtful) and will cover about two-thirds of all borrowers that need restructuring.

The plan is to complete the revitalisation of the borrowers within three years. The four subsidiaries – one managing loans for Mizuho Bank (retail), two for Mizuho Corporate (one domestic and one handling overseas borrowers or Japanese borrowers with overseas operations) and one for Mizuho Trust – will cover borrowers from the whole group. The four subsidiaries will be advised by one advisory firm, of which Mizuho will own 60%, Development Bank of Japan (DBJ) 10%, and five foreign parties will each own 6%. It is worth pointing out that Mizuho has enrolled the Development Bank of Japan as a key player in the scheme, which at the very least would earn the bank some political dividends.

The high levels of profitability have improved capital adequacy. Tier I capital ratio at 9/03 was 5.4%, up from 4.9% at 3/03. The BIS ratio was up to 10.6% at 9/03 from 9.5% at 3/03. The bank expects the Tier I ratio to be around 5.5% at 3/04 and BIS to be between 10.5% and 11.0%.

At current prices, the stock yields an implied discount rate of about 4%, which leaves limited upside for the shares when compared to its peers. We rate the shares as HOLD, with a target price of ¥356,000.

Mizuho

Japan

Share Price:	499,000	**Reuters Code:**	8411.T	**Shares Outstanding**	10.58
52 Week Price Range:	58,700 - 505,000	**Bloomberg Code:**	8411 JP	**Market Cap (US$m)**	48,004

INCOME STATEMENT	**01**	**02**	**03**	**04**	**05**
Interest income	3,020	1,991	1,940	1,943	1,943
Interest expense	1,493	735	716	717	717
Net interest income	**1,528**	**1,256**	**1,224**	**1,226**	**1,226**
Non-interest income	934	977	780	768	777
Total operating income	**2,462**	**2,234**	**2,004**	**1,994**	**2,003**
Non-interest expense	1,368	1,238	1,182	1,135	1,106
Pre provision profit	**1,094**	**996**	**822**	**859**	**897**
Loan loss provisions	2,488	2,092	702	346	259
Non-operating income	44	-1,034	110	0	0
Pre tax profit	**-1,350**	**-2,131**	**230**	**513**	**638**
Tax	-435	53	34	205	255
Net profit	**-976**	**-2,377**	**194**	**303**	**377**

BALANCE SHEET	**01**	**02**	**03**	**04**	**05**
Gross loans	84,594	69,210	67,203	66,456	66,367
Loan loss reserves	-1,950	-2,211	-1,880	-1,786	-1,696
Net loans	82,644	66,999	65,324	64,670	64,670
Total earning assets	118,020	106,322	104,498	103,814	103,814
Other assets	33,293	27,711	26,184	25,562	25,562
Total Assets	**151,312**	**134,033**	**130,682**	**129,375**	**129,375**
Deposits	85,606	72,223	73,667	74,404	74,776
Other paying liabilities	40,744	39,452	39,452	39,452	39,452
Other liabilities	19,280	18,459	14,561	12,268	11,572
Total Liabilities	**145,630**	**130,134**	**127,680**	**126,124**	**125,800**
Total Equity	**4,731**	**2,861**	**3,002**	**3,252**	**3,575**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	5,024	4,475	2,685	2,282	1,940
NPAs/total loans	5.9	6.5	4.0	3.4	2.9
Reserve coverage of NPAs	38.8%	49.4%	70.0%	78.2%	87.5%

PER SHARE DATA (¥)	**01**	**02**	**03**	**04**	**05**
EPS	N/A	-254,525	18,323	28,639	35,599
DPS	0	0	3,000	3,000	3,000
Effective payout ratio (%)	*N/M*	*N/M*	*16%*	*10%*	*8%*
BVPS	N/A	-18,026	99,483	123,093	153,662

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	96.5	92.8	88.7	86.9	86.5
Equity to assets	3.1	2.1	2.3	2.5	2.8
Tier 1 CAR	5.3	4.9	5.5	6.3	6.5
Total CAR	10.6	9.5	10.8	11.5	11.5

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	N/A	-27.7x	4.9x	4.0x	3.3x
Price to earnings	N/M	N/M	17.3x	16.9x	13.5x
Price to underlying profit	5.3x	5.8x	6.1x	6.3x	5.9x
Yield at current price (%)	-	-	0.60	0.60	0.60

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	2	2	2	2	3
Mortgage (%)	16	19	21	22	23
Corporate (%)	72	72	70	70	68
Other (%)	11	7	7	6	6

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	1.17	1.00	1.00	1.01	1.01
Yield on assets	2.31	1.59	1.59	1.61	1.61
Cost of liabilities	1.18	0.58	0.55	0.55	0.55
Non-int. inc (% Op income)	38.0	43.8	38.9	38.5	38.8
Cost to income	55.6	55.4	59.0	56.9	55.2
Overhead to assets	0.90	0.87	0.89	0.87	0.86
ROA	-	(1.7)	0.1	0.2	0.3
ROE	-	(62.6)	6.6	9.7	11.0

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings		-9%	-17%	5%	4%
Net profit		N/M	N/M	56%	24%
EPS		N/M	N/M	56%	24%
DPS		N/M	N/M	0%	0%
Net Loans		-19%	-3%	-1%	0%
Assets		-11%	-3%	-1%	0%
Deposits		-16%	2%	1%	0%

Sumitomo Trust

Pays back

Rating: HOLD

Sumitomo Trust boasts one of the highest asset and capital quality among Japan's major banks. The bank cut NPLs by 41.6% in the last FY and then another 7.4% in 1H to of ¥373bn. This represented only 3.4% of total credit, the lowest among the major banks. Furthermore, for the three months to December, the bank cut NPLs by an additional 9.9%.

The bank's high asset quality and relatively strong capital position (9/03 Tier I ratio of 6.7%) enabled the bank to repay government money in January 2004. Sumitomo Trust reached an agreement with the Resolution and Collection Corporation (RCC), the formal holder of the securities, to repay its remaining ¥200bn in public capital by 14 January 2004. The public money was injected by the government in 1999, with half of it in preferred shares and the rest in subordinated bonds. The repayment made Sumitomo Trust the second bank after MTFG to fully repay its government funds.

Sumitomo Trust repaid the ¥100bn in subordinated bonds in full and then retired them. The ¥100bn in preferred shares, part of Tier I capital, though, were sold by the RCC to 29 companies, mostly Sumitomo group companies.

The potential benefits from the repayment of the government money could be substantial for the bank's capital quality and profit enhancement.

- First, the new holders of the preferred shares (the 29 group companies) may be more willing to convert their holdings into common shares, a higher quality capital, under a favourable share price scenario.

- Second, the bank will have full control over its lending practices, which are currently constrained by the government's lending targets to SMEs. In order to meet these targets and avoid FSA punishment, banks would often extend loans at subsidised rates. With the government gone as a shareholder, the bank will have a chance to implement its long-stated plans to lend at rates commensurate with the underlying credit risk, and as a result, improve loan spreads.

Sumitomo Trust's core profitability remains an issue. While the bank has made substantial progress in developing a strong fee-based business, its loan balances continue to decline. In 1H, domestic loan balances were down 3.5%, while in 3Q, they dropped by 6.7% QoQ. This is a large drop, possibly due to maturing exposure or the bank cutting loans that were not appropriately priced.

At current prices, the stock yields an implied discount rate of about 7%, which leaves limited upside for the shares when compared to its peers. We rate the shares as HOLD, with a target price of ¥700.

Sumitomo Trust — Japan

Share Price:	631	**Reuters Code:**	8403.T	**Shares Outstanding**	1,459
52 Week Price Range:	294 - 718	**Bloomberg Code:**	8403 JP	**Market Cap (US$m)**	8,372

INCOME STATEMENT	**01**	**02**	**03**	**04**	**05**
Interest income	330	271	238	244	244
Interest expense	225	119	105	107	107
Net interest income	**105**	**152**	**133**	**137**	**137**
Non-interest income	163	119	135	136	138
Total operating income	**267**	**271**	**268**	**273**	**275**
Non-interest expense	135	135	131	127	125
Pre provision profit	**133**	**136**	**137**	**146**	**150**
Loan loss provisions	86	68	65	32	36
Non-operating income	-103	-134	10	0	0
Pre tax profit	**-57**	**-66**	**83**	**114**	**114**
Tax	18	-56	28	46	46
Net profit	**-42**	**-73**	**52**	**66**	**66**

BALANCE SHEET	**01**	**02**	**03**	**04**	**05**
Gross loans	8,922	9,143	9,032	9,026	9,021
Loan loss reserves	-222	-139	-118	-112	-107
Net loans	8,701	9,004	8,914	8,914	8,914
Total earning assets	15,271	13,963	13,823	13,806	13,823
Other assets	2,933	2,933	2,933	2,933	2,933
Total Assets	**16,704**	**15,780**	**15,622**	**15,622**	**15,622**
Deposits	9,774	10,257	10,565	10,724	10,831
Other paying liabilities	2,330	1,976	1,976	1,976	1,976
Other liabilities	3,852	2,830	2,407	2,289	2,122
Total Liabilities	**15,956**	**15,063**	**14,948**	**14,988**	**14,929**
Total Equity	**660**	**628**	**674**	**633**	**693**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	689	402	302	256	218
NPAs/total loans	7.7	4.4	3.3	2.8	2.4
Reserve coverage of NPAs	32.2%	34.6%	39.2%	43.8%	48.9%

PER SHARE DATA (¥)	**01**	**02**	**03**	**04**	**05**
EPS	-30	-51	35	45	45
DPS	0	3	4	4	4
Effective payout ratio (%)	*N/M*	*N/M*	*11%*	*9%*	*9%*
BVPS	387	361	393	434	475

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	89.0	87.8	84.4	83.1	82.3
Equity to assets	3.9	4.0	4.3	4.1	4.4
Tier 1 CAR	6.2	6.1	6.7	7.0	7.0
Total CAR	10.9	10.5	11.5	12.0	12.0

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	1.7x	1.9x	1.7x	1.6x	1.4x
Price to earnings	N/M	N/M	19.0x	15.0x	15.0x
Price to underlying profit	7.4x	7.2x	7.2x	6.7x	6.6x
Yield at current price (%)	-	0.45	0.59	0.59	0.59

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	4	5	4	5	5
Mortgage (%)	11	9	10	11	12
Corporate (%)	81	82	81	80	79
Other (%)	4	4	5	4	4

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	0.71	1.08	0.96	0.98	0.98
Yield on assets	2.23	1.93	1.72	1.76	1.76
Cost of liabilities	1.52	0.85	0.73	0.74	0.73
Non-int. inc (% Op income)	60.8	44.1	50.3	50.0	50.2
Cost to income	50.4	49.9	48.8	46.6	45.4
Overhead to assets	0.81	0.83	0.83	0.81	0.80
ROA	-	(0.4)	0.3	0.4	0.4
ROE	-	(11.3)	8.0	10.0	9.9

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings		2%	1%	6%	3%
Net profit		N/M	N/M	27%	0%
EPS		N/M	N/M	27%	0%
DPS		N/M	N/M	0%	0%
Net Loans		3%	-1%	0%	0%
Assets		-6%	-1%	0%	0%
Deposits		5%	3%	1%	1%

Bank of Yokohama

Still improving

Rating: BUY

Despite being the best restructuring story in Japan's banking industry, in our opinion, Bank of Yokohama (BoY) continues to post a remarkably strong performance.

1H RP was ¥34.9bn (up over 8x YoY) and NP was ¥19.8bn (also up over 8x YoY) on declining credit costs and stock losses. Net business profit was up some 11.6% YoY in 1H to ¥60.4bn.

- The bank managed to improve net interest income by 3.1% YoY despite the difficult environment. Loan yields were up 3bps YoY to 2.09%, a remarkable achievement given the difficult lending environment.
- Average loan balances were also strong, up some 0.8% YoY, as growth in retail loans outpaced declines in the corporate loan book. Housing loans were up 4.4% HoH and at 9/03 accounted for some 33.7% of the bank's loan book, among the highest in Japan.
- Fee income was up 17.7% YoY on rising sales of investment trusts and insurance sales.
- G&A costs were down 4.8%YoY, another impressive performance considering the bank has been cutting costs for six years in a row. At 9/03, the bank had an overhead ratio of 41.7%, one of the lowest among Japanese banks.
- NPLs were down 7.1% HoH to ¥375bn and at 9/03 accounted for 4.5% of total credit, down from 4.9% at 3/03 and 6.2% at 9/02. The bank managed to contain 1H non-consolidated credit costs at ¥24.0bn versus the initially expected ¥25.0bn.

In 3Q, momentum slowed a bit, but the bank seems to be on track towards achieving its full-year targets. Parent NPLs at 12/03 fell 1.7% QoQ to ¥368.6bn. The bank expects the Tier I ratio to be over 7.0% at 3/04 (vs 7.00% at 9/03) while it expects BIS to be between 10.0% and 10.5% versus 10.83% at 9/03. Loan balances in 3Q fell by 1.8% QoQ to ¥7.76tr after rising some 4.1% in 1H.

The stock currently trades at a PER of 11.5x our FY3/05 EPS (basic) and 1.3x 9/03 BVPS. The bank has a ¥60.0bn convertible bond with a conversion price that was reset to ¥420 in August 2003 from ¥525. This was the final conversion price reset prior to the bond's maturity in September 2004 and, assuming the CB converts in full, we estimate the increase in shares outstanding will be about 12.5%.

The stock trades on 1.86x our PBR estimate, which we believe is not a demanding level for a large, liquid and highly profitable regional bank with a strong management team. We rate the shares as BUY, with a target price of ¥550.

Bank of Yokohama Japan

Share Price:	652	**Reuters Code:**	8332.T	**Shares Outstanding**	1,139
52 Week Price Range:	359 - 513	**Bloomberg Code:**	8332 JP	**Market Cap (US$m)**	6,749.2

INCOME STATEMENT	**01**	**02**	**03**	**04**	**05**
Interest income	194	178	174	178	182
Interest expense	31	15	9	10	10
Net interest income	**163**	**162**	**165**	**169**	**172**
Non-interest income	47	42	45	46	47
Total operating income	**210**	**204**	**210**	**215**	**220**
Non-interest expense	100	99	96	96	95
Pre provision profit	**110**	**105**	**113**	**119**	**124**
Loan loss provisions	56	51	44	40	41
Non-operating income	-21	-27	0	0	0
Pre tax profit	**34**	**27**	**69**	**79**	**84**
Tax	13	13	29	32	34
Net profit	**20**	**17**	**41**	**46**	**49**

BALANCE SHEET	**01**	**02**	**03**	**04**	**05**
Gross loans	7,593	7,833	7,990	8,070	8,150
Loan loss reserves	-110	-91	-82	-78	-74
Net loans	7,483	7,742	7,908	7,992	8,076
Total earning assets	8,750	9,527	9,684	9,787	9,883
Other assets	2,015	1,145	1,157	1,168	1,180
Total Assets	**10,765**	**10,673**	**10,841**	**10,955**	**11,063**
Deposits	9,192	9,434	9,257	9,307	9,311
Other paying liabilities	359	328	270	220	220
Other liabilities	751	448	812	887	948
Total Liabilities	**10,302**	**10,209**	**10,339**	**10,414**	**10,479**
Total Equity	**451**	**457**	**492**	**530**	**572**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	477	404	363	326.91	294
NPAs/total loans	6.3	5.2	4.5	4.1	3.6
Reserve coverage of NPAs	23.1%	22.6%	22.6%	23.8%	25.1%

PER SHARE DATA (¥)	**01**	**02**	**03**	**04**	**05**
EPS	16	14	35	39	42
DPS	5	5	5	5	5
Effective payout ratio (%)	*31%*	*37%*	*14%*	*13%*	*12%*
BVPS	309	313	344	378	415

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	81.4	82.1	85.4	85.9	86.7
Equity to assets	4.2	4.3	4.5	4.8	5.2
Tier 1 CAR	6.3	6.3	6.5	6.0	6.5
Total CAR	10.5	10.2	10.5	10.5	10.5

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	1.6x	1.6x	1.5x	1.3x	1.2x
Price to earnings	31.1x	37.0x	14.4x	12.9x	12.1x
Price to underlying profit	5.2x	5.5x	5.1x	4.8x	4.6x
Yield at current price (%)	0.99	0.99	0.99	0.99	0.99

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	4	4	4	5	5
Mortgage (%)	29	32	35	36	37
Corporate (%)	62	60	57	55	54
Other (%)	5	4	4	4	4

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	1.83	1.83	1.72	1.73	1.75
Yield on assets	2.17	2.00	1.81	1.83	1.85
Cost of liabilities	0.34	0.17	0.09	0.10	0.10
Non-int. inc (% Op income)	22.4	20.4	21.3	21.5	21.5
Cost to income	47.5	48.5	46.0	44.6	43.4
Overhead to assets	0.93	0.92	0.90	0.88	0.87
ROA	0.2	0.2	0.4	0.4	0.4
ROE	4.4	3.7	8.7	9.0	8.9

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings		-5%	8%	5%	4%
Net profit		-15%	145%	11%	6%
EPS		-16%	157%	11%	7%
DPS		0%	0%	0%	0%
Net Loans		3%	2%	1%	1%
Assets		-1%	2%	1%	1%
Deposits		3%	-2%	1%	0%

Bank of Fukuoka

On an upward trend

Rating: BUY

Bank of Fukuoka (BoF) has made substantial progress in improving profitability and asset quality over the past couple of years. While last FY bottom-line profits were depressed due to the high level of credit costs, this FY, profits appear set to recover significantly. The bank's 1H results underpinned its improving fundamentals.

- Non-consolidated net business profit (before credit costs) was up 8.0% YoY to ¥27.0bn on cost reduction (SG&A was down 3.9% YoY to ¥35.6bn) and higher fee income.
- Net interest income declined 0.8% YoY, though, as asset yields fell on declining loan rates and securities yields.
- NPLs were down an impressive 23.2% HoH to ¥268bn as the bank pressed on with aggressive bad debt disposal. As a result, NPLs as a percentage of total credit fell to 5.1%, which is at the lower end when compared to other regional banks, from 6.5% at 3/03.
- Credit costs for the 1H were ¥10.9bn, or about 21bps of total credit, slightly ahead of initial forecasts of ¥9.5bn. For the full year, the bank is forecasting credit costs of ¥19.0bn, which we believe is an achievable target as we expect credit costs to drop in 2H.

The bank's 3Q results confirmed the trend. Unlike most banks, BoF released a detailed P&L statement. For the nine months to December, NP was ¥16.3bn, while for the full year, the bank expects ¥18.0bn. The bank's results assumed no change in default rates in 3Q from 1H this FY, which does not appear to be a stretched assumption given the slowdown in bankruptcies in 2003.

Net business profit (before credit costs) for the nine months to December was ¥40.9bn, annualising at ¥54.5bn, just under the bank's full-year target of ¥55.0bn. Core profits appear to have accelerated in 3Q compared to the average for 1H, which may help the bank achieve its target.

Parent NPLs at 12/03 were down 4.7% QoQ to ¥251.4bn as the bank proceeded with bad debt disposal.

Loan balances at 12/03 were virtually flat QoQ, as growth in housing loans managed to offset declines in corporate lending, easing pressure on net interest income.

The stock currently trades at a PER of 12.4x our FY3/05 EPS (basic) and 0.8x 9/03 BVPS. The bank has a ¥47.4bn convertible bond with a conversion price that was reset to ¥449 in September 2003 from ¥559. This was the final conversion price reset prior to the bond's maturity in September 2007 and, assuming the CB converts in full, we estimate the increase in shares outstanding will be about 16.7%.

The stock trades on PBR of 1.1x, which we believe is not a demanding level. We rate the shares as BUY, with a target price of ¥600.

Bank of Fukuoka

Japan

Share Price:	606	**Reuters Code:**	8326.T	**Shares Outstanding**	635
52 Week Price Range:	413 - 620	**Bloomberg Code:**	8326 JP	**Market Cap (US$m)**	3,497.0

INCOME STATEMENT	**01**	**02**	**03**	**04**	**05**
Interest income	137	130	125	127	132
Interest expense	32	22	18	19	22
Net interest income	**105**	**107**	**107**	**108**	**110**
Non-interest income	20	23	23	22	22
Total operating income	**126**	**130**	**129**	**130**	**132**
Non-interest expense	80	79	76	76	76
Pre provision profit	**46**	**51**	**53**	**54**	**56**
Loan loss provisions	10	26	19	16	16
Non-operating income	-8	-9	0	0	0
Pre tax profit	**28**	**16**	**34**	**38**	**40**
Tax	13	9	14	16	17
Net profit	**19**	**8**	**20**	**22**	**24**

BALANCE SHEET	**01**	**02**	**03**	**04**	**05**
Gross loans	4,851	5,176	5,203	5,205	5,205
Loan loss reserves	-231	-181	-154	-146	-139
Net loans	4,620	4,994	5,049	5,059	5,066
Total earning assets	6,444	6,750	6,846	6,891	6,891
Other assets	298	295	298	301	301
Total Assets	**6,742**	**6,995**	**7,144**	**7,192**	**7,192**
Deposits	5,966	6,153	6,225	6,268	6,268
Other paying liabilities	178	154	198	199	194
Other liabilities	301	371	337	321	306
Total Liabilities	**6,444**	**6,678**	**6,760**	**6,789**	**6,769**
Total Equity	**295**	**315**	**382**	**401**	**421**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	453	349	279	237	213.44
NPAs/total loans	9.3	6.7	5.4	4.6	4.1
Reserve coverage of NPAs	51.0%	52.0%	55.2%	61.7%	65.1%

PER SHARE DATA (¥)	**01**	**02**	**03**	**04**	**05**
EPS	29	13	31	35	38
DPS	5	5	5	5	6
Effective payout ratio (%)	*17%*	*39%*	*16%*	*14%*	*16%*
BVPS	467	497	601	632	663

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	77.4	81.2	81.1	80.7	80.8
Equity to assets	4.4	4.5	5.3	5.6	5.9
Tier 1 CAR	5.7	5.6	5.9	6.0	6.2
Total CAR	9.5	9.4	9.3	9.5	9.5

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	1.3x	1.2x	1.0x	1.0x	0.9x
Price to earnings	20.7x	47.7x	19.3x	17.2x	16.0x
Price to underlying profit	8.4x	7.5x	7.3x	7.1x	6.9x
Yield at current price (%)	0.83	0.83	0.83	0.83	0.99

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	2	2	3	4	4
Mortgage (%)	18	19	21	22	23
Corporate (%)	76	75	73	71	70
Other (%)	4	4	3	3	3

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	1.73	1.68	1.57	1.57	1.59
Yield on assets	2.24	2.03	1.84	1.85	1.91
Cost of liabilities	0.53	0.36	0.29	0.30	0.34
Non-int. inc (% Op income)	16.0	17.6	17.5	17.1	16.8
Cost to income	63.7	60.5	59.0	58.4	57.6
Overhead to assets	1.20	1.14	1.08	1.06	1.06
ROA	0.3	0.1	0.3	0.3	0.3
ROE	6.3	2.5	5.7	5.7	5.8

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings		13%	3%	2%	4%
Net profit		-58%	159%	12%	7%
EPS		-58%	159%	12%	7%
DPS		0%	0%	0%	0%
Net Loans		8%	1%	0%	0%
Assets		4%	2%	1%	0%
Deposits		3%	1%	1%	0%

Shizuoka Bank

Core profits lag

Rating: HOLD

Shizuoka Bank remains one of the strongest banks in Japan in terms of asset and capital quality. The bank had a Tier I ratio of 11.3% at 9/03, double the level of most other major and regional banks. NPLs as a percentage of total credit were 5.75% at 9/03, while the coverage ratio was over 85%, among the highest in Japan. The bank is en route to post a strong profit recovery this FY on low credit charges. Nonetheless, core profits remain weak. 1H results highlight the solid bounce back to profits:

- 1H RP and NP came in at ¥22.9bn (up 64.9% YoY) and ¥13.2bn (up 40.8% YoY), The substantial YoY improvement was largely accounted for by massive declines in credit costs.
- Non-consolidated credit costs in 1H fell to ¥0.8bn, or only 3bps of total credit, from ¥8.0bn a year ago as the downward migration of borrowers abated. Shizuoka Bank, which boasts one of the highest asset qualities among Japan's banks, has been conservatively raising levels of provisioning over the past couple of years. For the full year, the bank forecasts credit costs of 7bps or ¥3.6bn (versus an initial projection of 30bps), down from ¥9.0bn a year ago.
- Core business, though, continued to struggle. Consolidated net interest income was down 5.2% YoY on contracting loan and securities yields. Furthermore, the bank recorded ¥3.3bn in bond trading losses in 1H following a sharp rise in yields in 2Q.
- Net interest income fell 5.2% YoY on contracting margins and declining volumes.
- While fee income growth was robust (up 16.4% YoY to ¥10.9bn), gross operating profit was down 6.4%YoY.
- SG&A costs were down only 0.4% YoY and, as a result, pre-provision operating profit was down some 17.5% YoY.

The bank also recorded ¥3.6bn in gains from the return of pension assets managed on behalf of the government, which offered RP an additional boost. Furthermore, the bank recorded ¥0.6bn in gains on equity sales versus ¥2.1bn in losses a year ago.

The bank's 3Q release did not offer any major surprises. NPLs were virtually flat QoQ at ¥281.6bn, while the bank expects slightly higher capital adequacy ratios at 3/04 as strong bottom-line profits are set to expand equity. One encouraging sign in the 3Q release was the slight rise in loan balances, up by almost ¥200bn, or 3.7% QoQ.

The stock currently trades at a PBR of 1.3x. We believe that the low credit costs the bank has enjoyed in 1H are not sustainable and expect charge-offs to rise next FY. The shares trade on 29x our EPS estimate for next FY, leaving limited upside potential. We rate the shares as HOLD, with a target price of ¥775.

Shizuoka Bank

Japan

Share Price:	997	**Reuters Code:**	8355.T	**Shares Outstanding**	750
52 Week Price Range:	747 - 1020	**Bloomberg Code:**	8355 JP	**Market Cap (US$m)**	6,798.9

INCOME STATEMENT	**01**	**02**	**03**	**04**	**05**
Interest income	158	132	122	123	125
Interest expense	44	22	16	16	17
Net interest income	**114**	**110**	**106**	**107**	**107**
Non-interest income	19	22	20	23	24
Total operating income	**133**	**132**	**126**	**130**	**132**
Non-interest expense	88	85	84	82	81
Pre provision profit	**45**	**47**	**42**	**48**	**50**
Loan loss provisions	39	10	5	12	15
Non-operating income	6	-14	5	2	2
Pre tax profit	**12**	**22**	**42**	**37**	**38**
Tax	5	12	17	15	15
Net profit	**7**	**13**	**24**	**21**	**22**

BALANCE SHEET	**01**	**02**	**03**	**04**	**05**
Gross loans	5,064	4,881	4,893	4,893	4,918
Loan loss reserves	-114	-102	-92	-88	-83
Net loans	4,950	4,779	4,801	4,806	4,835
Total earning assets	7,976	7,984	8,105	8,130	8,181
Other assets	202	225	160	180	179
Total Assets	**8,178**	**8,210**	**8,265**	**8,311**	**8,360**
Deposits	7,019	7,109	7,155	7,201	7,214
Other paying liabilities	318	267	245	235	235
Other liabilities	277	305	313	301	316
Total Liabilities	**7,613**	**7,681**	**7,713**	**7,737**	**7,765**
Total Equity	**557**	**520**	**544**	**565**	**587**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	263	290	261	235	211
NPAs/total loans	5.2	5.9	5.3	4.8	4.3
Reserve coverage of NPAs	43.4%	35.3%	35.3%	37.3%	39.4%

PER SHARE DATA (¥)	**01**	**02**	**03**	**04**	**05**
EPS	10	17	34	31	31
DPS	6	6	6	6	7
Effective payout ratio (%)	*60%*	*35%*	*17%*	*19%*	*22%*
BVPS	742	722	789	820	851

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	70.5	67.2	67.1	66.7	67.0
Equity to assets	6.8	6.3	6.6	6.8	7.0
Tier 1 CAR	10.9	11.0	11.4	11.5	11.5
Total CAR	12.5	12.4	13.4	13.5	13.5

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	1.3x	1.4x	1.3x	1.2x	1.2x
Price to earnings	100.2x	58.4x	29.1x	32.0x	31.8x
Price to underlying profit	16.7x	16.0x	17.7x	15.7x	14.8x
Yield at current price (%)	0.60	0.60	0.60	0.60	0.70

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	5	5	5	5	5
Mortgage (%)	20	22	24	25	25
Corporate (%)	72	70	68	67	67
Other (%)	3	3	3	3	3

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	1.52	1.48	1.37	1.38	1.39
Yield on assets	2.11	1.77	1.59	1.60	1.62
Cost of liabilities	0.61	0.28	0.22	0.22	0.23
Non-int. inc (% Op income)	14.4	16.4	16.1	18.0	18.4
Cost to income	66.3	64.5	66.5	63.3	61.7
Overhead to assets	1.07	1.04	1.02	0.99	0.98
ROA	0.1	0.2	0.3	0.3	0.3
ROE	1.3	2.4	4.4	3.8	3.7

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings		4%	-10%	13%	6%
Net profit		70%	90%	-11%	1%
EPS		72%	101%	-9%	1%
DPS		0%	0%	0%	0%
Net Loans		-3%	0%	0%	1%
Assets		0%	1%	1%	1%
Deposits		1%	1%	1%	0%

Japan brokers

Paradise lost

Rating: Neutral

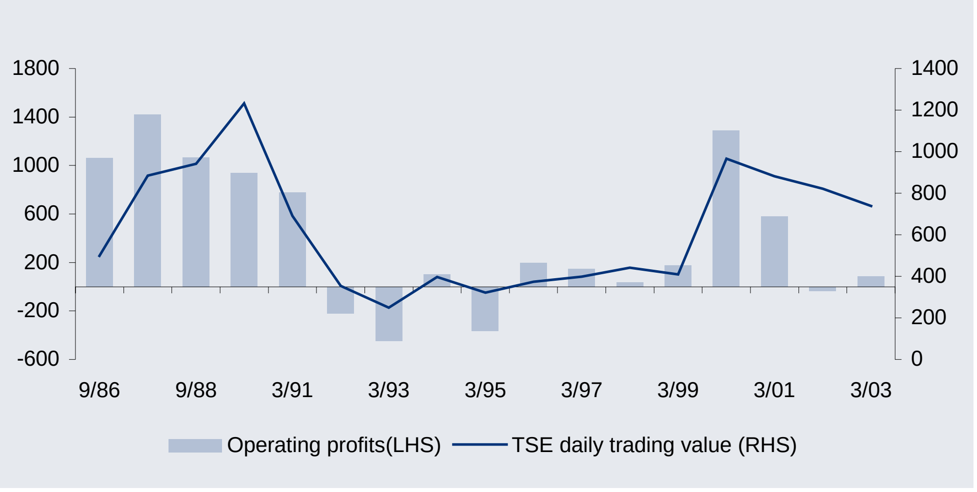
Despite record volumes, the Big Three's earnings remain unimpressive. With deregulation, a large portion of the lucrative retail market was lost to online brokers. Valuation multiples have contracted, perhaps lastingly, as a result. We remain neutral on the brokers.

Trading value and profits: Paradise lost

Trading value as the main earnings driver for brokers' profits

Historically, equity trading value was the main driver of Japanese brokers' earnings. In particular, prior to commission rate deregulation in October 1999, an equity market turnaround and a resultant pick-up in trading value generally led to improved profitability for brokers. Securities industry profits in the late 1980s and, more recently in FY3/00, are good examples of how a pick-up in trading value has produced high levels of profitability. In fact, between FY3/91 and FY3/01, variations in average daily trading value on the TSE (Sections I and II) accounted for 84% of the changes in brokerage industry aggregate operating profits (see chart below).

Fig 83 Securities industry OP and TSE average daily trading value (¥bn)



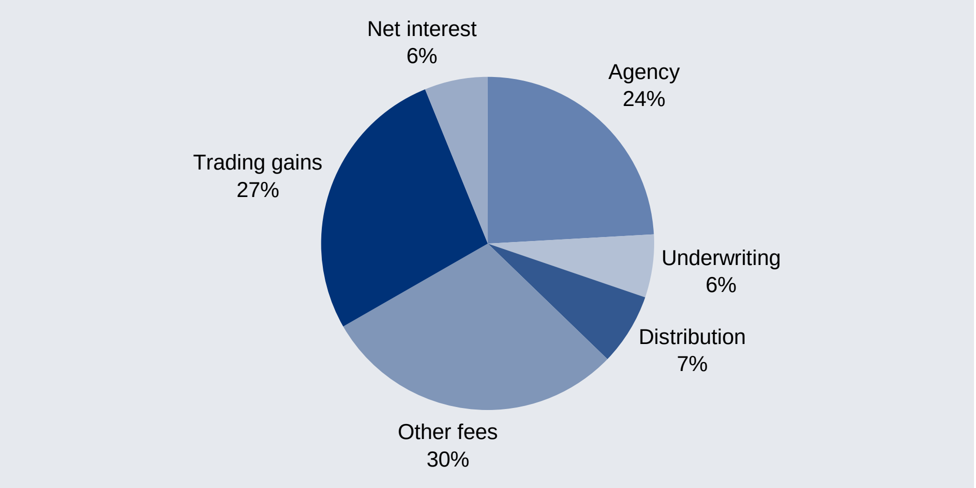
* FY3/03 OP based on listed brokers' results. Adjusted pre-tax profit for Nomura.
Source: JSDA, TSE, ING

Recent data suggests a weakening relationship

However, this remarkably strong relationship breaks down if we add more recent data. If data for the last two fiscal years, FY3/02 and FY3/03, is included, variations in trading value account for only 59% of the changes in the industry's operating profits.

With deregulation of commission rates, competition intensified and market share and average rates declined. This resulted in a decline in the importance of trading value as a primary earnings driver. For example, while in FY3/00 equities contributed 52% of the revenue at Nomura's retail business, in FY3/03, this figure was down to 28%. At the same time, bond-related revenue rose from an insignificant 10% of the company's retail revenue in FY3/00 to 41%, making it the top contributor in FY3/03.

Fig 84 Aggregate revenue breakdown, all securities companies FY3/03 (%)



Source: TSE, ING

Recent profitability

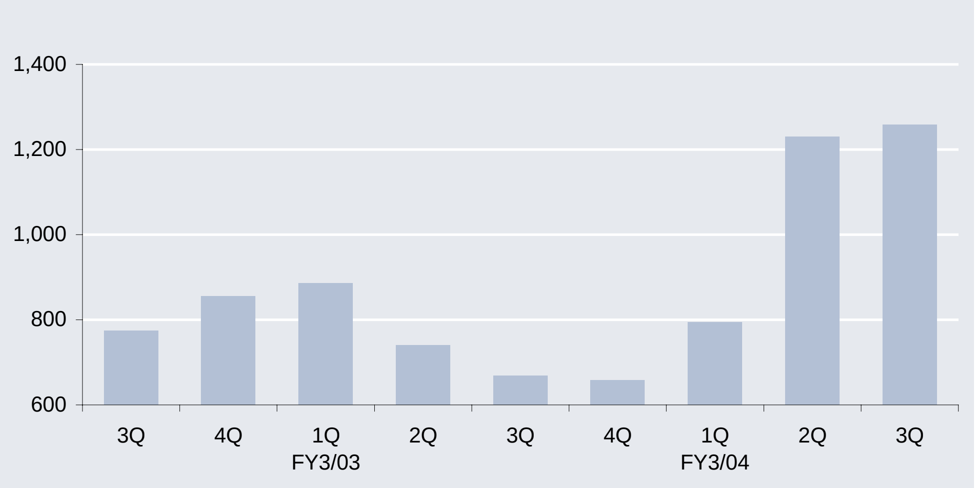
2Q and 3Q results highlight the structural changes

Brokers' results for 2Q and 3Q FY3/04 highlighted the structural changes in the industry over the past four years. While 3Q proved to be the second-best quarter since the equity market bubble of the late 1980s, the Big Three's profits were considerably lower than they would have been pre-1999.

In 2Q, despite the a 54.9% QoQ increase in trading value, core earnings, if adjusted for one-off gains, would have fallen at two of the three major brokers.

We expect average daily trading value for the rest of this FY and next FY to be about ¥1tr. While 2Q and 3Q average trading value was above ¥1.2tr, or about 20% higher than our assumption, we believe these levels are not sustainable. Average daily trading value as a percent of total market capitalisation reached 10.8% in October 2003, well above the average of 5.6% since the deregulation of commission rates in October 1999 and above the peak of the late 1980's bubble of 8.9%. As a result, we do not expect dramatic changes to brokers' profitability over the next couple of years.

Fig 85 Average daily trading value on TSE (¥bn)



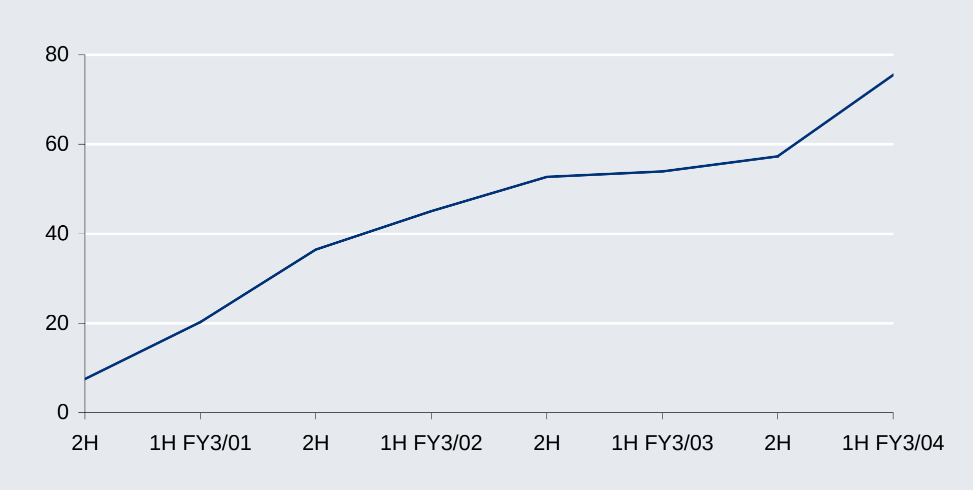
Source: TSE, ING

The online nirvana

Post-deregulation: A boom in online retail trading...

The main reason for the lower profile of equity in brokers' revenue is the decline in retail equity brokerage. Since commission rates were deregulated in October 1999, online brokers have made steady gains in market share at the expense of traditional players, including the Big Three. Online brokers' convenience and, more importantly, low commission rates have attracted a large number of customers since 1999. The statistics are compelling – according to JSDA and TSE data, we estimate that in 1H FY3/04 (April–September 2003), 75.5% of retail trading value was derived from online transactions, up from only 7.5% in 2H FY3/00 (October 1999 to March 2000).

Fig 86 Online retail trading value as % of total (%)

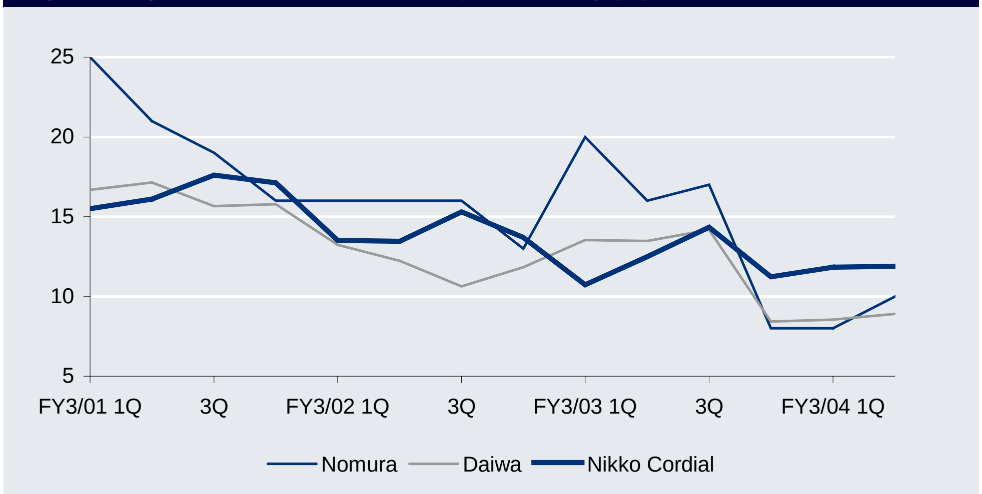


Source: JSDA, TSE, ING

...causing a massive loss of market share at the Big Three

While the trading value of the major brokers' online arms is included in the figure above, it offers little consolation as the online services of the Big Three have lower commission rates than their branches. Furthermore, the Big Three's market share has fallen substantially over the past four years. While in 1Q FY3/01 Nomura claimed 25% of the retail market, at 2Q FY3/03 its share was only 10%. This is well below the share commanded by some of the online brokers (15-16% at E*Trade Japan and 12-13% at Matsui Securities). Daiwa and Nikko Cordial are no exceptions, and, while Nikko Cordial's share appears to be more resilient, it has come at the expense of low commission rates compared with its peers.

Fig 87 Big Three's share of retail equity trading (%)



Source: Company data, TSE, ING

Although their market share improved with the market rebound in 2Q, the Big Three are unlikely to enjoy the same windfall of revenue as they did in 1999 and 2000. While we believe a continued market recovery will help the Big Three regain some market share as many of their traditional customers return, much of the ground that has been lost to online brokers is unlikely to be reclaimed. On the contrary, online brokers like Matsui had their best quarter in 3Q. Naturally, a substantial pick-up in retail volumes is likely to benefit the Big Three, but at this point we see limited evidence that current volumes will be sustained for long.

Bond revenues

Bond revenues a much-needed substitute

Bond-related revenue has become a much-needed revenue substitute for the Big Three. The prolonged bear market and the ultra-low interest rate environment in Japan have created robust retail demand for foreign fixed income products. The Big Three were quick to tap this demand, and bond-related revenue has been driving profitability at the major brokers over the last couple of years.

The following chart plots Japanese household investments in foreign securities over the past 12 years. In the last fiscal year alone, the net inflow of foreign currency denominated products was ¥3.93tr. In 1Q FY3/04, Nomura and Daiwa in particular enjoyed strong foreign bond sales to retail investors, which resulted in substantial bond trading profits.

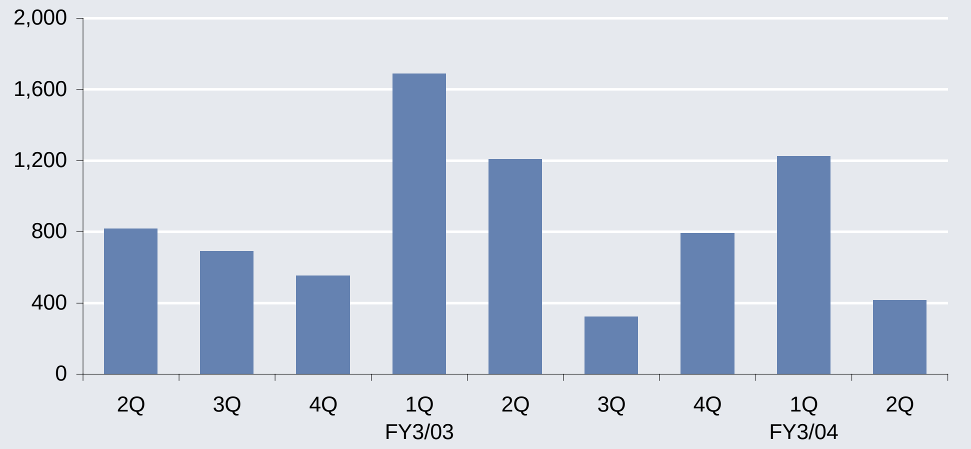
Fig 88 Net investments in foreign securities by households, annually (¥tr)

Source: BOJ, ING

But the equity market recovery and yen strength cooled retail interest

However, the equity market recovery and the strong yen made foreign currency investments less attractive in 2Q, and retail demand dropped substantially. Since the foreign bond business is far more profitable than equity — foreign bond sales to retail investors generate between 2-3% in fees — brokers' trading profits declined substantially. It appears that sales of foreign bonds have continued to decline in 3Q. Barring a substantial decline in equity markets or in the JPY rate versus major currencies, we do not expect a significant recovery in demand for foreign bonds.

Fig 89 Net investments in foreign securities by households, quarterly (¥bn)



Source: BOJ, ING

Institutional business

Underwriting activity is recovering sharply, though

That said, institutional business at the Big Three seems to be doing better. Primary markets were reinvigorated by the equity market rebound, and a number of IPOs that had been postponed over the past couple of years have been re-launched. Underwriting activity was particularly strong in 3Q FY3/04, with volume totalling almost US$18bn, according to Thomson Financial. This is the largest 3Q increase since 1998, and it is some five times the level of a year ago.

Fig 90 Top equity and equity-related bookrunners in 2003

Bookrunner	Proceeds ($m)	Rank 2003	Market share	# of issues	Rank 2002
Nomura	11,992	1	32.7	105	2
Nikko Citigroup	6,621	2	18.0	53	1
Daiwa Securities SMBC	5,051	3	13.8	60	3
Goldman Sachs	4,088	4	11.1	2	5
Morgan Stanley	2,279	5	6.2	4	7
UBS	1,976	6	5.4	10	4
Merrill Lynch	1,800	7	4.9	6	6
MTFG	665	8	1.8	15	8
Mizuho	612	9	1.7	13	11
Credit Suisse First Boston	435	10	1.2	4	13
Industry total	**36,693**			**334**	

Source: Thomson Financial

Furthermore, banks and other corporates have pressed on with aggressive reductions in their cross shareholdings. We expect primary businesses to continue to be strong for the next couple of quarters at least. With the Big Three maintaining their firm grip at the top of the league tables, they are likely to be the biggest beneficiaries.

But trading profits weak

Trading profits, though, are unlikely to reach the heights achieved in FY00 and FY01, as the Big Three have generally been refraining from aggressive proprietary trading recently. Bond trading profits are likely to remain lacklustre, in line with weak sales of foreign currency bonds, while equity trading, although improving with the market, remained weak in 3Q.

According to an official at one of the Big Three brokers, one reason for the Big Three's reluctance to engage in aggressive proprietary trading in recent years is the decline in commission revenue, which in the fixed commission rate environment offered a comfortable cushion for potential losses.

Contracting multiples

Structural changes are causing a substantial contraction in multiples

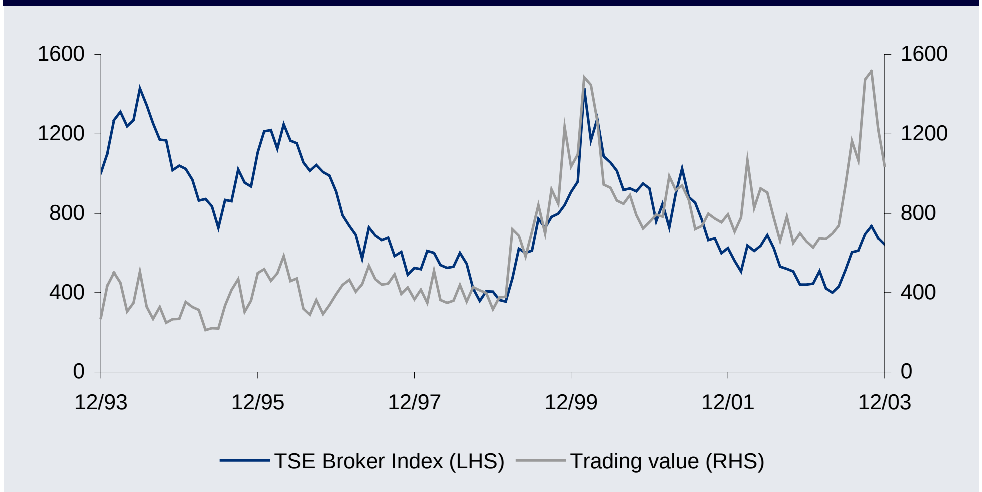
The structural changes in the industry over the past few years have resulted in a substantial contraction in valuation multiples at the Big Three. The average PBR multiples at which the Big Three traded between July and December 2004 are only 50 to 60% of the levels seen the last time the market experienced similar trading value activity (November 1999 to April 2000). Furthermore, despite the rising market, two of the Big Three brokers have underperformed the TOPIX over the past six months.

The following chart plots the TOPIX Securities Companies Index against the average daily trading value on the TSE. Prior to deregulation, brokers' performance was strong despite the low volume levels, since their market share was higher and commission rates were fixed. Post-1999, however, that has changed, and in spite of the substantial increase in trading volumes, performance has been relatively weak.

Although a continued bull market is likely to push valuations higher, we believe multiples are unlikely to revert to the levels of four years ago. To a considerable degree this is due to deregulation of commission rates as well as the entry of other financial institutions like banks into the brokerage industry. Although the challenge posed by banks to the Big Three is likely to remain muted for some years, their success in the investment trust distribution has been remarkable. As of November 2003, banks placed some 38.4% of stock investment trusts, an impressive achievement since they were only allowed to sell investment trusts from 1999. Market share gains by the banks came almost exclusively at the expense of the brokers.

Despite record volumes, performance has been poor

Fig 91 Average daily trading value on TSE (¥bn) versus TSE Broker Index



Source: Datastream, TSE, ING

Second-tier brokers' valuations appear more attractive

While earnings at the Big Three are en route to registering a substantial YoY recovery this FY, we believe current valuations discount this. Some of the second-tier and bank-related brokers, though, seem to offer relatively low valuations on Toyo Keizai estimates. PERs on Toyo Keizai's FY3/04 EPS estimates tend to be somewhat misleading as the vast majority of the second-tier brokers are not paying taxes this FY (following a couple of years of losses). Nonetheless, even if EPS is normalised for taxes, valuations of some of the second-tier brokers remain low.

Fig 92 Brokers' valuations

Code	Name	Price* (¥)	Market cap (¥bn)	PBR	PE FY3/04E**	PE norm*** FY3/04E	PE FY3/05E**
8601	Daiwa	850	1,132	2.00	22.2	22.2	22.2
8603	Nikko Cordial	671	1,307	1.82	36.9	36.9	29.7
8604	Nomura	1,815	3,568	2.07	21.9	21.9	19.2
8606	Shinko	416	337	1.48	22.5	31.1	19.8
8607	Mizuho Investors	306	377	5.72	38.1	54.2	37.7
8609	Okasan	752	149	2.18	17.7	12.6	15.3
8611	Cosmo	291	123	4.11	45.7	62.3	43.3
8613	Marusan	755	57	1.12	13.5	16.1	17.8
8614	Toyo	441	35	1.61	6.7	11.6	7.2
8615	Mitsubishi	1,472	696	1.92	22.6	40.7	23.3
8616	Tokai Tokyo	369	105	1.28	10.0	18.1	11.1
8617	Kosei	300	28	1.57	35.1	148.2	91.8
8621	UFJ Tsubasa	558	337	1.57	29.0	34.8	33.7
8622	Mito	427	31	1.30	10.3	15.6	8.6
8623	SMBC Friend	615	183	1.86	11.1	17.2	18.7
8624	Ichiyoshi	876	42	1.34	10.6	16.2	8.5
8625	Takagi	379	23	1.03	13.7	21.6	13.6
8626	Monex	107,000	167	18.19	79.4	125.8	53.8
8628	Matsui	3,660	325	9.42	54.2	54.2	41.0

* As of 22/04/04. ** ING estimates for 8601, 8603, 8604 and 8628. Toyo Keizai estimates for the rest.
*** Normalised NP = RP less taxes at 40%.

Source: Company data, Toyo Keizai, ING estimates

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Daiwa Securities

Fee-driven gains

Rating: HOLD

The highlight of Daiwa's recent performance, similar to the other two major brokers, was a rebound in commission revenue. 2Q agency commissions were up 69.3% and underwriting fees more than doubled QoQ, helped by the recovering market. However, trading gains remain lacklustre on lower gains from foreign bond sales to retail investors, the main earnings driver in 1Q.

The recently released 3Q results did not offer any surprises or significant changes from the 2Q. Commission and fee revenue was strong while trading gains remained lacklustre:

- Daiwa's 3Q FY3/04 (October – December 2003) NP was ¥9.1bn, up from a net loss of ¥2.5bn a year ago. NP for the nine months to December was ¥28.4bn, up more than 5x YoY.
- 3Q OP was ¥22.0bn, up from ¥6.9bn a year ago. Cumulative OP for the nine months to 12/03 was ¥64.6bn, up 2.5x YoY.
- Commissions were strong on robust underwriting fees. Daiwa recorded an impressive increase in equity underwriting fees in 3Q – up 168.2% YoY and 50.0% QoQ to ¥13.5bn, the highest levels since Daiwa SMBC, the wholesale arm of Daiwa Securities, was formed.
- Equity brokerage commissions were down 5.7% QoQ, in spite of the increase in overall trading value, as the company's share of retail trading value fell to 8.0% from 8.9% in 2Q. Also, the proportion of online trading increased.
- Equity trading profits, though, disappointed with gains of ¥9.2bn for the 3Q. If adjusted for intra-company transactions, equity trading gains would have been even lower at ¥7.1bn, down from ¥8.0bn in 2Q. Overall trading gains amounted to ¥23.2bn, down 7.0% QoQ.
- SG&A expenses in 3Q were down 1.5% QoQ to ¥63.7bn on lower real estate related costs (down 6.6% QoQ) and office and stationery (down 8.0% QoQ).

We expect 4Q commissions to remain strong on the continuing flow of financing deals. We also expect trading profits to rise as the flow of cross-shareholding trades accelerates before the fiscal year-end in March.

The shares trade on 22x our FY3/05 EPS estimate, which we believe is a fair valuation. We rate the shares as HOLD with a target price of ¥790.

Daiwa Securities — Japan

Share Price:	850	**Reuters Code:**	8601.T	**Shares Outstanding**	1,328
52 Week Price Range:	434 - 955	**Bloomberg Code:**	8601 JP	**Market Cap (US$m)**	10,320

INCOME STATEMENT	**02**	**03**	**04**	**05**	**06**
FY ended March					
Commission revenue:					
Agency	59.8	46.8	75.7	72.2	71.0
Underwriting	27.8	27.9	32.3	37.1	37.9
Distribution	15.6	14.7	24.5	29.3	31.4
Other	68.7	54.8	47.4	57.6	62.0
	171.9	144.3	179.9	196.3	202.3
Net gain on trading	63.4	93.9	128.6	135.0	140.0
Gains on investments	3.9	(2.6)	1.5	4.0	4.0
Financial revenue	195.9	114.7	111.0	112.1	113.2
Other revenues	53.0	37.4	32.6	34.3	34.9
TOTAL REVENUE	**488.0**	**387.7**	**453.6**	**481.6**	**494.5**
Financial costs	164.5	90.6	82.6	84.1	84.9
Other costs	38.6	26.3	21.8	22.3	22.7
Net interest	31.4	24.1	28.4	28.0	28.3
NET REVENUE	**284.9**	**270.8**	**349.2**	**375.3**	**386.8**
SG&A expenses:					
Trading related	47.0	40.7	39.8	40.7	41.2
Personnel costs	130.0	123.9	134.6	137.3	137.8
Rents & other real estate relate	35.1	33.3	33.4	35.0	35.4
Office & stationery	16.5	14.7	15.5	16.2	16.5
Depreciation	18.8	21.1	21.2	21.8	22.0
Taxes	5.3	4.7	7.4	7.5	7.6
Other SG&A expenses	9.5	8.3	8.0	8.3	8.4
	262.2	246.7	259.9	266.8	269.0
OPERATING PROFIT	**22.8**	**24.1**	**89.4**	**108.5**	**117.9**
Nonoperating income	8.6	8.2	7.0	7.3	7.6
Nonoperating expense	5.5	3.1	3.6	3.7	3.8
Recurring profit	25.9	29.2	92.8	112.1	121.6
Extraordinary income	32.0	15.6	2.4	-	-
Extraordinary expenses	177.8	32.9	4.2	-	-
Pretax profit	(120.0)	11.8	91.0	112.1	121.6
Income tax	5.6	15.4	36.6	44.8	48.7
Minority interest profit	5.0	2.8	15.4	16.7	18.1
NET PROFIT	**(130.5)**	**(6.3)**	**39.0**	**50.6**	**54.8**

REVENUE BREAKDOWN	**02**	**03**	**04**	**05**	**06**
% of net revenues					
Agency	21.0	17.3	21.7	19.2	18.3
Underwriting	9.8	10.3	9.3	9.9	9.8
Distribution	5.5	5.4	7.0	7.8	8.1
Other commissions	24.1	20.2	13.6	15.4	16.0
Net gain on trading	22.2	34.7	36.8	36.0	36.2
Net interest	11.0	8.9	8.1	7.5	7.3

KEY RATIOS	**02**	**03**	**04**	**05**	**06**
SG&A ratio	92.0	91.1	74.4	71.1	69.5
Personnel / revenues ratio	45.6	45.8	38.5	36.6	35.6
Non-personnel costs / SG&A	50.4	49.8	48.2	48.6	48.8
Operating profit margin	8.0	8.9	25.6	28.9	30.5
Recurring profit margin	9.1	10.8	26.6	29.9	31.4
Net profit margin	(45.8)	(2.3)	11.2	13.5	14.2
ROE	(20.3)	(1.1)	7.0	8.5	8.6

PER SHARE DATA	**02**	**03**	**04**	**05**	**06**
Shares outstanding ('000)	1,328,519	1,328,256	1,328,256	1,328,256	1,328,256
Dividend	6.0	6.0	6.0	6.0	6.0
EPS	(98.3)	(4.8)	29.3	38.1	41.3
BVPS	429.7	407.8	431.2	463.2	498.5

GROWTH RATES	**02**	**03**	**04**	**05**	**06**
Agency	(27.9)	(21.6)	61.6	(4.6)	(1.7)
Underwriting	(28.4)	0.5	15.6	14.9	2.0
Distribution	(60.6)	(6.1)	67.1	19.6	7.2
Other commissions	(26.4)	(20.2)	(13.6)	21.6	7.7
Net gain on trading	(61.7)	48.2	36.9	4.9	3.7
Net interest	12.2	(23.3)	17.7	(1.3)	1.0
Net revenues	(39.0)	(5.0)	28.9	7.5	3.1
SG&A expenses	(8.6)	(5.9)	5.3	2.7	0.8
Operating profit	(87.3)	5.9	270.6	21.4	8.7
Net profit	nm	nm	nm	29.8	8.4

Nikko Cordial

Profits and expectations

Rating: SELL

While Nikko Cordial's valuations have risen over the past six months, its profitability remains unimpressive. Following the recovery in equity markets and a strong 1H, Nikko Cordial appears set to swing back into profit this FY. However, earnings quality in 1H was poor, with commission revenue below our expectations despite strong trading volumes.

3Q results, albeit ahead of our expectations, fail to justify valuations, in our opinion. Much of the stronger-than-expected performance was accounted for by lower personnel costs due to accounting policy at Nikko Citigroup. We nevertheless expect personnel expenses to bounce back in 4Q.

- For the three months to December 2003, the company posted NP of ¥11.2bn, while cumulative NP for the full year was ¥25.7bn, up from only ¥0.3bn for the same period a year ago.
- OP for the three months to December was ¥23.2bn, while cumulative 3Q OP was ¥51.4bn, up 75.9% YoY.
- Commission revenue was up 17.0% QoQ on very strong underwriting fees. Fees from equity underwriting in 3Q were ¥13.2bn, almost 4.5x the level in 2Q.
- Brokerage commissions, though, were down 7.8% QoQ as, in retail, Nikko Cordial's share of trading value declined to 10.3% from 11.9% in 2Q.
- Equity trading gains for the three months to December 2003 were ¥7.3bn, up 4x QoQ, but below our expectations of ¥9.0bn for the quarter. Overall trading gains for the 3Q were ¥14.8bn, up slightly from ¥13.9bn in 2Q.
- Consolidated SG&A expenses in 3Q were down 9.0% QoQ to ¥55.9bn on substantially lower personnel costs, down 21.2%. Much of the decline is due to accounting procedures at Nikko Citigroup, but we expect personnel costs to increase in 4Q, as was the case last FY.

Similar to Daiwa, we expect 4Q commissions to remain strong on the continuing flow of financing deals. Nikko Citigroup is among the lean managers of Shinsei Bank's IPO, which is likely to be the largest deal in 4Q. We also expect trading profits to rise as the flow of cross-shareholding trades accelerates before the fiscal year-end in March.

Nikko Cordial's shares trade on a PER of 29x our FY3/05 EPS estimate. We believe this valuation is demanding and we rate the shares as SELL with a target price of ¥550.

Nikko Cordial

Japan

Share Price:	671	**Reuters Code:**	8603.T	**Shares Outstanding**	1,841
52 Week Price Range:	295 - 764	**Bloomberg Code:**	8603 JP	**Market Cap (US$m)**	11,292

INCOME STATEMENT	**02**	**03**	**04**	**05**	**06**
FY ended March					
Commission revenue:					
Agency	71.5	50.5	72.8	73.0	71.9
Underwriting	24.3	18.0	24.0	30.4	32.5
Distribution	11.7	13.6	39.8	42.9	49.1
Other	90.2	79.4	85.4	95.2	98.4
	197.7	161.4	221.9	241.4	251.9
Net gain on trading	35.1	72.9	67.8	86.9	90.6
Gains on investments	0.8	(2.4)	2.6	5.0	6.0
Financial revenue	54.8	52.4	48.6	47.6	47.1
Other revenues					
TOTAL REVENUE	**288.3**	**284.3**	**340.8**	**381.0**	**395.6**
Financial costs	34.9	33.6	35.9	42.8	42.4
Other costs					
Net interest	19.9	18.8	12.7	4.8	4.7
NET REVENUE	**253.4**	**250.7**	**304.9**	**338.2**	**353.2**
SG&A expenses:					
Trading related	35.2	30.0	33.7	30.8	30.9
Personnel costs	122.4	111.5	133.2	139.0	141.4
Rents & other real estate relate	34.0	28.0	26.0	26.8	26.8
Office & stationery	21.0	19.5	16.2	16.7	17.2
Depreciation	12.7	13.4	13.2	13.4	13.7
Taxes	3.2	2.8	2.1	2.3	2.4
Other SG&A expenses	20.9	15.8	14.0	14.6	15.0
	249.5	221.0	238.3	243.6	247.4
OPERATING PROFIT	**3.9**	**29.7**	**66.7**	**94.5**	**105.8**
Nonoperating income	4.3	6.0	5.4	5.4	5.5
Nonoperating expense	6.7	4.0	2.7	2.7	2.8
Recurring profit	1.5	31.6	69.4	97.2	108.6
Extraordinary income	10.4	0.5	2.9	-	-
Extraordinary expenses	57.3	26.4	5.1	-	-
Pretax profit	(45.3)	5.8	67.2	97.2	108.6
Income tax	16.8	20.0	26.6	38.9	43.4
Minority interest profit	4.2	7.4	8.8	10.9	11.7
NET PROFIT	**(66.4)**	**(21.6)**	**31.8**	**47.4**	**53.4**

REVENUE BREAKDOWN	**02**	**03**	**04**	**05**	**06**
% of net revenues					
Agency	28.2	20.1	23.9	21.6	20.4
Underwriting	9.6	7.2	7.9	9.0	9.2
Distribution	4.6	5.4	13.0	12.7	13.9
Other commissions	35.6	31.7	28.0	28.2	27.8
Net gain on trading	13.9	29.1	22.2	25.7	25.6
Net interest	7.8	7.5	4.2	1.4	1.3

KEY RATIOS	**02**	**03**	**04**	**05**	**06**
SG&A ratio	98.4	88.1	78.1	72.1	70.0
Personnel / revenues ratio	48.3	44.5	43.7	41.1	40.0
Non-personnel costs / SG&A	50.9	49.5	44.1	43.0	42.8
Operating profit margin	1.6	11.9	21.9	27.9	30.0
Recurring profit margin	0.6	12.6	22.8	28.7	30.8
Net profit margin	(26.2)	(8.6)	10.4	14.0	15.1
ROE	(9.1)	(3.2)	4.9	7.1	7.6

PER SHARE DATA	**02**	**03**	**04**	**05**	**06**
Shares outstanding ('000)	1,841,146	1,840,708	1,841,062	1,841,062	1,841,062
Dividend	3.0	3.0	3.0	8.0	9.0
EPS	(36.0)	(11.8)	17.3	25.8	29.0
BVPS	374.4	352.8	353.0	370.7	390.8

GROWTH RATES	**02**	**03**	**04**	**05**	**06**
Agency	(28.5)	(29.4)	44.1	0.3	(1.4)
Underwriting	(48.1)	(26.0)	33.3	26.7	7.1
Distribution	(46.1)	16.1	192.1	7.9	14.5
Other commissions	(22.3)	(12.0)	7.5	11.6	3.3
Net gain on trading	(52.0)	107.3	(7.0)	28.3	4.2
Net interest	9.3	(5.5)	(32.5)	(62.4)	(1.0)
Net revenues	(33.4)	(1.1)	21.6	10.9	4.5
SG&A expenses	(13.9)	(11.4)	7.8	2.3	1.5
Operating profit	(95.7)	655.4	124.4	41.7	12.0
Net profit	nm	nm	nm	49.0	12.6

Nomura Holdings

Still in the lead

Rating: HOLD

Nomura maintains its position as the top broker in Japan. It has fallen behind online competitors in terms of share of retail equity brokerage, but continues to dominate in wholesale and asset management. 1H results underscored the strength of its position, with its revenues leading the Big Three quantitatively and qualitatively.

Nomura's 3Q results, however, disappointed. Much of poor performance, though, was accounted for by low trading gains, in particular in equities.

- NP for the three months to December was ¥15.7bn, broadly flat YoY, but down from ¥46.7bn in 2Q. NP for the nine months to December was ¥102.4bn, down 29.9%, with the decline largely due to one-off gains from the company's transfer to US GAAP accounting recorded in 1Q last FY.
- Cumulative pre-tax profit for the nine months to December 2003 was ¥189.2bn, up over 2x YoY; we were forecasting pre-tax profit of ¥218.8bn.
- While bond-trading profits were in line with our expectations, equity trading gains disappointed. For the three months to December 2003, equity trading gains were ¥6.2bn, well below the ¥32.8bn the company recorded in 2Q. Much of the decrease appears to be due to the decline in large cross-shareholding unwinding trades in 3Q. Trading profits in 2Q and 4Q tend to be stronger as corporates cut shareholdings just before the book closing periods in September and March.
- Nomura also booked a ¥2.1bn loss on private equity investments, arising from the costs of financing existing positions and no exit cases.
- Commission revenue was up 2.9% QoQ on strong fees from the distribution of equity investment trusts, while brokerage commissions were broadly flat QoQ as average trading value in 3Q was up 2.3% QoQ.
- Fees from underwriting, as expected, registered a 22.9% increase QoQ on strong equity underwriting fees as primary markets recovered.
- SG&A expenses in 3Q were down 5.1% QoQ to ¥120.3bn on lower personnel costs (down 8.7%).

Like the other two major brokers, we expect 4Q commissions to remain strong on the continuing flow of financing deals. Nomura is among the lean managers of Shinsei Bank's IPO, which is likely to be the largest deal in 4Q. We also expect trading profits to rise as the flow of cross-shareholding trades accelerates before the fiscal year-end in March.

Nomura trades on 19x our FY3/05 EPS estimates. We believe such valuation is fair and we rate the shares as HOLD with a target price of ¥1,850.

Nomura

Japan

Share Price:	1,815	**Reuters Code:**	8604.T	**Shares Outstanding**	1,940
52 Week Price Range:	1,104 - 2070	**Bloomberg Code:**	8604 JP	**Market Cap (US$m)**	32,104

INCOME STATEMENT	**02**	**03**	**04**	**05**	**06**
FY ended March					
Commission revenue	140.0	141.6	189.5	185.4	186.5
Fees from investment banking	75.3	81.8	73.4	84.3	89.2
Asset management fees	110.0	79.3	65.7	75.5	79.3
Interest & dividends	500.5	401.9	419.7	411.3	362.3
PFG entities product sales	294.9	-	-	-	-
PFG entities rental income	177.1	-	-	-	-
Gain on sales of PFG entities	116.3	-	-	-	-
Gain on private equity	232.5	(14.4)	13.6	20.0	20.0
Other	72.5	19.6	28.3	28.0	28.0
Net gain on trading	162.2	172.3	280.0	296.5	305.7
Gains on investments	(55.9)	(41.3)	31.8	-	-
TOTAL REVENUE	**1,825.4**	**840.9**	**1,101.9**	**1,101.0**	**1,071.1**
Interest Expense	504.0	274.6	312.0	304.4	271.7
Other costs					
Net interest	(3.5)	127.3	107.7	106.9	90.6
NET REVENUE	**1,321.4**	**566.3**	**789.9**	**796.6**	**799.3**
SG&A expenses:					
Trading related	21.0	20.8	18.6	18.7	19.0
Personnel costs	379.5	244.2	263.3	255.4	244.1
Rents & real estate	73.8	57.2	53.7	53.4	53.2
IT and communications	87.3	77.4	77.6	75.9	75.2
Business development	26.7	24.4	20.2	20.0	20.0
PFG entities COGS	200.9	-	-	-	-
PFG rental related expenses	111.5	-	-	-	-
Other SG&A expenses	247.8	95.0	67.3	67.1	67.6
	1,148.4	518.9	500.8	490.7	479.0
OPERATING PROFIT	**173.0**	**47.4**	**289.1**	**306.0**	**320.3**
Nonoperating income					
Nonoperating expense					
Recurring profit	173.0	47.4	289.1	306.0	320.3
Extraordinary income					
Extraordinary expenses					
Pretax profit	173.0	47.4	289.1	306.0	320.3
Income tax	4.9	37.3	128.4	122.4	128.1
Cumulative accounting change	-	109.8	-	-	1.0
NET PROFIT	**168.0**	**119.9**	**160.7**	**183.6**	**193.2**

REVENUE BREAKDOWN	**02**	**03**	**04**	**05**	**06**
% of net revenues					
Commissions	10.6	25.0	24.0	23.3	23.3
Fees from investment banking	5.7	14.5	9.3	10.6	11.2
Asset mgmt fees	8.3	14.0	8.3	9.5	9.9
Net gain on trading	12.3	30.4	35.5	37.2	38.2
Net interest	(0.3)	22.5	13.6	13.4	11.3

KEY RATIOS	**02**	**03**	**04**	**05**	**06**
SG&A ratio	86.9	91.6	63.4	61.6	59.9
Personnel / revenues ratio	28.7	43.1	33.3	32.1	30.5
Non-personnel costs / SG&A	58.2	48.5	30.1	29.5	29.4
Operating profit margin	13.1	8.4	36.6	38.4	40.1
Recurring profit margin	13.1	8.4	36.6	38.4	40.1
Net profit margin	12.7	21.2	20.3	23.0	24.2
ROE	10.4	7.0	8.7	9.5	9.3

PER SHARE DATA	**02**	**03**	**04**	**05**	**06**
Shares outstanding ('000)	1,966	1,940	1,940	1,940	1,940
Dividend	15.0	15.0	15.0	15.0	16.0
EPS	85.6	61.3	82.8	94.6	99.6
BVPS	816.4	846.4	914.2	993.8	1,066.2

GROWTH RATES	**02**	**03**	**04**	**05**	**06**
Commissions	(26.3)	1.2	33.8	(2.1)	0.6
Fees from investment banking	(13.7)	8.8	(10.4)	14.9	(0.8)
Asset mgmt fees	(24.1)	(27.9)	(17.2)	15.0	5.0
Other commissions	NA	NA	NA	NA	NA
Net gain on trading	(47.3)	6.2	62.5	5.9	3.1
Net interest	NA	NA	NA	NA	NA
Net revenues	44.3	(57.1)	39.5	0.9	1.2
SG&A expenses	51.2	(54.8)	(3.5)	(2.0)	(1.7)
Operating profit	10.8	(72.6)	509.8	5.8	5.9
Net profit	192.7	(28.6)	34.0	14.2	6.5

Matsui Securities

From record to record

Rating: HOLD

Matsui Securities, Japan's largest online broker by revenues, had its best quarter ever in terms of revenues and profits in 2Q. This record was to last until 3Q results were announced, as 3Q OP was up 21.4% QoQ and NP was up 22.4% QoQ. The strong retail volumes over the past six months, as well as Matsui's highly active customer base, accounted for the record performance.

- 3Q OP and NP were up 2.6x YoY to ¥4.2bn and ¥2.1bn, respectively, as net revenues more than doubled and costs were up 26.8% YoY.
- Both agency commissions and net interest income, the two main revenue drivers, more than doubled YoY as retail trading value rose 89.0% YoY, and Matsui's share expanded to 13.0% from 8.8% a year ago. Margin loan balances were up 127.6% on the market rally, increased retail trading activity and the growing number of margin accounts.
- Sequentially, net revenues were up 11.1% QoQ, while SG&A expenses declined 3.3% QoQ on lower default provisions and outsourcing fees.

In January, Matsui announced a couple of changes to its commission rates, which will be introduced in April. Both changes seem to be targeted at stimulating trading by active traders:

- Trades with a trading value of less than ¥100,000 in one day will be free (regardless of the number of trades). From January 2005, though, the commission rate for such trades will be ¥500, ie, 50bps or higher.
- Trades that involve buying and selling of one stock in a given day will be regarded as one-way only trades, ie, the trading value of only one of the transactions (the higher in terms of value) will be included in the "box rate". Matsui applies the "box-rate" commission schedule, according to which customers pay ¥3,000 for any number of trades under ¥3m in trading value. If trading value is above ¥3m but below ¥6m, then the commission rate becomes ¥6,000, and so on.

The first change will be free for eight months, but after that, customers will be paying 50bps or higher versus Matsui's current average commission rate of just under 14bps. The second change clearly targets day-traders, a high-turnover customer base, by not including one of the legs in a buy-sell transaction.

Average commission rates may decline about 10% from just under 14bps to about 12.5bps as a result of the new commission schedule. Nonetheless, the pick-up in trading value could be substantial and more than offset the decline in commission rates.

Matsui's remarkable performance has been generously discounted in the share price. Assuming 4Q profit remains unchanged QoQ, FY3/04 EPS would come to about ¥77, putting the stock on 41x. Furthermore, if we annualise Matsui's 3Q profit, EPS would come to about ¥97, giving the stock a PER of 26x. The stock currently trades on 39x our FY3/05 EPS estimate. We believe this is fair given the company's quality of earnings and we rate the shares as HOLD with a target price of ¥2,500.

Matsui Securities

Japan

Share Price:	3,660	**Reuters Code:**	8628.T	**Shares Outstanding**	88
52 Week Price Range:	724 - 3740	**Bloomberg Code:**	8628 JP	**Market Cap (US$m)**	2,951

INCOME STATEMENT	**02**	**03**	**04**	**05**	**06**
FY ended March					
Commission revenue:					
Agency	9,543.0	9,516.0	17,700.6	17,564.4	17,564.4
Underwriting	-	27.0	175.0	200.0	200.0
Distribution	157.0	16.0	38.0	60.0	60.0
Other	514.0	680.0	940.9	1,004.0	1,241.2
	10,214.0	10,240.0	18,854.5	18,828.4	19,065.6
Net gain on trading	22.0	(39.0)	1.0	-	1.0
Gains on investments					
Financial revenue	2,549.0	3,224.0	4,670.7	5,493.4	6,592.1
Other revenues					
TOTAL REVENUE	**12,785.0**	**13,425.0**	**23,526.3**	**24,321.8**	**25,658.7**
Financial costs	1,350.0	1,274.0	1,248.0	1,208.5	1,450.3
Other costs					
Net interest	1,199.0	1,950.0	3,422.7	4,284.8	5,141.8
NET REVENUE	**11,435.0**	**12,151.0**	**22,278.2**	**23,113.2**	**24,208.4**
SG&A expenses:					
Trading related	1,857.0	1,635.0	2,168.8	2,130.5	2,109.2
Personnel costs	1,874.0	1,786.0	1,936.7	1,956.1	1,975.7
Rents & other real estate relate	799.0	622.0	337.0	353.9	371.5
Office & stationery	964.0	2,564.0	3,830.3	3,947.4	3,805.3
Depreciation	1,437.0	1,578.0	680.0	659.6	639.8
Taxes	29.0	25.0	68.0	70.5	73.9
Bad debt charges	7.0	313.0	125.0	80.0	81.0
Other SG&A expenses	100.0	88.0	111.6	113.8	116.1
	7,067.0	8,612.0	9,257.4	9,311.9	9,172.6
OPERATING PROFIT	**4,368.0**	**3,540.0**	**13,020.8**	**13,801.3**	**15,035.9**
Net nonoperating items	(429.0)	(22.0)	(257.0)	-	1.0
Recurring profit	3,939.0	3,518.0	12,763.8	13,801.3	15,036.9
Net extraordinary items	(344.0)	(834.0)	(417.0)	-	1.0
Pretax profit	3,595.0	2,684.0	12,346.8	13,801.3	15,037.9
Income tax	1,725.0	1,199.0	5,568.9	5,934.6	6,466.3
Minority interest profit					
NET PROFIT	**1,870.0**	**1,485.0**	**6,777.9**	**7,866.7**	**8,571.6**

REVENUE BREAKDOWN	**02**	**03**	**04**	**05**	**06**
% of net revenues					
Agency	83.5	78.3	79.5	76.0	72.6
Underwriting	-	0.2	0.8	0.9	0.8
Distribution	1.4	0.1	0.2	0.3	0.2
Other commissions	4.5	5.6	4.2	4.3	5.1
Net gain on trading	0.2	(0.3)	0.0	-	0.0
Net interest	10.5	16.0	15.4	18.5	21.2

KEY RATIOS	**02**	**03**	**04**	**05**	**06**
SG&A ratio	61.8	70.9	41.6	40.3	37.9
Personnel / revenues ratio	16.4	14.7	8.7	8.5	8.2
Non-personnel costs / SG&A	73.5	79.3	79.1	79.0	78.5
Operating profit margin	38.2	29.1	58.4	59.7	62.1
Recurring profit margin	34.4	29.0	57.3	59.7	62.1
Net profit margin	16.4	12.2	30.4	34.0	35.4
ROE	9.2	4.7	19.7	19.9	20.3

PER SHARE DATA	**02**	**03**	**04**	**05**	**06**
Shares outstanding ('000)	87,611	88,205	88,205	88,205	88,205
Dividend	3.2	2.5	11.5	13.4	14.6
EPS	21.3	16.8	76.8	89.2	97.2
BVPS	355.3	363.2	417.0	479.4	-

GROWTH RATES	**02**	**03**	**04**	**05**	**06**
Agency	NA	(0.3)	86.0	(0.8)	-
Underwriting	NA	NM	548.1	14.3	-
Distribution	NA	(89.8)	137.5	57.9	-
Other commissions	NA	32.3	38.4	6.7	23.6
Net gain on trading	NA	NM	NM	NM	NM
Net interest	NA	62.6	75.5	25.2	20.0
Net revenues	53.7	6.3	83.3	3.7	4.7
SG&A expenses	59.9	21.9	7.5	0.6	(1.5)
Operating profit	44.5	(19.0)	267.8	6.0	8.9
Net profit	20.7	(20.6)	356.4	16.1	9.0

Singapore

Looking outwards

Rating: UNDERWEIGHT

Key signposts for 2004

Aside from a rebound in net profits, driven partially by lower loan loss provisions, we expect the following factors to influence the Singapore banks' share prices in 2004:

- **Loan growth, volume versus rate.** As indicated in the November issue of our "Singapore Country Strategy", with the rebound in the domestic economy, we expect further momentum in loan growth, driven by retail and the commercial sectors like manufacturing and commerce. We estimate 2004 loan growth of 6.3%. This compares with the 2003 growth of 7.0%, although we should note that 2003 loan growth has been boosted by the first-time inclusions of Overseas Union Trust (which was merged into UOB) and OCBC Finance (which was merged into OCBC). Excluding these, 2003 loan growth was 3.4%. However, what will be key in driving stronger net interest income is rate hikes.

- **Asset quality not an issue.** Barring a return of SARS or events to derail the economic recovery, we expect the banks' non-performing loans to continue declining. With the decline in NPLs, loan loss provisioning is expected to recede. Together with write-offs, we estimate that loan loss coverage will improve to above 59% in FY04 for the three Singapore banks.

- **Regulatory changes.** Among the regulatory changes expected is the implementation of bank-specific capital requirements, which the Monetary Authority of Singapore has indicated will be finalised within 2Q04. This will be done with a view to the final implementation of the BIS 2 capital requirements, whereby we expect the Singapore banks to use the internal risk-rating system as a means to decide on the amount of capital to set aside. Separately, we expect the MAS to make further progress on the proposed deposit insurance scheme, which could see banks having to pay more for their deposits via contributions to a bail-out fund. It remains to be seen if this would be passed on to their customers.

- **US-Singapore FTA.** The US-Singapore FTA was implemented on 1 January 2004. The implications for the financial services sector are two-fold in that US financial institutions like Citigroup will gain further access to Singapore, and vice versa, subject to regulatory approvals (it is less clear whether the Singapore banks will be keen to enter the US market). Near-term benefits will accrue to Citibank as it will be able to expand its market access to 30 customer service locations (as compared with the 15 locations allowed under the QFB status). Further along, US banks like American Express Bank will be able to gain entry via the QFB licence. However, an indirect benefit of the FTA is expected to be increased trade with the US, as evidenced by earlier FTAs with Australia and Japan.

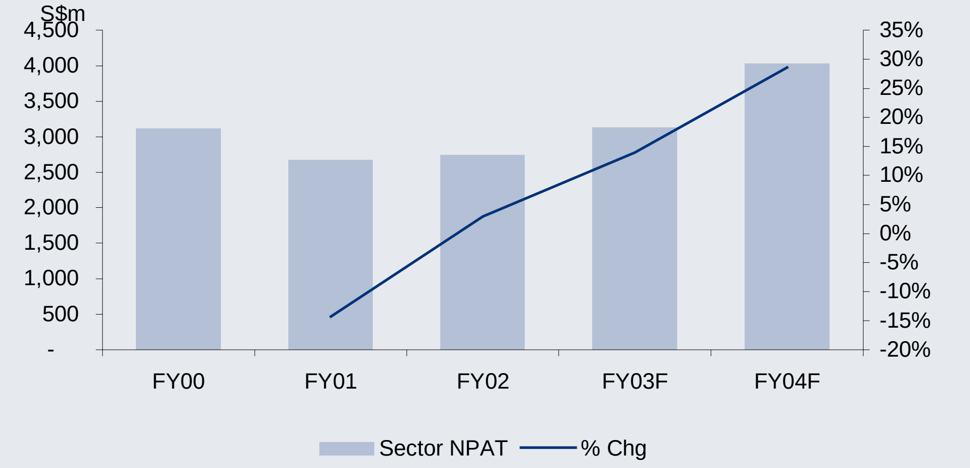
- **Divestment of non-core assets.** While OCBC is expected to continue with its divestment of non-core assets, we believe UOB will still be examining its options on the divestment of associate Overseas Union Enterprise (OUE). Note that unlike OCBC, UOB only has to divest these two associates. In fact, UOB has already announced its plans to divest United Overseas Land (UOL) via an offer to sell 36.9% to UOB shareholders at a discount. OCBC has already put several properties up for sale. In addition, it has reduced its stakes in Fraser and Neave and WBL Corporation and is in the process of selling its stake in Robinson & Company. We believe 2004 will see further divestment of its properties and associates. However, we caution that shareholders may not see any of the gains in terms of a special dividend payout.

- **Regional M&A.** All three Singapore banks have indicated their intention to expand in the region, although we believe DBS Group and UOB are more likely to enter potential M&A action in 2004 than OCBC. In particular, UOB's chairman has made known his intention to expand in Thailand and Indonesia. UOB made an initial bid for Bank Internasional Indonesia (BII), but subsequently dropped out. We believe 2004 could see some M&A action for the Singapore banks.

Net profits to rebound

Net profits for all three Singapore banks are estimated to rise 29 in FY04, building on the 14% rise in FY03. As illustrated below, we estimate FY04 net profits of S$4.03bn compared with the S$3.13bn in FY03.

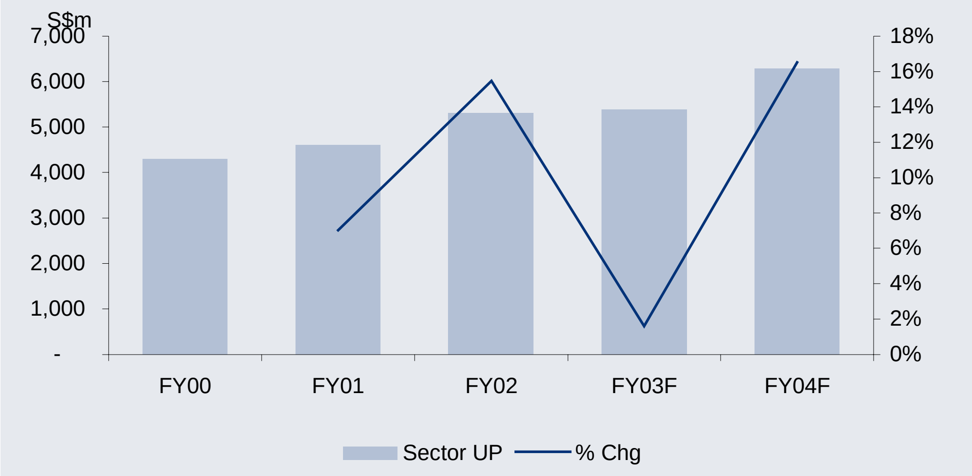
Fig 93 Singapore banks – net profits



Source: Company data, ING estimates

However, a look at the underlying profits of the sector indicates that we expect most of the gains to arise from lower loan loss provisions rather than stronger earnings. As seen in the following chart, underlying profits for the three Singapore banks are expected to reach S$6.28bn in FY04, an increase of 17% YoY compared with the S$5.39bn in FY03.

Fig 94 Singapore banks – underlying profits



Source: Company data, ING estimates

As indicated above, loan loss provisions are expected to trend down by 25% YoY to S$841.8m in FY04, as compared with the S$1.13bn in FY03. The lower loan loss provisions are predicated on lower gross NPLs for all the Singapore banks. We should note that the lower NPLs may not be immediately apparent in 1H04 given that the impact of the higher unemployment rate will lag in an economic recovery.

Fig 95 Singapore banks – loan loss provisions

Source: Company data, ING estimates

Loan growth

Finally, we expect loan growth of 6.1% in the banking sector in 2004, following growth of 7.0% in 2003. As indicated earlier, loan growth in 2003 was boosted by the first-time addition of Overseas Union Trust and OCBC Finance in April and November, respectively. Adjusting for these, loan growth was 3.4% for 2003. Consequently, our 2004 loan growth forecast is still relatively healthy given the higher base from 2003.

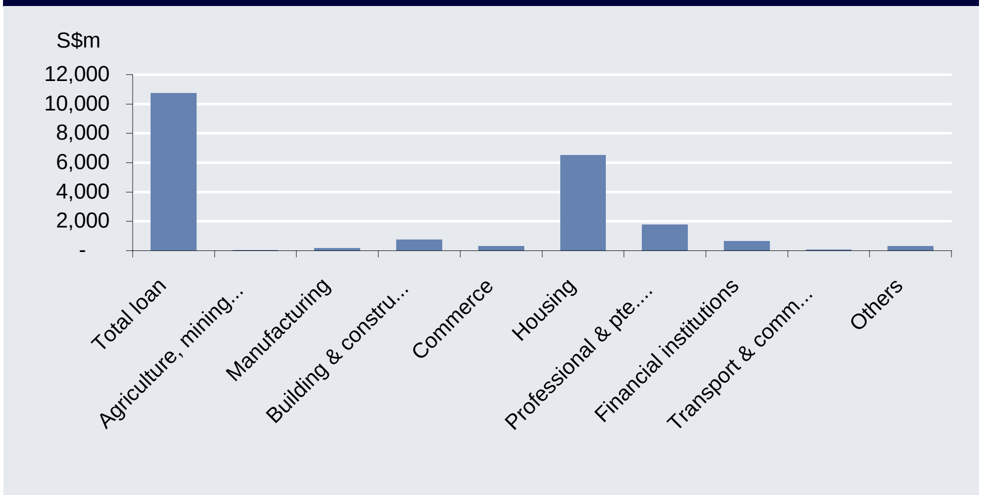
Fig 96 Singapore banks – loan growth

	1998	1999	2000	2001	2002	2003	2004F	2005F	2006F
Total loan	**5.9%**	**-2.9%**	**4.7%**	**5.8%**	**-1.6%**	**7.0%**	**6.1%**	**6.5%**	**6.9%**
Agriculture, mining, quarrying	19.2%	-14.4%	-6.6%	-36.8%	43.0%	25%	22%	16%	12%
Manufacturing	-1.8%	-5.5%	0.4%	3.0%	-10.2%	-4%	2%	4%	5%
Building & construction	-2.5%	-8.4%	9.4%	3.6%	-10.7%	3%	2%	4%	4%
Commerce	-18.2%	-7.4%	-4.9%	-6.7%	-6.4%	1%	2%	4%	5%
Housing	38.6%	10.6%	9.7%	8.2%	10.5%	18%	12%	11%	10%
Professional & pte individuals	-4.4%	-0.8%	14.5%	12.2%	-2.8%	11%	6%	5%	6%
Financial institutions	8.2%	-7.3%	-0.9%	3.4%	0.8%	2%	3%	5%	5%
Transport & communications	24.7%	-16.1%	10.2%	49.1%	-26.2%	-6%	2%	3%	6%
Others	46.4%	-7.3%	-10.6%	0.2%	3.0%	-15%	3%	5%	6%

Source: Monetary Authority of Singapore, ING estimates

In terms of the drivers of loan growth in 2004, again, we expect this to remain with the retail sector, namely housing and personal loans. In fact, housing loans are expected to rise by S$6.58bn in 2004, consisting of a combination of private housing and HDB market rate loans. Personal loans are expected to increase by S$1.79bn in 2004, driven by banks' focus on more credit card-related loans and overdrafts. However, we assume that manufacturing and commerce loans will grow by only S$213.2m and S$324.9m, respectively, on the back of the economic recovery. These estimates may be surpassed given that a return of the capex cycle is possible. If so, our full-year loan growth estimate of 6.1% may be subject to upward revision.

Fig 97 Singapore banks – loans by sector, 2004 YoY change



Source: ING estimates

Among the Singapore banks, our gross loan growth estimates vary by 6-7%, with UOB leading the other two banks. We should note that these estimates include the foreign operations of the banks, which may grow at faster rates.

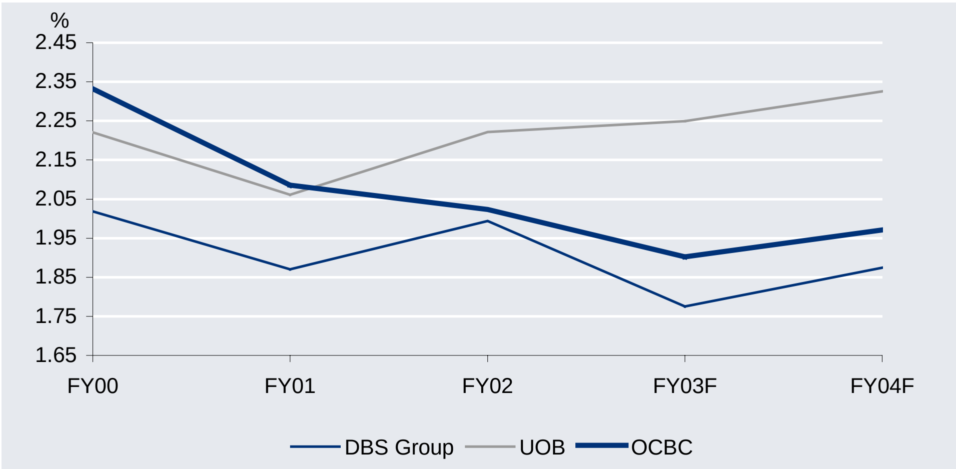
Rate versus volume

We highlighted in the November issue of our Singapore Country Strategy the impact of stronger-than-expected loan growth on net interest income. Assuming a 1% additional rise in loan growth for the three Singapore banks, we estimate an average 0.6% increase in their net interest income. Note that our estimate assumes constant net interest margins. On the other hand, assuming a 10bps hike in net interest margins and constant average interest earning assets, the three Singapore banks are estimated to see a 5% rise in their net interest income. Clearly, the impact from better net interest margins is larger than that from loan growth. However, we should point out that our estimates do not differentiate between Singapore and overseas loans, which in some cases are more profitable. For instance, in FY03, DBS' Hong Kong loans generated a margin of 2.38%, as compared with the group margin of 1.78%. Consequently, if the additional loan growth is generated from its Hong Kong subsidiary, the impact on net interest income should be larger.

Margins

As indicated in our earlier analysis, we expect net interest margins to have a more significant impact on net interest income than loan growth will, assuming everything else is held constant. Overall, sector average net interest margins are expected to improve in FY04 over FY03. However, among the three banks, we expect UOB and DBS Group to see stronger YoY improvements than OCBC, which is not expected to enjoy the same improvement due to its aggressive market share building in the past few years.

Fig 98 Singapore banks – net interest margins



Source: Company data, ING estimates

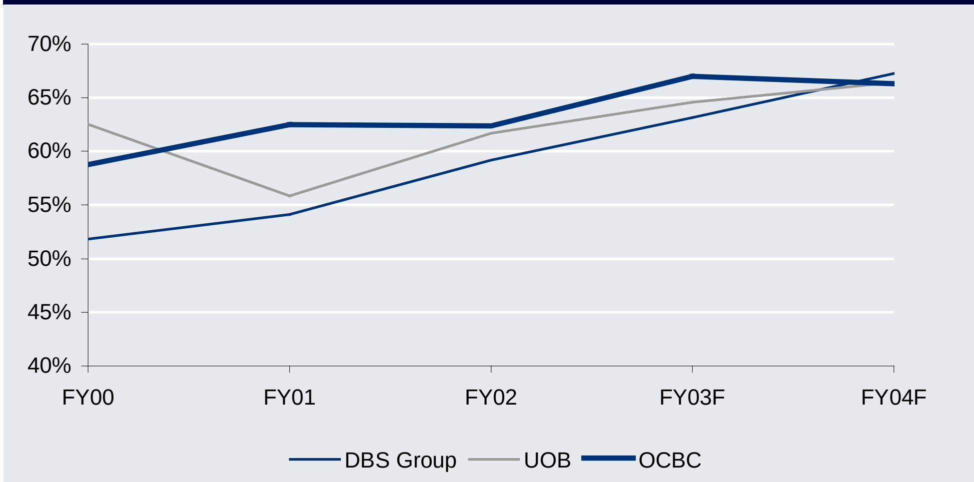
As seen in the above chart, we note that UOB has consistently held up its net interest margins in the past three years. Meanwhile, OCBC's net interest margins have slid over the same period.

Asset quality not an issue

Gross NPLs for the three Singapore banks are estimated to decline to S$12.1bn in FY04 from S$12.8bn in FY03. Compared with their gross loans, the NPL ratio is expected to decline to 6.3% from an estimated 7.1% in FY03. The improvement in NPLs is predicated on continued improvement in the domestic economy, which hinges very much on both regional and global economic recoveries. It also assumes that there would be no repeat of the SARS epidemic or other events that could derail the regional and US economies.

In light of the receding NPLs, we expect loan loss charges to be lower in FY04, as highlighted above, contributing in part to the recovery in net profits. Together with better recoveries and write-offs of NPLs, loan loss coverage ratios for the banks should improve in FY04.

Fig 99 Singapore banks – loan loss coverage



Source: Company data, ING estimates

As illustrated in the chart above, DBS is expected to lead the banks in terms of loan loss coverage in FY04.

Regulatory changes

As indicated above, we expect some changes in regulations from the Monetary Authority of Singapore in 2004. First among these will be the review of the capital adequacy framework for the banks, which is expected to be in place by 2Q04. We believe the review may result in one or more of the following:

Bank-specific capital requirements. The MAS may decide to impose individual capital requirements for each bank, depending on their assessment of the bank's risk management and other factors.

Lower capital requirements. The current minimum capital adequacy ratio (CAR) of 12%, consisting of 8% Tier 1 capital and 4% Tier 2 capital, may be revised downwards. While it is possible that the overall minimum ratio of 12% could be reduced to 10%, we believe this is unlikely. Instead, a further reduction in the Tier 1 ratio to 6% and a simultaneous raising of the Tier 2 ratio to 6% may occur. We should note that a different and lower CAR may be applied to specific banks.

Scenario analysis

As illustrated below, the Singapore banks currently maintain Tier 1 capital adequacy ratios in excess of the minimum 8% required by the MAS. Assuming they maintain a 10% Tier 1 ratio, the amount of excess Tier 1 capital available would vary between S$409m and S$1.90bn. UOB leads the other two banks in terms of excess Tier 1 capital. Assuming the MAS lowers the Tier 1 ratio to 6% and that the Singapore banks maintain an additional 2% buffer, leading to a Tier 1 ratio of 8%, the amount of excess capital will vary between S$2.22bn and S$1.57bn. Again, UOB will lead the rest of the banks, although the amount of excess capital at DBS Group would increase significantly.

As for the potential use of the excess capital, the usual alternatives are most probable: either for acquisitions or returned to shareholders. We discuss possible acquisitions later.

Fig 100 Singapore banks – capital adequacy ratios (S$m)

	DBS	UOB	OCBC
Tier 1 capital	16,952	13,018	9,762
Less: Goodwill	7,489	3,533	2,104
Tier 1 capital excl goodwill	9,463	9,485	7,658
Tier 2 capital	4,271	4,329	5,769
Total capital	13,734	13,814	13,427
RWA	90,542	75,802	62,301
Tier 1 CAR	10.5%	12.5%	12.3%
Tier 2 CAR	4.7%	5.7%	9.3%
CAR	15.2%	18.2%	21.6%
Tier 1 at 10%:			
Excess tier 1 capital	408.8	1,904.8	1,427.9
Shares O/S	1,470.0	1,572.0	1,283.5
Excess tier 1 capital per share (S$)	0.28	1.21	1.11
Tier 1 at 8%:			
Excess tier 1 capital	2,219.6	3,420.8	2,673.9
Shares O/S	1,470.0	1,572.0	1,283.5
Excess tier 1 capital per share (S$)	1.51	2.18	2.08

Figures are as at 30 Sep 03.

Source: Company data, ING estimates

Higher capital requirements for non-core investments

In the MAS' statement of August 2003, where it extended the deadline for banks to divest their non-core or non-financial businesses, it alluded to the fact that it was reassessing the capital treatment of banks' significant investments in both non-financial and financial companies. Currently, the banks' investments in financial and non-financial companies carry a risk weighting of 100%. However, should the MAS perceive some of these to be of higher risk, a higher risk weighting could be applied.

In light of this, we have attempted to estimate the impact of a higher risk weighting on the capital adequacy ratios of UOB and OCBC. Note that we have not included DBS Group in light of our assumption that UOB and OCBC have more non-core assets than DBS Group. However, it is entirely possible that the MAS could apply higher risk weights to DBS Group's investments in its financial companies.

Scenario analysis

Based on UOB's 2002 Annual Report, we note that it had investments in securities where it had significant influence, as well as associates, of S$1.27bn. If we assume a 25% increase in the MAS' risk weighting (ie, to 125% from 100%), UOB's Tier 1 ratio would fall by about 10 basis points to 12.43%. Raising this to 50% results in the Tier 1 ratio falling by about 15 basis points to 12.35%. In both cases, the impact on the overall CAR is about 10 basis points for every 25% increase in the risk weighting.

Similarly, we estimate that OCBC's investments in securities that are considered non-core and associates (which includes Great Eastern Holdings) amounted to S$1.05bn as at 31 Dec 02. Applying the higher risk weight of 125% to these investments results in a similar 10 basis point reduction in its Tier 1 ratio. However, the same 25% increase in risk weighting results in its CAR falling by 20 basis points to 21.4%. A 50% increase in the risk weight results in a 14 basis point reduction in its Tier 1 ratio and a 30 basis point reduction in the overall CAR.

Fig 101 UOB and OCBC's investments and capital adequacy ratios

S$m	UOB	OCBC
Investment securities where bank has influence or they are non-core	703.5	318.4
Investment in associates	1,274.2	1,047.4
Current RWA	75,802	62,301
25% increase in wt.		
Investment securities	175.87	79.60
Investment in associates	318.56	261.86
Total increase	494.44	341.46
Existing Tier 1 ratio	12.5%	12.3%
New Tier 1 ratio	**12.43%**	**12.22%**
Existing CAR	18.2%	21.6%
New CAR	**18.1%**	**21.4%**
50% increase in wt.		
Investment securities	351.75	159.19
Investment in associates	637.12	523.72
Total increase	988.87	682.91
Existing Tier 1 ratio	12.5%	12.3%
New Tier 1 ratio	**12.35%**	**12.16%**
Existing CAR	18.2%	21.6%
New CAR	**18.0%**	**21.3%**

Investments in associates and securities as at 31 Dec 02. Capital and risk weighted assets as at 30 Sep 03.
Source: Company data, ING estimates

Our estimates above indicate that even with the implementation of additional risk weights for the investments in financial and non-financial companies, the impact on their capital adequacy ratios is not significant.

Deposit insurance

Another potential regulatory change is the introduction of a deposit insurance scheme for banks. However, we believe 2004 is unlikely to see any impact given that the MAS is still working out details on the scheme. Note that in August 2002, it had sought feedback from the industry through the release of its consultation paper. At that time, the MAS had also indicated that it would take a year or more and that further consultations were possible. We did not see any in 2003. Consequently, we believe implementation will take place only in 2005, at the earliest.

In the event of its introduction, we believe the cost to banks will be kept low and is unlikely to severely burden the banks or their depositors.

US-Singapore FTA

With the implementation of the US-Singapore Free Trade Agreement (FTA), we will see greater access being granted to the US financial services companies. However, the near-term impact, particularly in 2004, is expected to be muted given that the immediate benefits conferred on Citibank Singapore via a larger number of service locations (30 against the previous 15) is unlikely to be realised in the short term. This is based on the fact that Citibank did not even utilise its 15-branch limit previously. However, it is in the longer term that the FTA will see greater competition entering the sector. As we mentioned previously, the threat of new entrants will be restricted to a few banks that will target specific customer niches. Additionally, we believe Citibank will want access to the Singapore banks' ATM networks.

Nonetheless, we do expect a positive impact from the FTA via greater trade flows, which should ultimately translate into stronger loan demand and growth. We predicate this on the experiences with the other FTAs signed with Japan and Australia.

Divestment of non-core assets

We note that of the three Singapore banks, only UOB and OCBC need to divest their non-core assets. While UOB has only to divest Overseas Union Enterprise (OUE) and Hotel Negara, given that it has already announced its plans for United Overseas Land (UOL) OCBC has a longer list of such assets. While there may be no urgency for UOB to divest its stakes in the other associates, we believe management will take a measured approach to the divestment process, while being careful not to lose sight of the cross-shareholding structure that binds the ownership of the bank.

As for OCBC, we highlight a list of the non-core investments in both companies as well as properties below. To date, OCBC has reduced its stake in Fraser & Neave and WBL Corporation to below 10%. In addition, it is proposing to restructure its holdings in Raffles Investments via a sale of the latter's stake in Raffles Hotel (1886) to Raffles Centre, a subsidiary of Raffles Holdings. More recently, OCBC has sold its land at Mt Emily via a public tender.

The remaining stakes that need to be reduced, as far as we can determine, are The Straits Trading Company and Robinson & Company. Additionally, there are several pieces of properties that would need to be sold.

Fig 102 OCBC non-core assets

OCBC's non-core properties	**Type**	**Net book value 2002 (S$m)**	**Mkt value 2002 (S$m)**	**Price sold (S$m)**
Specialists' Shopping Centre & Hotel Phoenix	Retail/hotel	9.7	260.0	
The Waterside, Blocks 9 & 13	Residential	46.9	129.2	
Somerset Compass	Residential	29.5	112.8	
The Compass	Residential	16.2	36.0	
Valley Lodge	Residential	3.3	8.6	
Whitesands	Retail/ entertainment	87.7	120.0	
Land at Kim Seng Road	Land for development	56.2	192.0	
Development at Telok Ayer Street	Land for development	30.2	68.0	
Land at Mt Emily & Niven Road	Land for development	3.5	59.0	50.4
Land at Bassein Road	Land for development	0.1	12.6	
Sub-total		**283.2**	**998.2**	

Fig 102 OCBC non-core assets – cont.

OCBC's investment securities	Shares held ('000)	Net book value 2002 (S$m)	Mkt value 2002 (S$m)	Price sold (S$m)	Gains (S$m)	Original stake	Remaining stake
Asia Pacific Breweries	8,651.63	1.38	42.74			3.41%	
Fraser & Neave	22,272.64	32.16	173.73	88	87.5	8.34%	10%
Raffles Holdings	94,831.58	34.14	34.14	53		4.56%	
Robinson & Co	14,473.25	1.76	79.60			16.84%	
The Straits Trading Company	47,194.74	13.84	65.60			13.24%	
United Overseas Bank	3,152.16	36.13	37.20			0.20%	
WBL Corporation	14,371.57	18.27	23.57	8.75		8.34%	
Sub-total		**137.67**	**456.57**				
Total		**420.92**	**1,454.80**				
Potential gains		1,033.88					

Figures as at 31 Dec 02. Stakes held may vary due to information gaps
Source: Company data

Regional M&A

As indicated earlier, all three banks have indicated some aspirations for regional expansion. However, we believe any potential acquisitions will be carefully weighed. In November 2003, UOB was reported by the media to have made an initial bid for Bank Internasional Indonesia, although it subsequently dropped the bid.

More recently, a government initiative to consolidate the banking sector in Thailand has seen DBS Group's participation via the exchange of its majority stake in DBS Thai Danu Bank for a minority stake in the merged Thai Military Bank. At the time of this report, media reports indicated that UOB's Thai subsidiary, UOB Radanasin, could merge with Bank of Asia and remain in control.

Beyond Thailand, we do not see further M&A action in the other ASEAN countries. However, Hong Kong/China remain potential surprises in M&A for the Singapore banks. Finally, depending on the political climate and opportunities, Malaysia may feature as well.

We believe that the Singapore banks are more cognisant of the fact that regional acquisitions need to be of certain critical mass to make a meaningful contribution to group earnings. As such, unless an acquisition is sufficiently large enough to matter to the group, any other move is likely to be more strategic and longer-term in outlook. Finally, we expect that additional capital raising may be necessary for the banks to execute their regional strategies.

Valuations

The three Singapore banks are currently trading at a FY04F P/BV of 1.4x, P/UP multiple of 9.5x and PER of 14.8x. The banks' share prices have generally underperformed the broader STI Index since January. However, UOB's share price has seen the best absolute increase of 2% year-to-date, but was not sufficient to beat the STI.

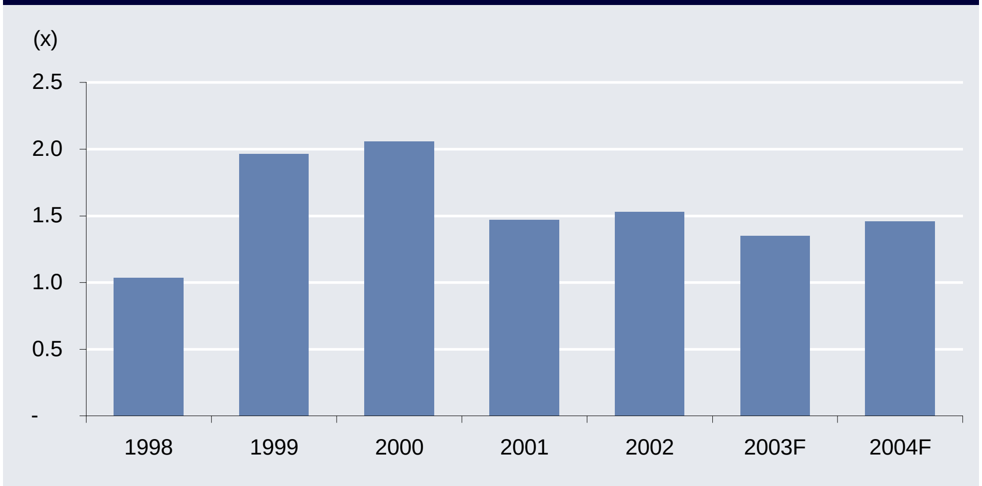
Fig 103 Singapore banks' share price performance

	2-Jan-04	22-Apr-04	% chg	Rel perf
DBS Group	$ 14.90	$ 13.90	-7%	-11%
UOB	$ 13.40	$ 13.70	2%	-2%
OCBC	$ 12.20	$ 12.20	0%	-5%
STI index	1791.35	1863.71	4%	

Source: Bloomberg

Putting the current valuations into historical context, we note that on a P/BV multiple, the sector remains below the peak average multiple of 2.1x seen in 2000. While a comparison with 2001 and 2002 would suggest that the current forward multiple looks fair, we would point out that unlike in 2001 and 2002, economic growth in 2004 is likely to be significantly stronger and more similar to that in 1999 and 2000. Consequently, it is logical to expect a higher P/BV multiple.

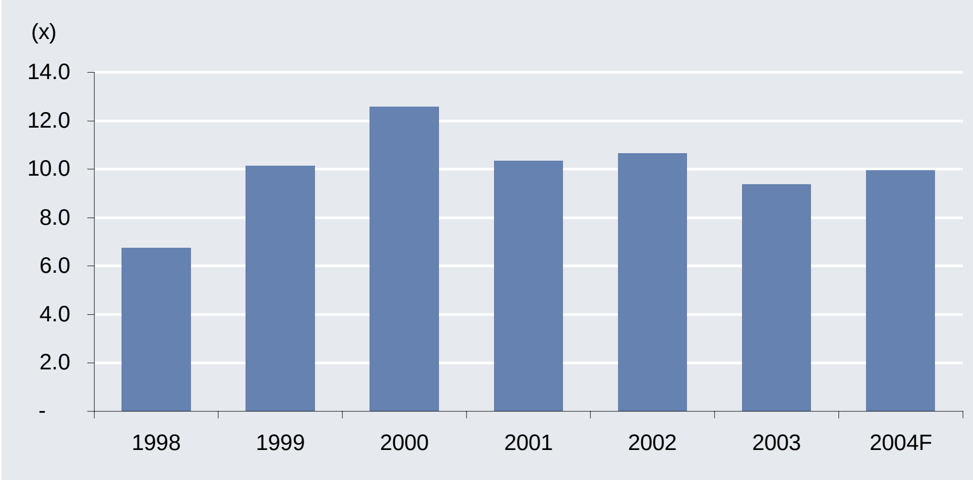
Fig 104 Singapore banks – P/BV



Source: Company data, ING estimates

On a P/UP multiple comparison, we see a similar trend in that the current forward multiple of 9.5x is at somewhat similar levels to 2001 and 2002. Again, on the same argument of stronger economic growth in 2004, there remains 26% upside potential if we assume the multiple returns to the last peak reached in 2000.

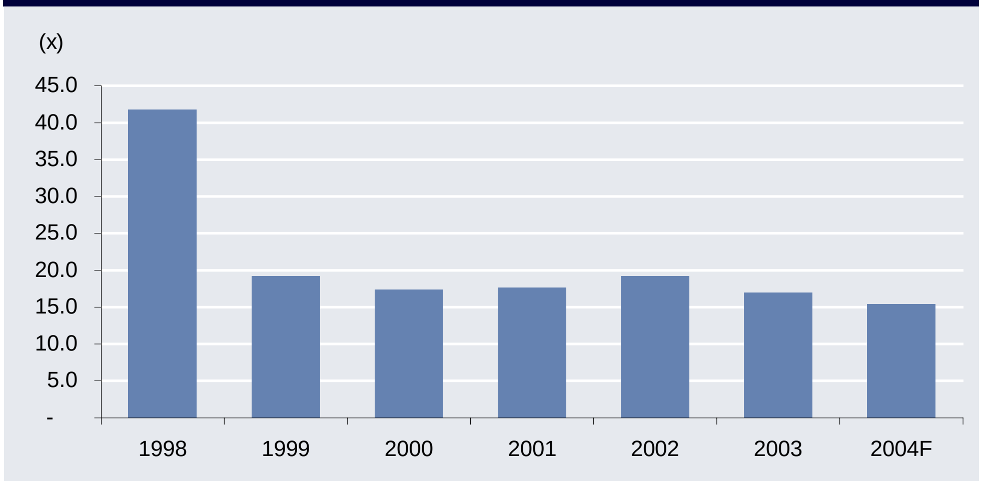
Fig 105 Singapore banks – P/UP



Source: Company data, ING estimates

Finally, in comparing the current forward PER of 14.8x with historical multiples, we note that the previous peaks were in 1999 and 2002, when it reached 19.2x. While we would argue that stronger economic growth should see stronger net earnings, given the unpredictability of loan provision write-backs, the forward multiple could be much lower than our current forecasts. Consequently, even if the current forward multiple is maintained, a higher earnings base could still result in higher share prices.

Fig 106 Singapore banks – PER



Source: Company data, ING estimates

Recommendations

We remain Overweight on the Singapore banks within the context of the Singapore market on the assumption that stronger economic growth should see stronger loan growth and improving asset quality allowing for lower loan loss provisions. At the same time, a reversal of earlier interest rate trends by the end of the year should see better net interest margins for the banks.

We maintain our Buy ratings on both DBS Group and UOB, although we prefer UOB given its share price underperformance so far and potential for positive news flow. We remain unconvinced that OCBC will outperform its peers, barring an improvement in its fundamentals. We believe the divestment of non-core assets and capital management is already reflected in the current share price. In fact, the recent abortion of the sale of its stake in Robinson & Company suggests the potential gains will be lower on the assumption that OCBC will not dispose of all its stake and that not all of the cash in Robinson will be paid to shareholders. We are positive on the recent acquisition of part of Indonesia's Bank NISP, but this is still too small to make a material difference to the group.

Fig 107 Stock recommendations and valuations (FY04F)

Company	B'berg code	Rec	Price (22/4/04) (S$)	Price to u'lying profit (x)	x	U'lying profit-ability (%)	x	Lever-age (x)	=	Price to book (x)	PER (x)	Yield (%)
UOB	UOB SP	BUY	13.70	9.7	x	1.98	x	8.3	=	1.6	14.5	4.4
DBS Group	DBS SP	BUY	13.90	9.2	x	1.47	x	10.5	=	1.3	15.5	2.5
OCBC	OCBC SP	HOLD	12.20	9.8	x	1.64	x	9.1	=	1.3	14.2	2.1

Source: Company data, ING estimates

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DBS Group Holdings Focus

Rating: BUY

Exiting Thailand?

The ongoing negotiations between DBS Group, Thai Military Bank (TMB) and International Finance Corporation of Thailand (IFCT) are expected to result in a merger. As we understand it, DBS Group will be injecting its DBS Thai Danu Bank into TMB, in exchange for shares in TMB. On 8 Mar 04, all 3 banks announced their merger which would result in DBS Group holding a 16.1% stake in the merged entity, giving it the second largest stake after the Ministry of Finance, Thailand (31.2%). While board representation and various technical service agreements suggest that DBS may still have influence over the management of the new bank, we view the merger as a temporary exit from Thailand, with the possibility of returning in the future if and when DBS increases its stake in the merged TMB. However, aside from a possible write-back of loan loss provisions and modest improvements in the operating ratios of the group, DBS' Thai operations have never been and may never be a major contributor to the group.

Remaining focused

In light of the developments in Thailand and barring any further M&A activities in Asia, we believe DBS Group's focus will remain on its dominant position in the home market, Singapore, and a significant position in Hong Kong. We see no reason why DBS Group should not be able to lift its income yield, which still lags its peers. As illustrated in the FY03 results, Hong Kong operations are beginning to bear fruit while domestically the group is more leveraged into a recovery than its peers. At the end of FY03, interbank loans amounted to S$ 27.5bn or 44% of net loans. Given the expectation of a rebound in interest rates, which is usually seen in the interbank market first, the yields on these excess funds should improve going forward (FY03 interbank lending yield fell YoY due to the weaker rates for most of the year). Additionally, a domestic recovery will be felt through stronger loan growth, which will be positive for DBS Group. Finally, Hong Kong's improving economic conditions will be another positive factor given that loan growth coupled with higher margins will help lift its contribution to the group.

Risks

Risks for DBS Group lie in the current bird flu epidemic, which at this point in time seems to have wound down. Additionally, we believe investors remain wary of any potential acquisitions that DBS may engage in, given its track record. Moreover, as demonstrated in its Hong Kong operations, any acquisition has to add to the group by being sufficiently large in size, which suggests that additional fundraising cannot be ruled out.

Valuations remain attractive

We maintain our BUY recommendation with a target price of S$17.93, based on DDM. The forward P/BV multiple of 1.3x is a far cry from the peak of 2.4x in 2000. Relative to its peers, DBS Group remains the most attractive on P/BV and P/UP multiples.

DBS Group

Singapore

Share Price:	13.90	**Reuters Code:**	DBSM.SI	**Shares Outstanding**	1,216
52 Week Price Range:	8.30 - 16.20	**Bloomberg Code:**	DBS.SP	**Market Cap (US$m)**	9,960

INCOME STATEMENT (S$m)	**01**	**02**	**03**	**04**	**05**
Interest income	5,271	4,406	3,640	4,398	5,866
Interest expense	-3,014	-1,761	-1,265	-1,822	-3,010
Net interest income	**2,257**	**2,645**	**2,375**	**2,576**	**2,856**
Non-interest income	1,275	1,502	1,823	1,929	2,046
Total operating income	**3,532**	**4,147**	**4,198**	**4,505**	**4,902**
Non-interest expense	-1,860	-2,128	-2,271	-2,201	-2,191
Pre provision profit	**1,672**	**2,018**	**1,927**	**2,304**	**2,711**
Loan loss provisions	-379	-544	-541	-354	-183
Non-operating income	70	45	51	56	62
Pre tax profit	**1,363**	**1,519**	**1,437**	**2,006**	**2,590**
Tax	-127	-130	-83	-89	-96
Net profit	**969**	**1,078**	**1,005**	**1,370**	**1,870**

BALANCE SHEET (S$m)	**01**	**02**	**03**	**04**	**05**
Gross loans	70,649	63,210	66,722	70,760	73,343
Loan loss reserves	*2,441*	*2,500*	*2,387*	*2,341*	*2,224*
Net loans	68,208	60,710	64,335	68,419	71,120
Total earning assets	137,287	125,132	133,451	140,236	146,742
Other assets	14,007	24,313	26,144	30,762	28,379
Total Assets	**151,294**	**149,445**	**159,595**	**170,999**	**175,121**
Deposits	106,771	101,315	108,041	112,337	115,180
Other paying liabilities	18,936	15,572	18,794	20,844	22,024
Other liabilities	12,058	18,321	17,864	21,962	20,663
Total Liabilities	137,765	135,208	144,699	155,143	157,867
Total Equity	**13,529**	**14,237**	**14,896**	**15,855**	**17,253**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	4,512	4,224	3,780	3,480	3,280
NPAs/total loans	6.4%	6.7%	5.7%	4.9%	4.5%
Reserve coverage of NPAs	54.1%	59.2%	63.1%	67.3%	67.8%

PER SHARE DATA (S$)	**01**	**02**	**03**	**04**	**05**
EPS	0.74	0.71	0.66	0.90	1.22
DPS	0.30	0.30	0.30	0.35	0.40
Effective payout ratio (%)	*40%*	*42%*	*46%*	*39%*	*33%*
BVPS	10.83	9.74	10.13	10.79	11.74

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	64%	60%	60%	61%	62%
Equity to assets	8.9%	9.5%	9.3%	9.3%	9.9%
Tier 1 CAR	12.2%	10.3%	10.5%	11.1%	12.2%
Total CAR	17.40%	15.54%	15.08%	15.43%	16.36%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	1.3x	1.4x	1.4x	1.3x	1.2x
Price to earnings	18.7x	19.6x	21.1x	15.5x	11.4x
Price to underlying profit	10.7x	10.4x	10.9x	9.2x	7.8x
Yield at current price (%)	2.16	2.16	2.16	2.52	2.89

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	12%	12%	11%	11%	11%
Mortgage (%)	35%	35%	34%	34%	35%
Corporate (%)	22%	24%	28%	29%	30%
Other (%)	31%	29%	27%	25%	25%

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	1.87%	1.99%	1.78%	1.87%	2.00%
Yield on assets	4.37%	3.32%	2.72%	3.20%	4.10%
Cost of liabilities	2.63%	1.44%	1.01%	1.41%	2.25%
Non-int. inc (% Op income)	36.10%	36.21%	43.43%	42.81%	41.74%
Cost to income	52.66%	51.33%	54.10%	48.86%	44.69%
Overhead	1.40%	1.42%	1.46%	1.37%	1.32%
ROA	0.83%	0.81%	0.70%	0.91%	1.18%
ROE	8.42%	7.70%	6.90%	8.91%	11.30%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	-1%	21%	-5%	20%	18%
Net profit	-29%	11%	-7%	36%	37%
EPS	-30%	-5%	-7%	36%	36%
DPS	-33%	0%	0%	17%	15%
Net Loans	31%	-11%	6%	6%	4%
Assets	36%	-1%	7%	7%	2%
Deposits	32%	-5%	7%	4%	3%

UOB Patience pays

Rating: BUY

Careful buyers

UOB has not executed on its regional M&A strategy to date, but we put this down to it being a careful buyer. Late last year, there were reports that it was bidding for a stake in Bank Internasional Indonesia (BII), but had subsequently dropped out of the process. We believe the group may not have been comfortable with various aspects of the deal, including its target. Given its cash hoard, which includes US$1bn raised via subordinated debt, UOB has the means to make a significant acquisition when it finds the right party and terms. Lately, initial signs of a consolidation in the Thai banking sector could present the group with opportunities to bring its Thai operations to a more significant level. UOB's chairman had previously indicated the bank's interest in Thailand, which suggests that in light of the government-led consolidation, UOB will need to merge or acquire to remain viable. If it succeeds and still remains in control, it would be better positioned than DBS Group. Aside from Thailand, China remains another potential market for UOB to enter, although we believe its initial foray will be limited in size.

Divestment of non-core assets

While UOB has yet to execute on its divestment of non-core assets, we should note that its non-core assets are different from OCBC's in both the form and ownership structure. Unlike OCBC, which has a preponderance of properties, UOB's non-core assets are solely with its associates. In particular, United Overseas Land (UOL), Overseas Union Enterprise (OUE) and Hotel Negara are the only associates that are required to be divested. In addition, two of the associates, UOL and OUE, are also shareholders of UOB. Given that these cross shareholdings are part of the Wee family's means of controlling UOB, a divestment of these companies would need to take account of this. While the deadline for such divestments has been extended to 2006, we cannot rule out early moves under the right conditions. Finally, we should remember that capital management remains important and, in our view, will be reflected via a consistently higher dividend payout.

Strong domestic operations

Despite the declining trend in margins, UOB remains the ahead of its peers. This, together with its cost efficiencies, is still key to ensuring outperformance over its peers. We have no reason to believe that management has dropped the ball on building on its already strong franchise and retaining its lead in the retail banking arena.

Underperformance is opportunity

We maintain our BUY recommendation with a target price of S$17.56 based on DDM. Year to date, UOB has outperformed relative to DBS Group and OCBC. We believe the potential news flow could be positive.

UOB

Singapore

Share Price:	12.90	**Reuters Code:**	UOBH.SI	**Shares Outstanding**	1,571
52 Week Price Range:	10.00 - 14.40	**Bloomberg Code:**	UOB.SP	**Market Cap (US$m)**	11,943

INCOME STATEMENT (S$m)	**01**	**02**	**03**	**04**	**05**
Interest income	3,410	3,711	3,294	4,041	5,412
Interest expense	-1,981	-1,583	-1,224	-1,749	-3,019
Net interest income	**1,429**	**2,128**	**2,071**	**2,293**	**2,393**
Non-interest income	795	906	1,089	1,131	1,211
Total operating income	**2,224**	**3,034**	**3,160**	**3,424**	**3,604**
Non-interest expense	-922	-1,270	-1,297	-1,313	-1,318
Pre provision profit	**1,302**	**1,765**	**1,863**	**2,111**	**2,286**
Loan loss provisions	-165	-465	-362	-280	-115
Non-operating income	60	75	107	113	118
Pre tax profit	**1,198**	**1,376**	**1,608**	**1,943**	**2,289**
Tax	-4	-30	-13	-15	-17
Net profit	**925**	**1,006**	**1,202**	**1,482**	**1,769**

BALANCE SHEET (S$m)	**01**	**02**	**03**	**04**	**05**
Gross loans	64,226	62,388	62,629	66,873	70,151
Loan loss reserves	*3,334*	*3,504*	*3,332*	*3,262*	*3,077*
Net loans	60,892	58,884	59,297	63,611	67,074
Total earning assets	103,609	97,694	102,065	106,563	110,984
Other assets	10,279	9,736	11,401	6,581	6,146
Total Assets	**113,888**	**107,430**	**113,466**	**113,144**	**117,130**
Deposits	74,452	67,919	69,863	73,790	76,609
Other paying liabilities	22,251	21,449	23,035	22,770	22,386
Other liabilities	4,469	5,450	7,286	2,769	3,576
Total Liabilities	101,171	94,818	100,184	99,329	102,572
Total Equity	**12,717**	**12,613**	**13,282**	**13,815**	**14,558**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	5,968	5,679	5,160	4,910	4,730
NPAs/total loans	9.3%	9.1%	8.2%	7.3%	6.7%
Reserve coverage of NPAs	55.9%	61.7%	64.6%	66.4%	65.1%

PER SHARE DATA (S$)	**01**	**02**	**03**	**04**	**05**
EPS	0.77	0.64	0.77	0.94	1.13
DPS	0.40	0.40	0.60	0.60	0.65
Effective payout ratio (%)	*52%*	*62%*	*78%*	*64%*	*58%*
BVPS	8.09	8.03	8.45	8.79	9.26

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	82%	87%	85%	86%	88%
Equity to assets	11.2%	11.7%	11.7%	12.2%	12.4%
Tier 1 CAR	11.6%	11.8%	22.3%	13.7%	14.2%
Total CAR	18.52%	15.25%	18.25%	19.27%	19.50%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	1.6x	1.6x	1.5x	1.5x	1.4x
Price to earnings	16.7x	20.1x	16.9x	13.7x	11.5x
Price to underlying profit	11.3x	11.0x	10.3x	9.1x	8.4x
Yield at current price (%)	3.10	3.10	4.65	4.68	5.06

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	15%	15%	15%	16%	16%
Mortgage (%)	21%	22%	24%	24%	25%
Corporate (%)	35%	36%	36%	37%	37%
Other (%)	30%	27%	25%	23%	23%

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	2.06%	2.22%	2.25%	2.33%	2.34%
Yield on assets	4.92%	3.87%	3.58%	4.10%	5.30%
Cost of liabilities	2.98%	1.73%	1.36%	1.85%	3.10%
Non-int. inc (% Op income)	35.74%	29.87%	34.47%	33.04%	33.61%
Cost to income	41.44%	41.84%	41.05%	38.36%	36.56%
Overhead	1.18%	1.15%	1.19%	1.17%	1.14%
ROA	1.19%	0.94%	1.11%	1.34%	1.55%
ROE	10.84%	7.90%	9.30%	10.94%	12.47%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	13%	35%	6%	13%	8%
Net profit	1%	9%	19%	23%	19%
EPS	-11%	-17%	19%	23%	19%
DPS	0%	0%	50%	1%	8%
Net Loans	103%	-3%	1%	7%	5%
Assets	72%	-6%	6%	0%	4%
Deposits	72%	-9%	3%	6%	4%

OCBC Beyond divestments

Rating: HOLD

Non-core divestments priced-in

OCBC's divestment of non-core assets continues to dominate investors' minds since it first began with the reduction in its stake in Fraser & Neave last year. While the F&N divestment was followed by the successful sale of a piece of property at Mt Emily, the sale of Robinson & Company to third parties was aborted. As we had indicated earlier, selling all of OCBC's non-core properties would have only netted a potential gain of S$715.0m or S$0.55 per share based on market valuations at the end of 2002. The recent sale of the property at Mt Emily had demonstrated that prices in 2003 were already 14% below those of 2002. Consequently, our estimate of the potential gains may be lower. At the same time, we need to remember that OCBC has not committed to paying out the gains from the sale of these non-core assets. Instead, the CEO, David Conner, has indicated they could be used for acquisitions. But thus far, acquisitions have turned inwards, with the current proposal to acquire the remainder of Great Eastern Holdings, and we believe the bank could do better outside of the country.

Weak fundamentals

In a recent media report, OCBC was reported to have led the banks in market share for both private residential property as well as HDB market rate loans in 2003. The basis of the results lay in the caveats lodged that were tracked by a law firm. OCBC was estimated to have garnered a market share of 56% of the HDB market rate loans, while its market share in private properties was 21%. When we looked at the operating results reported at the end of FY03, OCBC's loan volume did indeed reflect the increased market share. But this came at the expense of margins, which contracted by 12bps YoY to 1.90% in FY03. This, compared with UOB's 3bp expansion to 2.25%, seems to suggest that the increase in market share was at the expense of margins. At the same time, OCBC's non-interest income was boosted by a one-time gain of S$128m arising from its disposal of a stake in F&N, sale of the Mt Emily property site and disposal of WBL Corporation shares. Stripping this out, non-interest income declined 12% YoY in contrast to DBS Group and UOB, which saw improvements. Consequently, we remain concerned with the fundamentals of the group, and unless it reverses the falling margins and non-interest income, we do not see it outperforming its peers.

Valuations unattractive

We maintain our HOLD recommendation with a target price of S$12.50 based on DDM. While the forward P/BV multiple of 1.5x is some way from the peak of 2.1x in 1999, we believe more attractive valuations and potential upside can be found in its peers. Relative to its peers, it remains the most expensive on P/UP.

OCBC

Singapore

Share Price:	12.20	**Reuters Code:**	OCBC.SI	**Shares Outstanding**	1,287
52 Week Price Range:	8.85 - 12.80	**Bloomberg Code:**	OCBC.SP	**Market Cap (US$m)**	9,254

INCOME STATEMENT (S$m)	**01**	**02**	**03**	**04**	**05**
Interest income	3,040	2,729	2,381	2,632	3,183
Interest expense	-1,648	-1,220	-946	-1,106	-1,562
Net interest income	**1,392**	**1,509**	**1,435**	**1,526**	**1,620**
Non-interest income	822	712	758	1,077	1,515
Total operating income	**2,214**	**2,222**	**2,193**	**2,603**	**3,136**
Non-interest expense	-918	-976	-981	-1,069	-1,234
Pre provision profit	**1,296**	**1,245**	**1,212**	**1,534**	**1,902**
Loan loss provisions	-518	-501	-225	-208	-215
Non-operating income	198	161	235	168	95
Pre tax profit	**977**	**905**	**1,222**	**1,494**	**1,781**
Tax	-3	-2	-29	-44	-44
Net profit	**778**	**666**	**927**	**1,178**	**1,400**

BALANCE SHEET (S$m)	**01**	**02**	**03**	**04**	**05**
Gross loans	52,849	49,884	52,589	56,115	60,169
Loan loss reserves	*3,239*	*2,717*	*2,568*	*2,476*	*2,391*
Net loans	49,610	47,167	50,021	53,639	57,778
Total earning assets	78,476	77,119	77,577	79,805	81,610
Other assets	6,941	6,933	6,921	42,603	43,030
Total Assets	**85,417**	**84,051**	**84,497**	**122,408**	**124,640**
Deposits	54,675	53,948	53,460	53,615	55,559
Other paying liabilities	19,167	18,088	17,949	19,517	19,213
Other liabilities	2,743	2,792	3,030	36,425	36,050
Total Liabilities	76,585	74,827	74,439	109,557	110,822
Total Equity	**8,832**	**9,224**	**10,059**	**12,852**	**13,817**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	5,183	4,356	3,834	3,734	3,584
NPAs/total loans	9.8%	8.7%	7.3%	6.7%	6.0%
Reserve coverage of NPAs	62.5%	62.4%	67.0%	66.3%	66.7%

PER SHARE DATA (S$)	**01**	**02**	**03**	**04**	**05**
EPS	0.60	0.52	0.72	0.86	0.97
DPS	0.18	0.20	0.23	0.26	0.30
Effective payout ratio (%)	*30%*	*39%*	*32%*	*30%*	*31%*
BVPS	6.87	7.15	7.80	9.44	9.56

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	91%	87%	94%	100%	104%
Equity to assets	10.3%	11.0%	11.9%	10.5%	11.1%
Tier 1 CAR	10.3%	11.5%	19.2%	13.1%	14.3%
Total CAR	19.73%	20.85%	21.78%	21.49%	22.46%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	1.8x	1.7x	1.6x	1.3x	1.3x
Price to earnings	20.2x	23.7x	17.0x	14.2x	12.6x
Price to underlying profit	10.5x	11.2x	10.9x	9.8x	8.8x
Yield at current price (%)	1.48	1.64	1.89	2.11	2.46

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	14%	15%	15%	16%	16%
Mortgage (%)	21%	25%	29%	31%	33%
Corporate (%)	32%	32%	29%	29%	29%
Other (%)	32%	29%	26%	24%	23%

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	2.09%	2.02%	1.90%	1.97%	2.04%
Yield on assets	4.56%	3.66%	3.16%	3.40%	4.00%
Cost of liabilities	2.77%	1.69%	1.32%	1.52%	2.10%
Non-int. inc (% Op income)	37.12%	32.06%	34.57%	41.38%	48.32%
Cost to income	41.47%	43.94%	44.75%	41.06%	39.35%
Overhead	1.27%	1.17%	1.16%	1.03%	1.03%
ROA	1.08%	0.80%	1.13%	1.17%	1.21%
ROE	9.04%	7.39%	9.48%	10.28%	10.50%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	21%	-4%	-3%	27%	24%
Net profit	-7%	-14%	39%	27%	19%
EPS	-7%	-15%	39%	20%	13%
DPS	-55%	11%	15%	12%	16%
Net Loans	51%	-5%	6%	7%	8%
Assets	43%	-2%	1%	45%	2%
Deposits	44%	-1%	-1%	0%	4%

Hong Leong Finance Niche market

Rating: BUY

Playing niche market

Hong Leong Finance continues to operate profitability in its niche market where customers tend to borrow smaller amounts, which the banks find uneconomical to lend due to their higher infrastructure costs. It also benefits from its long-standing relationships with small and medium-sized enterprises (SMEs), which the company has focused on aside from retail customers. The SMEs should start to see a turnaround in their activities in light of the pick-up in the domestic economy. We forecast loan growth of 5.9% for the company in FY04, driven by a combination of lending to retail (including HP and housing loans) and to SMEs. In the latter, Hong Leong has begun to benefit from its enlarged scope of activities, allowing it to lead its SME customers to public listings. This, together with its other fee-based activity, is expected to provide another facet to its earnings profile.

Growing other income

Aside from its new-found corporate finance activities, Hong Leong's fee income has grown as a result of sales of unit trusts to its customers. We believe that both of these will double the share of non-interest income to 6% of total income by this year, from 3% in FY02. Already, it has started to manage at least two initial public offerings for its customers. Even at our estimated 6% of total income, Hong Leong Finance has a long way to go in building its fee income in comparison with its larger peers.

Upgrading IT infrastructure

In FY03, Hong Leong Finance began an upgrade of its IT infrastructure, which, when completed, will enable the company to have better operating efficiency and shorten the processing times for its customers. The project, costing S$14m, is expected to be completed in 2Q04. In the meantime, the kicking in of the IT project has resulted in a mild rise in operating expenses, but its cost to asset ratio is expected to remain lower than those of its banking peers.

Capital management

Hong Leong remains over-capitalised, with its CAR in excess of 20% (28.7% based on our estimate for FY04). While its target customers may bring with them a higher risk profile, we believe it is excessive. As a result, its ROE is severely penalised by the low leverage of the group. While management is cognisant of this, we believe it may take some time to unlock the excess capital, although we believe higher dividend payouts are likely.

Attractive valuations

Valuations remain attractive, with our target price of S$3.18 based on DCF. It continues to trade at a discount to its larger peers. We maintain our BUY recommendation.

HLSF

Singapore

Share Price:	3.00	**Reuters Code:**	HLSF.SI	**Shares Outstanding**	430
52 Week Price Range:	1.94 - 3.04	**Bloomberg Code:**	SFIN.SP	**Market Cap (US$m)**	761

INCOME STATEMENT (S$m)	**01**	**02**	**03**	**04**	**05**
Interest income	192	296	265	286	336
Interest expense	-89	-99	-71	-100	-140
Net interest income	**102**	**197**	**194**	**185**	**195**
Non-interest income	35	8	12	14	16
Total operating income	**137**	**205**	**207**	**200**	**212**
Non-interest expense	-35	-50	-58	-52	-52
Pre provision profit	**102**	**154**	**149**	**148**	**160**
Loan loss provisions	-9	-44	-42	-22	-18
Non-operating income	0	0	0	0	0
Pre tax profit	**94**	**111**	**107**	**125**	**143**
Tax	0	0	0	0	0
Net profit	**79**	**85**	**85**	**99**	**113**

BALANCE SHEET (S$m)	**01**	**02**	**03**	**04**	**05**
Gross loans	5,525	5,444	5,273	5,616	5,959
Loan loss reserves	*239*	*305*	*340*	*342*	*337*
Net loans	5,286	5,139	4,933	5,274	5,622
Total earning assets	6,377	6,447	6,134	6,080	6,415
Other assets	30	31	39	41	43
Total Assets	**6,406**	**6,478**	**6,173**	**6,121**	**6,458**
Deposits	5,142	5,131	4,787	5,003	5,203
Other paying liabilities	-	-	-	-	-
Other liabilities	180	198	215	(113)	(51)
Total Liabilities	5,322	5,329	5,002	4,890	5,152
Total Equity	**1,084**	**1,149**	**1,171**	**1,232**	**1,306**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	342	354	348	343	346
NPAs/total loans	6.2%	6.5%	6.6%	6.1%	5.8%
Reserve coverage of NPAs	70.0%	78.1%	88.8%	91.1%	88.6%

PER SHARE DATA (S$)	**01**	**02**	**03**	**04**	**05**
EPS	0.28	0.20	0.20	0.23	0.26
DPS	0.08	0.12	0.12	0.12	0.00
Effective payout ratio (%)	*28%*	*61%*	*61%*	*52%*	*0%*
BVPS	2.52	2.67	2.72	2.86	3.03

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	103%	100%	103%	105%	108%
Equity to assets	16.9%	17.7%	19.0%	20.1%	20.2%
Tier 1 CAR	21.3%	23.0%	23.1%	24.6%	26.3%
Total CAR	24.43%	26.23%	26.71%	28.48%	30.34%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	1.2x	1.1x	1.1x	1.0x	1.0x
Price to earnings	10.6x	15.3x	15.2x	13.1x	11.5x
Price to underlying profit	8.2x	8.4x	8.7x	8.8x	8.1x
Yield at current price (%)	2.67	4.00	4.00	4.00	0.04

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Hire purchase & leasing	47%	45%	39%	39%	39%
Other (%)	53%	55%	61%	61%	61%

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	2.76%	3.14%	3.51%	3.16%	3.15%
Yield on assets	5.19%	4.71%	4.79%	4.87%	5.42%
Cost of liabilities	2.90%	1.93%	1.48%	2.00%	2.70%
Non-int. inc (% Op income)	25.37%	3.79%	5.96%	7.10%	7.77%
Cost to income	25.31%	24.59%	28.08%	26.06%	24.40%
Overhead	0.90%	0.78%	0.94%	0.85%	0.80%
ROA	2.05%	1.31%	1.38%	1.62%	1.74%
ROE	12.10%	7.36%	7.29%	8.04%	8.62%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	-32%	51%	-4%	-1%	8%
Net profit	-29%	7%	1%	16%	14%
EPS	-42%	-31%	1%	16%	14%
DPS	-11%	50%	0%	0%	-99%
Net Loans	-2%	-3%	-4%	7%	7%
Assets	-3%	1%	-5%	-1%	5%
Deposits	-5%	0%	-7%	4%	4%

Great Eastern Holdings No triggers

Rating: HOLD

Tough at the top

Whilst Great Eastern Holdings' (GEH) life insurance operations maintained their lead in terms of market share in Singapore (weighted premiums) in 2003, there was a marginal 1bp drop in market share to 26.5%. However, a look at the breakdown indicated a 110bp drop in its market share for annual premiums to 14.9% from 16.0% (excluding the 12.6% market share gained from the one-time launch of Eldershield, whereby GEH was one of two insurers selected to sell the product). This is in contrast with the 320bp rise in market share to 37.5% for single premium policies. We draw two conclusions from these statistics: 1) GEH's earnings are predominately derived from single premium policies; and 2) the annual premium market share is only about half that of its single premiums. Generally, annual premium policies are more profitable than single premium policies. The fact that GEH's premium income continues to be dominated by single premiums suggests that, unless corrected, it will face pressure on profits and competition from its non-traditional distribution channels. However, in Malaysia, where GEH derives 33% of its premium income, the company has a stronger position in annual premium income, which dominates with a 25.1% market share.

Targeting S$500m profits

GEH's management has disclosed its target of achieving net profits of S$500m on total assets of S$50bn by 2008. Based on the 2003 figures, this suggests an annual compound growth rate of 10% for net profits. In addition, the net profits of S$500m on an asset base of S$50bn indicate an ROA of 1%, in contrast to the 1.05% achieved in 2003. This suggests that profitability will remain flat at best. As indicated above, unless there is a shift in the distribution of its premium income to annual instead of single, GEH will find it difficult to grow its ROA.

Going overseas

While the contribution from Malaysia was a respectable 33% of total premiums and 38% of gross profits in FY03, GEH has indicated plans to expand into China. Whilst the low penetration rate and potential growth prospects in China are attractive, we believe contributions from China are still distant at this point in time.

Rise in embedded value

With the improvement in the equity markets and general operating conditions, GEH has reported a higher embedded value of S$9.35 per share (2002: S$7.83). In addition, its economic value of one year's new business has risen to S$0.39 per share in comparison with the S$0.33 per share in 2002. However, the improvement rests solely with improving yields on both its shareholders' funds and life insurance funds, which are subject to the vagaries of market forces. We maintain our target price of S$12.03, based on GEH's embedded value but with a lower one-year economic value of S$0.27 per share and a multiple of 10x. In the near term, we do not anticipate any price catalysts to warrant a re-rating of GEH.

GEH

Singapore

Share Price:	12.00	**Reuters Code:**	GELA.SI	**Shares Outstanding**	471
52 Week Price Range:	8.60 - 13.00	**Bloomberg Code:**	GE.SP	**Market Cap (US$m)**	3,333

INCOME STATEMENT (S$m)	**01**	**02**	**03**	**04**	**05**
Turnover	**6,536**	**6,555**	**6,052**	**6,232**	**6,480**
Life insur. profit	159	182	281	309	340
Gen. Insur. Profit	29	83	25	31	30
Fee income	23	26	28	31	34
Invest. Profit	40	43	70	77	95
Profit before expenses	**251**	**334**	**404**	**448**	**498**
Mgt. Expenses	-14	-14	-15	-16	-16
Other expenses	12	-3	24	-8	-8
EBITDA	249	318	413	425	475
Underlying profit	**248**	**317**	**413**	**424**	**474**
Prov. For dim.	29	0	0	0	0
Taxation	-72	-81	-98	-100	-111
Minorities	-3	-3	-3	-3	-4
Net profit	**202**	**234**	**312**	**321**	**359**

BALANCE SHEET (S$m)	**01**	**02**	**03**	**04**	**05**
Investments	16,904	19,857	25,544	26,690	29,746
Fixed assets	1,072	1,506	1,339	1,528	1,534
Total	17,976	21,363	26,883	28,218	31,281
Cash and equiv.	3,570	3,365	4,140	4,492	5,064
Other assets	525	673	1,329	3,456	3,819
Total Assets	**22,071**	**25,401**	**32,352**	**36,166**	**40,164**
Life insur. funds	20,298	23,348	27,556	30,698	34,153
Gen. Insur. Funds	108	124	145	148	151
Other liabilities	134	2,245	2,627	3,067	3,340
Total Liabilities	20,539	25,716	30,328	33,913	37,643
Total Equity	**1,531**	**1,630**	**2,024**	**2,254**	**2,521**

Life assur. Profit from: (S$m)	**01**	**02**	**03**
Participating fund	77	91	85
Non-participating fund	81	71	164
Invest.-linked fund	0	20	32

PER SHARE DATA (S$)	**01**	**02**	**03**	**04**	**05**
EPS	0.43	0.50	0.66	0.68	0.76
DPS	0.17	0.20	0.24	0.25	0.25
Effective payout ratio (%)	*40%*	*40%*	*36%*	*37%*	*33%*
BVPS	3.25	3.46	4.29	4.78	5.35

New business premiums (S$m)	**01**	**02**	**03**
Single premium	2,478	2,275	1,989
Annual premium	243	391	292
Renewal premium	2,959	2,606	2,775

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	3.7x	3.5x	2.8x	2.5x	2.2x
Price to earnings	28.0x	24.2x	18.1x	17.6x	15.7x
Price to underlying profit	22.8x	17.8x	13.7x	13.3x	11.9x
Yield at current price (%)	1.42	1.67	2.00	2.08	2.08

Embedded value (S$/share)	**01**	**02**	**03**
In-force business	4.08	4.32	4.99
Adjusted S/H funds	3.42	3.50	4.36
Embedded value	**7.50**	**7.83**	**9.35**
Eco. Value of 1-yr's new bus.	0.27	0.33	0.39

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Underlying profitability	1.26%	1.34%	1.43%	1.24%	1.24%
Total income yield	1.27%	1.41%	1.40%	1.31%	1.31%
Invest. Yield	0.20%	0.18%	0.24%	0.22%	0.25%
Invest. inc (% total income)	15.87%	12.79%	17.28%	17.14%	19.07%
Mgt cost to income	5.70%	4.04%	3.74%	3.51%	3.28%
Overhead (mgt. And other exp.)	1.27%	6.91%	-3.12%	6.83%	6.83%
ROA	1.02%	0.95%	1.05%	0.94%	0.94%
ROE	13.76%	14.79%	17.09%	15.03%	15.05%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	-15%	28%	30%	3%	12%
Net profit	12%	16%	34%	3%	12%
EPS	-7%	16%	34%	3%	12%
DPS	0%	18%	20%	4%	0%
Investments	41%	19%	26%	5%	11%
Assets	27%	15%	27%	12%	11%
Life insur. funds	29%	15%	18%	11%	11%

Korea

Cyclically attractive

Rating: Overweight

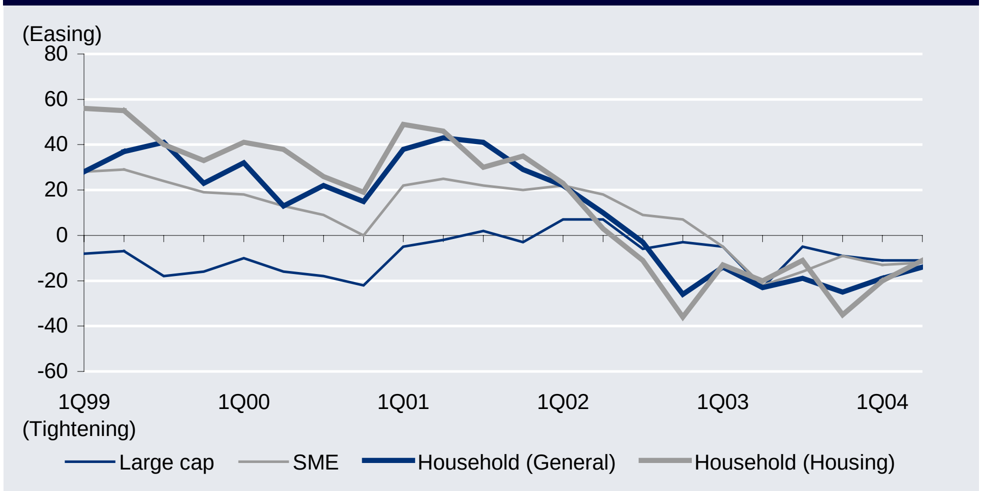
Overview

Slow loan growth in the 8-10% range

The Korean banks' asset growth target averages about 10% for FY04, led by loans rather than securities investment. We believe this remains ambitious given: 1) lingering weakness in domestic consumption; 2) still-high credit risk especially for SMEs; and 3) the not-yet-upgraded risk management system. As such, our asset growth assumption for Korean banks in FY04 is set at 6% on average. We also assume loan growth will average 8% in FY04, vs 9% (12%, if excluding Chohung Bank) in FY03. Speaking to all the banks under our coverage, we found that most remain cautious over the FY04 asset growth outlook, despite rising optimism towards a gradual recovery of the economy.

- Loan demand has not actually improved since 2Q03. Most conglomerates continue to de-leverage their balance sheets. Strong exports have created hopes of capital expenditure expansion, but this is likely to be led by large-sized companies that have increasingly been financing the required funds from operating cash flow and overseas funding. As such, loan growth at Korean banks should remain vulnerable to loan demand from SMEs and households (including credit cards). Most banks agree with us that they will keep focusing on loan extension to SMEs and households in FY04.

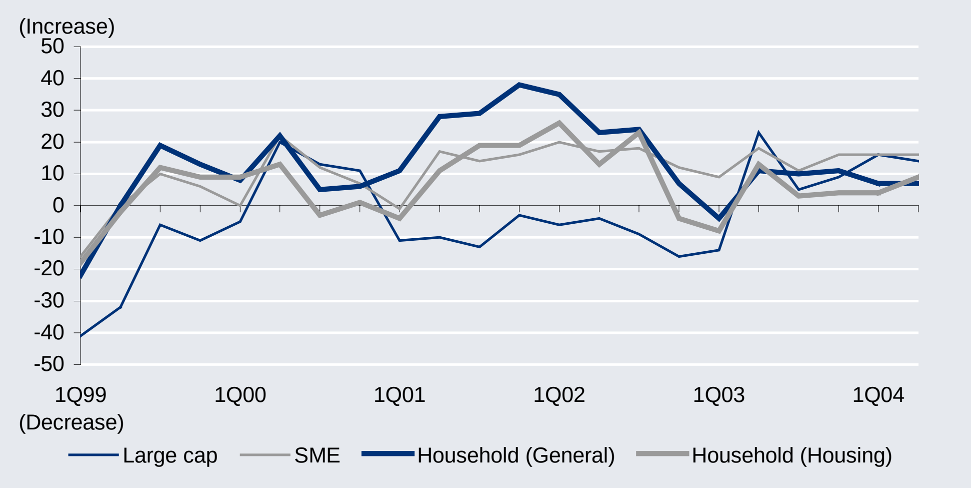
Fig 108 Lending policy diffusion index



NB: Survey of loan officers regarding lending policy. A positive index implies an easier lending policy while a negative index implies a tighter lending policy.

Source: Bank of Korea

Fig 109 Loan demand diffusion index



NB: Surveyed loan officers for loan demand outlook. A positive index implies an easier lending policy while a negative index implies a tighter lending policy.

Source: Bank of Korea

- Technically, the loan-to-deposit ratio at Korean banks has already reached a historic high of close to 100%. Loan growth has become highly correlated with deposit growth, but has slowed significantly over the past couple of quarters. As long as money supply growth (or M2 or M3) remains well below 10%, loan growth is not likely to pick up again. Moreover, Korean banks are also keen to enhance their capital adequacy ratio further, given the tightened regulatory requirements on a simple equity-to-asset ratio and the scheduled implementation of the new Basel Capital Accord (Basel 2) after 2006.

Fig 110 Loan-to-deposit trend at banks

Source: Bank of Korea

- Most banks are keen to develop new lending services such as long-term mortgage and project financing, both of which we expect to grow rapidly. But these are not big enough to create significant loan growth. The government is also keen to promote long-term mortgage loan services – but we are cautious over the demand outlook for this segment. First, most long-term mortgage loan demand should come from replacement demand for maturing short-term mortgage-backed loans. Second, most of the maturing short-term mortgage-backed loans (or 80-90%) are likely to be simply rolled over for another three years. Third, the secondary market for long-term mortgage loans is still in its infancy.

Major banks, such as Kookmin, Shinhan, Woori and Hana, have relatively high loan-to-deposit ratios, averaging over 90%, with low Tier I capital ratios and/or corporate integration needs. Chohung Bank and Korea Exchange Bank should continue to focus on asset de-leveraging and loan mix realignment this year. There are a few banks with lower loan-to-deposit ratios and higher Tier I capital ratios: 1) Industrial Bank of Korea (IBK: its loan-to-deposit ratio could fall to around 80%, if classifying its debentures as deposits); 2) Daegu Bank; and 3) Pusan Bank. But these banks have been historically reactive relative to the major banks with weak market leadership, concentrated customer bases and conservative management attitudes.

Fig 111 Loan-to-deposit and capital adequacy ratios by bank (March 2004)

(%)	LTD*	CAR	Tier I	Simple equity-to-assets
Kookmin	97.3	10.11	6.30	4.75
Chohung	78.5	8.92	4.42	3.73
Shinhan	96.7	11.50	6.67	4.61
Woori	88.7	11.23	6.82	5.73
Hana	89.9	11.17**	6.21**	4.34
Koram	87.6	10.77	6.82	3.58
KEB	70.8	9.35	4.68	4.72
Pusan	68.3	11.36	9.42	5.78
Daegu	74.2	10.57	8.53	4.91
IBK	118.1***	10.10	8.16	4.91
Weighted average	**91.0**	**10.44**	**6.40**	**4.68**

NB: As of December 2003 for Woori, KEB and IBK and March 2004 for others, *Based on average Won currency loans and deposits in FY03, ** As of December 2003, *** It could drop to 80.4%, if its debentures were classified as deposits.

Source: Company data, ING estimates

Better margin outlook, though marginal

Net interest margins (NIM) are likely to expand slightly in the coming quarters, in view of: 1) a shift of asset mix to loans from securities; 2) widening interest spread on loans and deposits; and 2) a reduced rise of delinquency in high-margin credit card assets. An increased proportion of earning assets resulting from the asset clean-up (or write-off and sale), Russian debt collection, treasury share sales (Shinhan Bank) and absence of share buy-back burden (Hana Bank) should also help banks widen NIM in FY04.

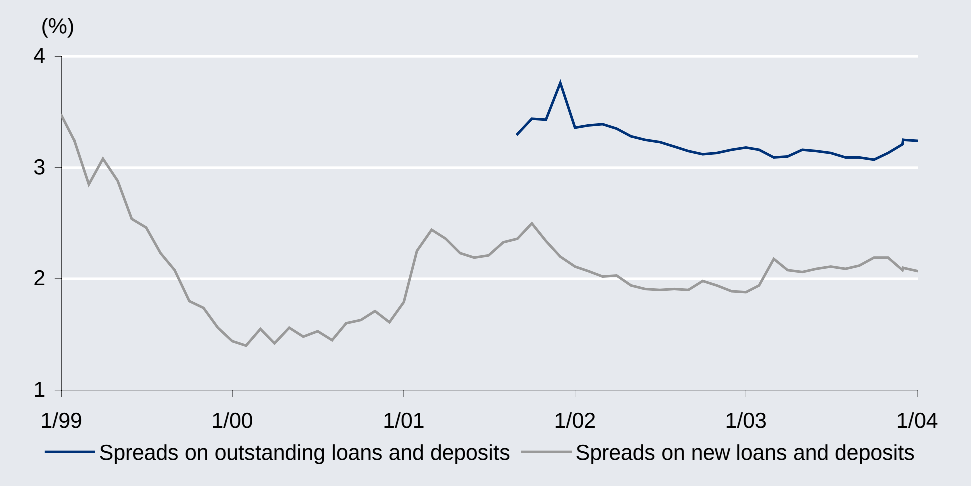
- Korean banks have been shifting their asset mix to loans from securities to reflect weak treasury bond rates recently, as witnessed in 1Q04. We assume loan asset growth will continue to outpace securities asset growth.

- Interest spreads on outstanding loans and deposits have widened sequentially over the past four months, mainly led by continued deposit rate cuts (especially for short-term saving deposits). We believe interest spreads on outstanding loans and deposits will continue to improve in the coming quarters. Our discussions with the banks indicated that they would focus more on improvement of credit risk management in FY04. This should allow them to raise lending rates and lower deposit rates further. Interest spreads on outstanding loans and deposits continued to widen 8bps MoM to 3.21% in December 2003 and 4bps MoM to 3.25% in January 2004. It edged down 1bp to 3.24% in February 2004, but we believe the spread should widen again in the coming quarters.

- The three-year treasury bond rate averaged 4.55% in FY03, higher than the current 4.5% rate. But we believe Korean treasury bond rates are at risk of trending upward given: 1) a high positive correlation between treasury rates in Korea and the US; 2) increased Fed rate hike talks in the US; and 3) continued local inflation pressure. Assuming treasury bond rates remain at close to 5% or move higher throughout FY04, we anticipate the FY04 average interest spread on treasury bonds and deposits to be over 50bps wider than FY03's 40bps.

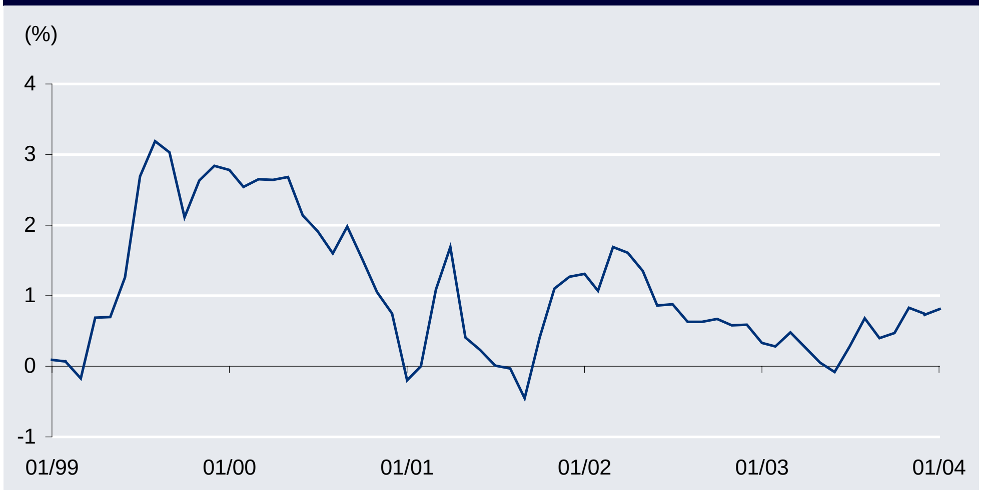
- We anticipate that growth in delinquent card assets will continue to decelerate in FY04, attributed to continued asset clean-up efforts and tightened credit risk management. This should negate downward pressure on NIM at banks from a continuing rise in delinquent household and SME loans

Fig 112 Interest spreads on loans and deposits



Source: Bank of Korea

Fig 113 Interest spreads on fixed-income securities and deposits



Source: Bank of Korea

Kookmin Bank has been benefiting from the acquisition of Kookmin Credit Card as witnessed since 4Q03. Potential sale of its holding treasury shares should help the bank widen its NIM further. Shinhan Financial Group (SFG) is also likely to see a wider NIM in FY04. Shinhan Bank sold its holding SFG shares (or treasury shares on a consolidated basis), from which Shinhan bank earned Won627bn in proceeds. This should lead to a 6-7bps rise in Shinhan Bank's NIM. We believe Hana Bank is the best positioned to widen its NIM. First, since the merger with Seoul Bank, the bank has been de-leveraging its balance sheet. This allows it to lower its funding costs through demoting high-cost time deposits. Second, the bank has continued to sell off its non-earning assets. This, together with the potential sale of its holding treasury shares, should enable the bank to expand its NIM further. Industrial Bank of Korea holds 19.5m KT&G shares. If the sale of the KT&G shares materialises, the bank will be able to expand its NIM by 4-5bps to close to 3%. Korea Exchange Bank re-capitalised itself with a Won1.1tr fresh capital injection from Lone Star last year. This should help the bank widen its short-term NIM by over 10bps to approximately 2.25% in FY04 from 2.14% in FY03. We expect NIM in both Daegu Bank and Pusan Bank will also expand in FY04, thanks to increased low-cost deposits (or core deposits) in FY04.

Strong bancassurance and fund sale services, but not enough

Net non-interest income represents approximately 20-30% of total operating income at Korean banks, and we believe this will remain unchanged in the next couple of years. We assume the decline in trust income will continue in FY04-06, in view of the further weakening attractiveness of money trust accounts against deposits. We do not anticipate any significant rise in income on credit card services, securities trading, and forex and derivatives trading. Indeed, speaking to all banks in our universe, we found that they would actively promote new fee-based income services such as bancassurance and fund sales, which we believe will develop at an accelerating pace along with the development of the asset management industry. This should the key reason why major banks (Kookmin, Woori and Hana) are keen to take over Korea Investment Trust Securities and/or Daehan Investment Trust Securities. We agree with the consensus that these services are not yet developed and have huge growth potential. But it is too early to expect any significant contribution to banks' pre-provision profit, in our opinion. We are also concerned that a decline in trust income would offset a rise in non-interest income from bancassurance and fund sale services.

Slight improvement in cost-to-income

Korean banks have kept telling us about their cost reduction efforts. Many of them have already implemented early retirement programmes (ERP) in 4Q03-1Q04, such as Kookmin Bank, Hana Bank, Koram Bank, Industrial Bank of Korea and Daegu Bank. These, amid the slowdown of asset growth, should lead to an improvement in cost-to-income ratios in FY04-06. But we believe the magnitude of improvement should be marginal. First, many banks plan to expand IT spending budgets for the upgrading of risk management systems as well as the adjustment of IT system for the new Basel Capital Accord. Second, the magnitude of the proposed ERP is smaller than we had assumed. Third, we feel the managers are becomes relatively less aggressive on cost reduction. Many banks assert that Korean banks' cost-to-income ratio is already low, especially compared to major foreign banks. As such, we do not anticipate any major improvement in cost-to-income ratios in FY04-05.

Sequential upward earnings momentum ahead

- A decline in loan-loss provisioning (LLP) should be the key earnings driver for Korean banks in FY04-05. We assume LLP pressure will ease sequentially in FY04 in view of: 1) the slowdown of loan growth; 2) the absence of major corporate failures such as SK Network (former SK Global) and LG Card; and 3) the sharply decelerating rise in delinquent card assets. We believe these should negate a likely rise in LLP pressure for household and SME delinquent loans as witnessed in 1Q04. We estimate new LLP will drop to approximately Won10tr in FY04 from Won14-15tr in FY03 and Won8tr in FY02. Moreover, if domestic consumption improves amid continuing healthy export demand in FY04, we believe the reduction in LLP pressure could accelerate in the coming quarters.

Fig 114 Proportion of card assets by bank

(%)	12/00	12/01	12/02	12/03
Kookmin Bank (incl KCC)	10.3	10.6	12.5	8.3
Kookmin Bank (excl KCC)	0.4	3.0	3.4	8.3
SHB+CHB+Shinhan Card	4.7	6.5	6.7	4.2
Shinhan Bank (incl Shinhan Card)	3.3	3.9	4.5	2.5
Shinhan Bank (excl Shinhan Card)	3.3	3.9	0.3	0.0
Chohung Bank	5.9	9.0	8.9	6.2
Woori Bank (incl Woori Card)	10.7	6.6	5.2	3.5
Woori Bank (excl Woori Card)	3.1	5.0	0.1	0.0
KEB (incl KEB Credit Service)	8.1	12.1	14.2	9.3
KEB (excl KEB Credit Service)	0.1	0.0	0.0	0.1
Hana Bank	1.1	2.2	2.9	2.1
Koram Bank	3.0	6.8	6.8	4.6
IBK	1.9	3.7	4.1	2.5
Pusan Bank	1.8	2.9	3.8	2.7
Daegu Bank	1.9	3.1	3.6	2.9
Weighted average (incl card subsidiaries)	**6.3**	**7.4**	**7.6**	**4.9**

NB: Managed basis for KCC and KEB CS and reported basis for Woori Card and Shinhan Card. Total assets at mono-line credit card companies were counted as credit assets

Source: Company data

Banks with less vulnerability to the domestic consumption cycle have better earnings visibility, such as Shinhan Bank, Hana Bank, Koram Bank and Industrial Bank of Korea. But there are also few doubts about sequential upward earnings momentum in Kookmin Bank and Chohung Bank (81%-owned by Shinhan Financial Group) for FY04. These banks are rated as the best beneficiaries in potential upturns in domestic consumption and interest rates. Daegu Bank and Pusan Bank should be no exception, either. But the magnitude of earnings recovery at regional banks is likely to be negated by their relatively high cost-to-income structure and normalised effective tax rates.

Easing but still-high caution over loan asset quality

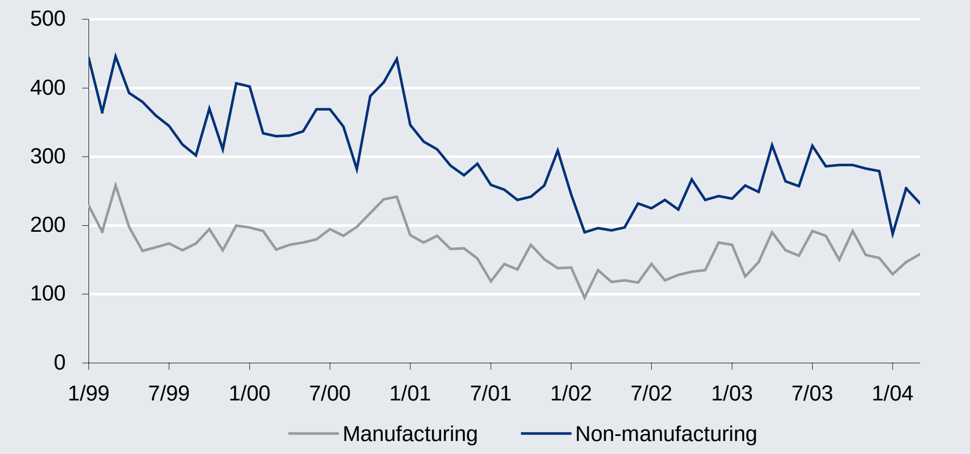
The delinquency ratio at banks peaked across all credit lines in 2Q-3Q03, and growth in new delinquent loans has subsequently eased. First, most marginal borrowers have already turned delinquent. Second, tightened credit risk management since 1Q03 has become effective. Third, high-risk card assets have reduced in substance. Fourth, banks wrote off sizeable unrecoverable non-performing loans (NPLs) last year. As such, caution over loan asset quality has relatively eased over the past couple of quarters. Nevertheless, doubts about the sustainability of easiness of credit risk at banks continue given 1Q04's rise in delinquencies in households and SMEs.

We admit the 1Q04's delinquency rise is due to not only seasonality and less NPL write-off (or sale) but also prolonged weakness in domestic consumption. We also agree with the popular view that unless domestic consumption turns around, a rise in delinquency in household and SME loans should creep up further. But compared to the large-sized corporate loans and credit card assets that resulted in the financial crises, SME loans are largely secured (up to approximately 70%) with property and quasi-government guarantees. We also anticipate a drop in LLP for card assets will also offset a rise in LLP for SME loans.

Indeed, the Bank of Korea's (BoK) bankruptcy statistics say that a rise in the number of bankruptcies has declined and stabilised since 3Q03. According to the BoK's quarterly survey on loan officers' attitude (for 42 institutions), the credit risk diffusion index (DI) has also declined since 3Q03; a positive index implies a rise in credit risk, while a negative index implies a decline in credit risk. This implies that loan officers' caution over credit risk has eased – albeit marginally – since 3Q03.

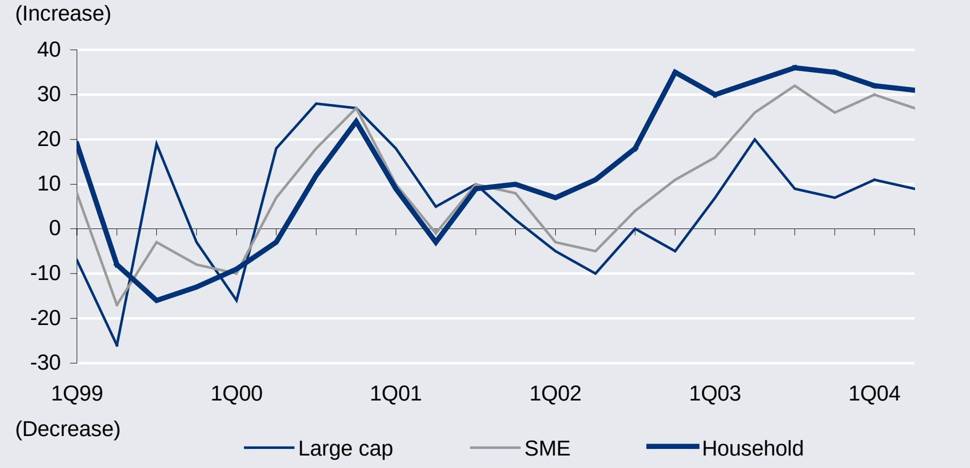
As such, we maintain our assumption that LLP pressure should continue to lessen in the coming years. We believe their NPL ratios should improve sequentially in FY04 unless Korean banks face other SK Network or LG Card-type incidents. If ING's economics team's optimism towards the economy in 2004 – with a 5.5% GDP growth estimate (vs FY03F's 3.1%) – is correct, we should also see the upward reclassification of NPLs in 2004. We do not yet factor in such an optimistic scenario in our NPL projection for Korean banks.

Fig 115 The number of bankruptcies by industry



Source: Bank of Korea

Fig 116 Loan officers' attitude index on credit risk (or credit risk DI)



Source: Bank of Korea

Fig 117 NPL trend at banks

	12/02	3/03	6/03	9/03	9/03*	12/03*	3/04*
Total loans (Won tr)	634	683	696	711	349	346	350
NPL (substandard & worse)	15	19	22	23	13	11	11
NPL ratio (%)	2.37	2.74	3.21	3.26	3.81	3.04	3.10

NB: NB: Based on 14 commercial banks and 5 special banks,, *Based on Kookmin, Shinhan, Chohung, Hana, Koram, Pusan and Daegu

Source: FSC, Company data

Valuations

Korean banks are less rated as value stocks. Korean banks are currently trading at 1.3x FY04F PBR, at a small premium to the market. Nevertheless, Korean banks should remain attractive relative to the market. This valuation premium is justifiable, in our view, by the banks' up-trending earnings momentum and improving asset quality (in terms of asset leverage, NPL ratio and NPL coverage ratio). Moreover, Korean banks should be major beneficiaries in the potential upturn of domestic consumption and interest rates given their increased gearing to the consumption cycle and wide negative duration gap, also supporting valuation premium of banks to the market.

Fig 118 Comparative valuations

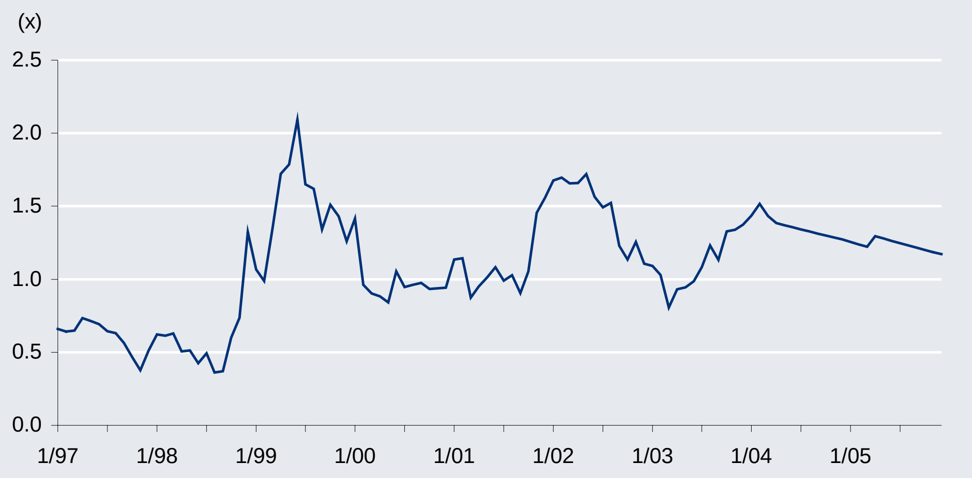
		Kookmin	SFG	Hana	Koram	IBK	Pusan	Daegu	Sector*
KSE code		060000.KS	055550.KS	002860.KS	016830.KS	024110.KS	005280.KS	005270.KS	
Recommendation		BUY	BUY	BUY	HOLD	BUY	BUY	HOLD	
Target price (Won)		60,000	27,300	32,500	15,200	9,300	8,800	7,500	
Upside potential (%)		27.7	18.7	16.9	0.0	8.1	18.4	3.7	
Price as of 22 April (Won)		47,000	23,000	27,800	15,200	8,600	7,430	7,230	
Adjusted number of shares (m)		336	339	192	203	458	147	132	
Adjusted market cap (Won bn)		15,810	7,796	5,347	3,087	3,941	1,090	955	38,026
Foreign ownership (%)		75.8	66.2	62.1	91.1	15.0	51.8	50.3	66.1
PUP(x)	04F	2.8	2.5	3.9	4.2	2.3	3.1	2.6	3.0
	05F	2.6	2.5	3.7	4.1	2.1	2.9	2.4	2.8
	06F	2.4	2.2	3.3	3.7	2.0	2.6	2.2	2.5
PER(x)	04F	11.8	8.6	6.4	8.8	7.1	7.5	7.0	9.4
	05F	6.4	6.8	5.5	8.0	5.1	6.1	5.7	6.4
	06F	5.5	5.1	6.5	7.2	4.5	5.2	4.9	5.6
Relative PER (%)	04F	149.7	108.5	80.5	97.1	78.3	82.4	77.1	103.5
	05F	89.5	95.1	76.1	102.3	65.8	78.8	72.5	81.4
	06F	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
P/BV (x)	04F	1.5	1.4	1.2	1.7	1.0	1.1	1.1	1.4
	05F	1.2	1.2	1.0	1.5	0.9	1.0	0.9	1.2
	06F	1.1	1.0	0.9	1.3	0.8	0.9	0.8	1.0
Price/assets (%)	04F	8.1	5.4	6.3	6.7	5.1	6.1	5.3	6.5
	05F	7.6	5.1	5.8	6.2	4.8	5.6	4.9	6.1
	06F	7.1	4.7	5.4	5.8	4.4	5.1	4.6	5.7
Yield (%)	04F	2.4	3.5	3.6	3.9	3.5	4.8	4.1	3.2
	05F	3.8	4.3	5.2	3.9	4.7	6.2	5.5	4.3
	06F	4.3	5.7	5.2	4.3	5.2	7.8	6.2	4.9

Fig 118 Comparative valuations – cont.

		Kookmin	SFG	Hana	Koram	IBK	Pusan	Daegu	Sector*
ROE (%)	04F	13.0	18.5	21.4	20.4	15.1	14.8	16.0	16.2
	05F	20.9	22.0	20.6	20.0	18.5	16.3	17.6	20.5
	06F	20.8	24.6	15.4	19.4	18.4	17.5	17.9	20.3
ROA (%)	04F	0.7	0.6	1.0	0.8	0.7	0.8	0.8	0.8
	05F	1.2	0.9	1.1	0.8	1.0	0.9	0.9	1.1
	06F	1.3	1.1	0.9	0.8	1.0	1.0	1.0	1.1
Adjusted year-end leverage (x)	04F	20.3	26.8	20.6	25.5	19.9	17.4	20.1	21.9
	05F	18.2	23.8	18.8	24.0	18.6	17.2	19.1	19.9
	06F	16.3	20.9	18.1	22.6	17.5	16.8	18.2	18.2

*Market capitalisation weighted average
Source: Company data, ING estimates

Fig 119 Sector PBR



Source: Company data, ING estimates

We are overweight on the banks in our Korean universe, and focus on those with better earnings visibility amid a widening NIM and a de-leveraging of the balance sheet. IBK is our top buy pick, followed by Kookmin Bank, Shinhan Financial Group (SFG), Hana Bank and Pusan Bank. IBK is still rated as value stock given its low P/BV of around 1x, healthy long-term ROE outlook of over 18% and average asset quality. Kookmin Bank and SFG are the best positioned to take advantages of potential upturn in domestic consumption and interest rates given their high operational and/or financial leverage as well as wide negative duration gap.

In the next six to 12 months, we foresee banks having much better earnings growth potential, which we believe will enable them to de-leverage their balance sheets and enhance their ROE prospects. First, Korean banks have become relatively more cautious over growth, though it is still doubtful how long they will remain so. An increase in the number of foreign-managed banks should also help refresh management strategy at Korean banks further. Second, following massive asset clean-up efforts – especially for credit card assets – we anticipate much less LLP pressure on the earnings flow of banks. Third, the likely sale of treasury shares at Kookmin Bank and Hana Bank should improve their Tier I capital ratios and reported BVPS as seen with SFG. IBK should also benefit from the potential sale of its holding KT&G shares.

Moreover, if the long-awaited turnaround in the domestic consumption materialises amid expanding capital expenditure and rising interest rates, we believe Korean banks would benefit significantly amid widening NIM and improving asset quality. Especially, in a cycle of interest rate hikes, all Korean banks should be major beneficiaries given their negative duration gap between assets and liabilities. We estimate Korean banks' average duration of assets to be approximately seven months as at December 2003 while their average duration of liabilities is approximately 10-11 months. The duration gap between assets and liabilities at Korean banks has dropped sharply over the past three years, mainly led by a sharp rise in short-term market rate-linked mortgage-backed loans. As such, Korean banks are more sensitive to variations in market interest rates. In theory, the more asset-sensitive banks should benefit most in a cycle of interest rate hikes. In our coverage, Kookmin Bank and Shinhan Financial Group are better positioned to take advantage in a cycle of interest rate hikes, as these banks are more asset-sensitive and leveraged than their peer banks.

Fig 120 Duration gap between assets and liabilities by bank

(Month: as of December 2003)	Simple duration gap	Assets	Liabilities
Kookmin	-4.20	6.36	10.56
Shinhan	-3.94	7.36	11.30
Chohung	-5.16	5.16	10.32
Hana	-3.56	7.95	11.51
Koram	-0.48	6.84	7.32
IBK	-3.28	6.35	9.63
Pusan	-2.04	8.64	10.68
Daegu	-1.54	12.25	13.79

Source: Company data, ING estimates

Meanwhile, there are several banks whose corporate value is highly vulnerable to the price performance of their holding equities, such as Korea Exchange Bank (KEB), Woori Financial Group (WFG), Chohung Bank (CHB) and Industrial Bank of Korea (IBK). KEB, WFG and CHB hold a significant number of Hynix shares. As semiconductor maker Hynix has performed strongly over the past three months, these banks should have huge valuation gains on their capital adjustment accounts on the balance sheet. IBK holds 19.5m shares of KT&G, whose price has jumped by 33% since end-2003. If IBK were to sell off these shares at the current price, the bank could realise sizeable capital gains. Corporate value of Kookmin Bank and Hana Bank is also vulnerable to the market price of their respective 30m and 28m holding treasury shares.

Fig 121 Hynix shareholdings by bank

	SFG (CHB)	KEB	Woori	KDB
Hynix shares (m)	45.419	61.232	59.839	32.413
(% of total outstanding shares)	10.2%	13.8%	13.5%	7.3%
Book value of Hynix shares (Won bn)				
31/12/03	254.3	342.9	335.1	181.5
31/03/04	556.4	750.1	733.0	397.1
22/04/04	554.1	747.0	730.0	395.4
% of market cap as of 22 April	**7.1% (24.4%)**	**18.3%**	**10.7%**	**N/A**

Source: Company data, ING estimates

Kookmin Bank

Long-term optimism intact

Rating: BUY

Upward earnings momentum. The bottom line turned around in 1Q04 with a Won169bn net profit, higher than our Won147bn estimate, though this is mainly due to special gains such as interest income on Russian debt collection, gains on securities (including ABS) and a corporate tax refund. The bank's long-term earnings visibility has also improved on a widening NIM and diminishing LLP pressure. We look for a steady YoY drop in LLP pressure in FY04-05, though we have marginally raised our FY04 LLP by 3% to reflect a higher-than-expected rise in delinquencies in household and SME loans. We have slightly lowered our FY04-05 EPS estimates by 4% and 2%, respectively. But we have raised our FY06 EPS estimate by 2%. Our optimism on the bank's upward earnings momentum remains intact.

Widened NIM as expected. As the income on ABS is included in the NIM calculation, the NIM has widened to 3.81% in 1Q04 from 3.41% in 4Q03 and 3.20% in 1Q03. We have raised our reported FY04-06 NIM estimates by 3.7% on average from the previous 3.5% on average to reflect the inclusion of income on ABS in the NIM calculation. This is actually in line with our expectation.

Better-than-expected asset quality. Delinquencies for household and corporate loans have increased in 1Q04, due to not only seasonality and less write-offs, but also prolonged consumption weakness. NPL and coverage ratios have also worsened. But we remain optimistic over the loan-loss provision outlook for FY04-06. First, the asset mix has been realigned towards low-risk loans. Second, the delinquency ratio for card assets has reduced in 1Q04 and is likely to drop further in coming quarters. This should negate a likely rise in LLP pressure from SMEs.

Potential sale of treasury shares. The bank bought back 27.4m treasury shares from the government in late 2003. If 50% of its treasury shares were sold off, we estimate the bank would see a 3bp (annualised) widening in its NIM, a 30bp (annualised) rise in ROE and a 50bp increase in its Tier-I capital ratio. We also see the possibility that treasury shares will be used for the acquisition of investment trust companies.

Best positioned to benefit. Any positive outlook for domestic consumption should immediately spur buying interest in banks with a high gearing to consumer loans (including credit cards) and domestic consumption-related SME loans. Kookmin Bank is the best candidate given its high gearing to household loans and credit card assets. The bank's SME mix is also highly geared to small non-manufacturing SMEs.

Moreover, a recovery in domestic consumption should raise the possibility that market interest rates will trend upwards. Most Korean banks should benefit from an upturn in interest rates, given their asset-sensitive balance sheet to interest rate movements. We believe Kookmin Bank will benefit the most, given its relatively high capital base and wide negative duration gap of four months.

Reiterate BUY with a target price of Won60,000. As we turn more optimistic over Kookmin Bank's share price upside, we reiterate our BUY recommendation with a target price of Won60,000. This is based on an FY04F P/BV of 1.85x, the middle of its five-year historical upper range (1.6-2.1x), from our high long-term sustainable ROE estimate of 20-21% and cost-of-equity assumption of 11.0%.

Kookmin Bank

South Korea

Share Price (Won):	47,000	**Reuters Code:**	060000.KS	**Shares Outstanding (m)**	336.379
52 Week Price Range:	29,650 51,200	**Bloomberg Code:**	060000 KS	**Market Cap (US$m)**	13,632
				Won/US$ rate	1159.8

INCOME STATEMENT (Won bn)	01	02	03	04E	05E
Interest income	7,407	10,989	11,626	12,949	13,790
Interest expense	-4,721	-6,075	-5,903	-6,080	-6,427
Net interest income	**2,686**	**4,914**	**5,723**	**6,869**	**7,364**
Net non-interest income	601	1,459	1,097	1,745	1,949
Total operating income	**3,288**	**6,373**	**6,820**	**8,614**	**9,313**
SG&A	-1,459	-2,551	-2,702	-2,994	-3,238
Pre provision profit	**1,829**	**3,822**	**4,117**	**5,620**	**6,075**
Loan loss provisions	-983	-1,556	-4,039	-3,717	-2,700
Non-operating income	247	-372	-1,083	3	51
Pre tax profit	**1,092**	**1,894**	**-1,005**	**1,905**	**3,426**
Tax	-352	-583	393	-566	-959
Net profit	**741**	**1,310**	**-612**	**1,340**	**2,466**

BALANCE SHEET (Won bn)	01	02	03	04E	05E
Gross loans	109,301	129,109	143,611	152,423	164,589
Loan loss reserves	2,271	2,379	3,690	4,108	4,408
Net loans	107,030	126,731	139,921	148,316	160,181
Total earning assets	147,951	162,271	174,549	182,003	194,706
Other assets	8,943	9,228	9,504	12,097	12,582
Total Assets	**156,894**	**171,499**	**184,053**	**194,100**	**207,288**
Deposits	115,161	123,110	132,180	136,247	144,153
Other paying liabilities	21,632	28,230	30,095	32,184	33,793
Other liabilities	11,187	9,785	13,362	16,129	17,941
Total Liabilities	**147,980**	**161,124**	**175,638**	**184,560**	**195,887**
Total Equity	**8,913**	**10,375**	**8,415**	**9,540**	**11,401**

ASSET QUALITY	01	02	03	04E	05E
Nonperforming assets	8,635	9,927	12,864	13,771	14,613
NPAs/total loans	7.6%	7.5%	9.1%	9.1%	8.9%
Reserve coverage of NPAs	29.7%	25.2%	28.9%	29.9%	30.2%

PER SHARE DATA (Won)	01	02	03	04E	05E
EPS	2,256	3,992	-1,819	3,975	7,292
DPS	100	1,000	0	1,150	1,800
Effective payout ratio (%)	*4%*	*25%*	*0%*	*29%*	*25%*
BVPS	29,749	31,605	28,964	32,306	37,838

BALANCE SHEET RATIOS	01	02	03	04E	05E
Loan-to-deposit	95%	105%	109%	112%	114%
Equity to assets	5.7%	6.0%	4.6%	4.9%	5.5%
Tier 1 CAR	7.1%	6.6%	6.2%	6.5%	7.2%
Total CAR	10.2%	10.4%	10.0%	10.3%	10.3%

VALUATION	01	02	03	04E	05E
Price to book value	1.6x	1.5x	1.6x	1.5x	1.2x
Price to earnings	20.8x	11.8x	-25.8x	11.8x	6.4x
Price to underlying profit	8.4x	4.0x	3.8x	2.8x	2.6x
Yield at current price (%)	0.21%	2.13%	0.00%	2.45%	3.83%

LOAN MIX	01	02	03	04E	05E
Consumer (%)	40.08%	38.16%	38.56%	38.16%	37.76%
Mortgage (%)	25.71%	27.79%	30.86%	31.06%	31.26%
Corporate (%)	34.21%	34.05%	30.58%	30.78%	30.98%
Other (%)	0.00%	0.00%	0.00%	0.00%	0.00%

PROFITABILITY RATIOS (%)	01	02	03	04E	05E
Net interest margin	2.38%	3.39%	3.30%	3.67%	3.71%
Yield on assets	9.47%	7.93%	7.35%	7.45%	7.55%
Cost of liabilities	5.58%	4.03%	3.54%	3.45%	3.50%
Non-int. inc (% Op income)	18.29%	22.90%	16.08%	20.26%	20.93%
Cost to income	44.37%	40.03%	39.62%	34.76%	34.77%
Overhead	1.22%	1.55%	1.52%	1.58%	1.61%
ROA	0.62%	0.80%	-0.34%	0.70%	1.22%
ROE	11.25%	13.59%	-6.08%	13.00%	20.90%

GROWTH RATES (%,YoY)	01	02	03	04E	05E
Pre-provision earnings	-32%	109%	8%	36%	8%
Net profit	-40%	77%	T/N	T/P	84%
EPS	-40%	77%	T/N	T/P	83%
DPS	-78%	900%	N/A	N/A	57%
Net Loans	112%	18%	10%	6%	8%
Assets	92%	9%	7%	5%	7%
Deposits	104%	7%	7%	3%	6%

SFG

Better ROE amid lowered leverage

Rating: BUY

Strong 1Q04 results were above our expectations, considering the Won228bn gain from the sale of treasury shares posted in the capital adjustment account of the balance sheet on a consolidated basis. This was largely helped by larger non-interest income and less LLP. Chohung Bank performed better, with a turnaround of the bottom line.

Most-leveraged. Shinhan Financial Group (SFG) is the second largest and most-leveraged bank in Korea. If 52.6m redeemable preferred shares (worth Won1.74tr) were re-classified as debentures, SFG's assets-to-equity ratio would have been 32x as at December 2003, much higher than the average of 24x for banks in our coverage. This is one of the major reasons why we have asserted that SFG deserves to trade at a deep discount to peer banks in terms of P/BV.

But asset de-leverage is underway. Shinhan Bank's (SHB) growth target has become less aggressive. We assume asset growth at SHB will decelerate to close to 10% in FY04, almost the same as its peer banks'. We also anticipate Chohung Bank (CHB) will continue to contract its asset base in the course of cleaning up the balance sheet throughout FY04. This, combined with a likely recovery in earnings from FY04, should make SFG less leveraged going forward. Moreover, as SHB (100% owned by SFG) sold its 10.15% stake (or 29.87m shares) in SFG, we estimate SFG's adjusted assets-to-equity ratio (based on balance sheets as at December 2003) to drop to 29.5x from 32x. SHB's CAR jumped by 100bps to 11.5% in March. The Won627bn proceeds from the sale of SFG shares are estimated to improve SHB's NIM by 6-7bp and enhance SFG's FY04-05 ROE by approximately 0.5%.

One of the major beneficiaries of an upturn in consumption and interest rates. Like Kookmin Bank, SFG is one of the major beneficiaries of an improvement in consumption and interest rates. First, SFG still has higher-than-industry-average financial gearing (or assets-to-equity), although this was recently lowered slightly. Second, both SHB and CHB have wide negative duration gaps of four months and five months, respectively (based on balance sheets as at December 2003), almost the same as Kookmin Bank's.

Likely acceleration of integration efforts to maximise synergy benefits. SFG has set its integration synergy benefit target at Won220bn for FY04 vs Won145bn for FY03. The completed sale of treasury shares should allow SFG to concentrate on: 1) cleaning up CHB's balance sheet; and 2) integrating its subsidiaries in the coming quarters. This should make SFG keener to fully utilise its 1,000-branch network, 16m retail customers and 250,000 corporate customers. Such tangible integration developments with CHB should further accelerate SFG's upward earnings momentum, in our opinion.

Buy with a target price of Won27,300. We set SFG's long-term sustainable ROE at 20.5% (after adjusting for the tax exemption effect for CHB's FY04-05 earnings). SFG has been trading at a deep discount to Kookmin Bank. But considering the sale of treasury shares, we believe the valuation discount of SFG to Kookmin Bank should narrow significantly going forward. We set our target FY04F P/BV at 1.7x, based on our cost-of-equity assumption of 12% (vs Kookmin Bank's 11% and Hana Bank's 11%) and long-term ROE estimate of 20.5%. This, combined with our BVPS estimate as at December 2004, puts our 12-month target price at Won27,300.

Shinhan Financial Group

South Korea

Share Price (Won):	23,000	**Reuters Code:**	055550.KS	**Shares Outstanding (m)**	391.541
52 Week Price Range:	9,050 -23,600	**Bloomberg Code:**	055550 KS	**Market Cap (US$m)**	7,765
				Won/US$ rate	1159.8

INCOME STATEMENT (Won bn)	**01**	**02**	**03**	**04F**	**05F**
Interest income	3,645	3,646	4,996	7,620	8,006
Interest expense	-2,550	-2,352	-2,997	-4,489	-4,664
Net interest income	**1,095**	**1,294**	**1,999**	**3,131**	**3,342**
Net non-interest income	614	797	1,231	2,106	2,268
Total operating income	**1,710**	**2,091**	**3,230**	**5,237**	**5,611**
SG&A	-670	-942	-1,348	-2,059	-2,238
Pre provision profit	**1,039**	**1,150**	**1,882**	**3,178**	**3,373**
Loan loss provisions	-557	-211	-1,096	-2,073	-1,615
Non-operating income	248	-87	-155	200	0
Pre tax profit	**731**	**852**	**631**	**1,305**	**1,757**
Tax	-175	-250	-268	-400	-448
Net profit	**555**	**602**	**363**	**904**	**1,309**

BALANCE SHEET (Won bn)	**01**	**02**	**03**	**04F**	**05F**
Gross loans	36,014	46,030	97,729	103,776	111,457
Loan loss reserves	*643*	*786*	*2,808*	*2,999*	*3,226*
Net loans	35,371	45,244	94,921	100,776	108,231
Total earning assets	52,888	63,546	129,343	135,466	143,804
Other assets	3,442	3,222	9,866	10,062	10,328
Total Assets	**56,330**	**66,768**	**139,209**	**145,528**	**154,132**
Deposits	34,390	38,722	87,547	91,517	96,577
Other paying liabilities	13,798	19,747	34,957	36,033	38,070
Other liabilities	5,066	4,337	10,552	10,798	11,273
Total Liabilities	**53,255**	**62,806**	**133,102**	**138,349**	**145,920**
Total Equity	**3,075**	**3,961**	**6,108**	**7,179**	**8,212**

ASSET QUALITY	**01**	**02**	**03**	**04E**	**05E**
Nonperforming assets	2,212	1,675	6,423	5,995	5,817
NPAs/total loans	5.7%	3.5%	6.5%	5.8%	5.3%
Reserve coverage of NPAs	32.9%	51.9%	48.1%	39.5%	33.2%

PER SHARE DATA (Won)	**01**	**02**	**03**	**04E**	**05E**
EPS	1,899.11	2,059.66	1,241.58	2,683.13	3,883.93
DPS	750.00	600.00	600.00	800.00	1,000.00
Effective payout ratio (%)	*39%*	*29%*	*48%*	*30%*	*26%*
BVPS	10,518.31	13,549.57	15,164.27	17,170.46	20,216.25

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04E**	**05E**
Loan-to-deposit	105%	119%	112%	113%	115%
Equity to assets	5.5%	5.9%	4.4%	4.9%	5.3%
Tier 1 CAR*	8.2%	6.8%	6.4%	7.4%	7.8%
Total CAR*	11.99%	10.91%	10.59%	11.75%	11.94%

VALUATION	**01**	**02**	**03**	**04F**	**05F**
Price to book value	2.2x	1.7x	1.5x	1.3x	1.1x
Price to earnings	12.1x	11.2x	18.5x	8.6x	5.9x
Price to underlying profit	6.5x	5.8x	3.6x	2.4x	2.3x
Yield at current price (%)	3.26%	2.61%	2.61%	3.48%	4.35%

LOAN MIX*	**01**	**02**	**03**	**04E**	**05E**
Consumer (%)	22.35%	22.73%	21.13%	20.73%	20.33%
Mortgage (%)	26.17%	31.34%	30.22%	30.52%	30.82%
Corporate (%)	51.13%	45.61%	47.88%	48.08%	48.28%
Other (%)	0.35%	0.32%	0.77%	0.67%	0.57%

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04F**	**05F**
Net interest margin*	2.79%	2.83%	2.26%	2.31%	2.33%
Yield on assets*	8.55%	7.50%	6.44%	6.49%	6.59%
Cost of liabilities*	5.74%	4.37%	3.93%	3.98%	4.08%
Non-int. inc (% Op income)	35.93%	38.11%	38.12%	40.21%	40.43%
Cost to income	39.21%	45.03%	41.73%	39.32%	39.88%
Overhead	1.19%	1.53%	1.31%	1.45%	1.49%
ROA	1.04%	0.98%	0.42%	0.64%	0.87%
ROE	17.26%	17.12%	8.70%	17.11%	20.65%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04E**	**05E**
Pre-provision earnings	N/A	11%	64%	69%	6%
Net profit	N/A	8%	-40%	149%	45%
EPS	N/A	8%	-40%	116%	45%
DPS	N/A	-20%	0%	33%	25%
Net Loans	N/A	28%	110%	6%	7%
Assets	N/A	19%	108%	5%	6%
Deposits	N/A	13%	126%	5%	6%

* Based on Shinhan Bank only

Hana Bank

On track

Rating: BUY

Better 1Q04 results, though backed by special gains. Net profit came in at Won202bn, higher than our Won173bn estimate, due to: 1) special gains such as interest income on Russian debt collection and valuation gains on SK Corp shares; 2) smaller G&A expenses; and 3) less loan-loss provision (LLP). But as witnessed at peer banks, delinquencies in household and SME loans increased in 1Q04.

Improved earnings visibility. We anticipate its net interest margin (NIM) to improve further in FY04, as already experienced since early-2003, on the back of continuing funding cost reduction efforts and the absence of its share buy-back burden. Second, the bank's customer base is less vulnerable to the domestic consumption cycle, relative to its peers, given its high business concentration on large-sized corporate customers, though the bank's loan mix has recently shifted to household and SMEs.

Potential sale or cancellation of treasury shares. The bank holds 19.2m (or 1 10% stake) treasury shares worth Won325bn in terms of book value. We expect the bank to sell or cancel the treasury shares. Otherwise, the bank may use its treasury shares to acquire non-bank financial institutions such as Korea Investment Trust Securities or Daihan Investment Trust Securities. Either way, the sale of treasury shares should lead to a further rise in reported NAV and the Tier I capital ratio. Moreover, the current market price is far greater than the acquisition price of close to Won16,900.

Hana Bank will benefit in the event of a potential consumption and interest rate upturn, but less so than Kookmin and SFG, despite its high gearing to large-sized corporate loans relative to its peers – this is because of its high financial gearing and wide negative duration gap of 3.6 months. But the magnitude of the benefit should be smaller compared with that of Kookmin Bank and Shinhan Financial Group.

Hana Bank plans to transform itself into a financial holding company. Thus, in the next couple of years, the bank should be keen to up-size its business presence in the credit card, securities, investment trust and insurance industries. To achieve this goal, we believe the bank should promote M&A and/or a strategic alliance with a major non-bank financial institutions. A large part of the required funds could be financed through the sale of treasury shares, we believe. Meanwhile, the bank is also keen to expand its China business with a plan to open another two branches in China this year.

Reiterate BUY with a slightly-raised target price of Won32,500. Following the completed sale of KDIC's shareholding, we have revised up our FY04-06 BIS capital adequacy ratio estimates to 11.4%, 11.7% and 11.6% (vs. 11.2%, 10.8% and 10.4% previously) with respective Tier I capital ratios of 7.4%, 8.0% and 8.3%(vs. 6.2%, 6.3% and 6.4% previously). We lower our cost-of-equity assumption on Hana Bank to 11.0% (vs. 11.5% previously), the same as Kookmin Bank's. Our new target price is set at Won32,500 (vs Won31,500 previously), based on an FY04 P/BV of 1.4x. This is lower than Kookmin's 1.85x and SFG's 1.7x due to Hana Bank's weak long-term ROE prospects (excluding tax benefits during FY94-05). NIM (or ROA) expansion would be a key driver for the upgrading of our target P/BV.

Hana Bank

South Korea

Share Price (Won):	27,800	**Reuters Code:**	002860.KS	**Shares Outstanding (m)**	192.353
52 Week Price Range:	8,800 -29,050	**Bloomberg Code:**	002860 KS	**Market Cap (US$m)**	4,611
				Won/US$ rate	1159.8

INCOME STATEMENT (Won bn)	**01**	**02**	**03**	**04E**	**05E**
Interest income	2,891	2,931	4,162	4,570	4,936
Interest expense	-2,121	-2,027	-2,610	-2,675	-2,829
Net interest income	**770**	**904**	**1,552**	**1,895**	**2,106**
Net non-interest income	287	287	434	345	339
Total operating income	**1,057**	**1,191**	**1,986**	**2,240**	**2,445**
SG&A	-396	-527	-882	-935	-1,005
Pre provision profit	**661**	**664**	**1,104**	**1,305**	**1,440**
Loan loss provisions	-270	-154	-829	-543	-480
Non-operating income	86	-55	218	87	24
Pre tax profit	**477**	**456**	**493**	**849**	**984**
Tax	-151	-133	24	-1	0
Net profit	**325**	**324**	**517**	**848**	**984**

BALANCE SHEET (Won bn)	**01**	**02**	**03**	**04E**	**05E**
Gross loans	29,348	51,966	56,398	62,511	68,447
Loan loss reserves	*428*	*839*	*1,056*	*1,082*	*1,182*
Net loans	*28,920*	*51,126*	*55,342*	*61,430*	*67,266*
Total earning assets	43,197	70,116	75,854	80,477	86,694
Other assets	*2,105*	*4,304*	*4,712*	*4,915*	*5,143*
Total Assets	**45,302**	**74,420**	**80,566**	**85,392**	**91,837**
Deposits	33,450	54,677	57,599	59,577	63,577
Other paying liabilities	6,806	12,105	13,721	15,071	16,357
Other liabilities	3,118	4,908	5,982	6,601	7,021
Total Liabilities	**43,373**	**71,690**	**77,302**	**81,248**	**86,954**
Total Equity	**1,929**	**2,731**	**3,255**	**4,144**	**4,883**

ASSET QUALITY	**01**	**02**	**03**	**04E**	**05E**
Nonperforming assets	1,407	2,027	2,569	2,728	2,844
NPAs/total loans	4.3%	3.6%	4.5%	4.3%	4.1%
Reserve coverage of NPAs	35.5%	46.0%	42.1%	43.7%	45.5%

PER SHARE DATA (Won)	**01**	**02**	**03**	**04E**	**05E**
EPS	2,515	2,288	2,603	4,372	5,076
DPS	200	500	500	1,000	1,450
Effective payout ratio (%)	*8%*	*22%*	*19%*	*23%*	*29%*
BVPS	13,334	16,066	18,853	23,232	27,071

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04E**	**05E**
Loan-to-deposit	88%	95%	98%	105%	108%
Equity to assets	4.3%	3.7%	4.0%	4.9%	5.3%
Tier 1 CAR	6.88%	5.71%	6.21%	7.42%	8.05%
Total CAR	10.29%	10.30%	11.17%	11.40%	11.69%

VALUATION	**01**	**02**	**03**	**04E**	**05E**
Price to book value	2.1x	1.7x	1.5x	1.2x	1.0x
Price to earnings	11.1x	12.2x	10.7x	6.4x	5.5x
Price to underlying profit	5.4x	5.9x	5.0x	4.1x	3.7x
Yield at current price (%)	0.72%	1.80%	1.80%	3.60%	5.22%

LOAN MIX	**01**	**02**	**03**	**04E**	**05E**
Consumer (%)	12.89%	22.80%	20.88%	20.58%	20.28%
Mortgage (%)	26.27%	26.52%	28.83%	28.93%	29.03%
Corporate (%)	59.38%	50.42%	50.16%	50.36%	50.56%
Other (%)	1.46%	0.27%	0.13%	0.13%	0.13%

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04E**	**05E**
Net interest margin	1.93%	1.97%	2.13%	2.32%	2.38%
Yield on assets	7.84%	6.66%	6.25%	6.35%	6.45%
Cost of liabilities	5.84%	4.63%	4.07%	4.10%	4.20%
Non-int. inc (% Op income)	27.17%	24.11%	21.87%	15.40%	13.86%
Cost to income	37.51%	44.23%	44.41%	41.75%	41.10%
Overhead	0.63%	0.88%	1.14%	1.13%	1.13%
ROA	0.75%	0.54%	0.67%	1.04%	1.12%
ROE	20.63%	14.51%	17.28%	21.36%	20.59%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04E**	**05E**
Pre-provision earnings	44%	1%	66%	18%	10%
Net profit	1487%	-1%	60%	64%	16%
EPS	1487%	-9%	14%	68%	16%
DPS	0%	150%	0%	100%	45%
Net Loans	17%	77%	8%	11%	10%
Assets	8%	64%	8%	6%	8%
Deposits	16%	63%	5%	3%	7%

Koram Bank

Premium fading

Rating: HOLD

Strong 1Q04 results, backed by special gains, as witnessed at peers. Net profit came in at Won118bn, higher than our Won59bn estimate, on the back of various one-off special gains: 1) Russian debt collection; 2) short-lived low-cost deposits from the City park condominium allotment; 3) a gain on securities disposal; and 4) a corporate NPL write-back. To reflect 1Q04 results and lower-than-expected G&A and LLP pressure, we have raised our FY04-06 EPS estimates by 10.8%, 5.0% and 5.5%, respectively.

Long-standing valuation premium. Koram Bank's valuation premium to its peer banks in terms of P/BV has persisted at over 20% over the past three years. We believe the bank deserves to trade at a premium to its peers given: 1) much better loan asset quality with a lower non-performing loan (NPL) ratio and higher NPL coverage; and 2) increased scarcity value on M&A expectations.

Premium should diminish as M&A story subdues. But as Citigroup announced its plan to acquire a minimum 80% stake (including the Carlyle/JP Morgan consortium's 36.6% stake) in Koram Bank on 23 February, we believe the valuation premium of Koram Bank is at risk of fading, and that it could eventually be delisted. Excluding the M&A theme from the valuation of Koram Bank, we believe the bank does not deserve to trade at a premium to its peers, despite its better loan asset quality, given: 1) weak market leadership; 2) a low long-term ROA estimate of close to 0.8%; and 3) high asset leverage of 26x-23x for FY04-06F.

Implications of acquisition by Citigroup. The potential merger between Koram Bank and Citibank Korea would enable Citigroup to expand its stake in Koram Bank and effectively shift its customer focus from high-income earners to middle-income earners. Citigroup would utilise Koram Bank's SME customer base to develop its investment banking services. These moves would also allow Citigroup to promote a variety of financial services (including private banking, foreign currency exchange, investment banking, fund sales and bancassurance) to a wider range of customers nation-wide. We anticipate three major positive developments at Koram Bank. First, we anticipate that the bank's return on assets and asset leverage would improve. Second, we expect the bank's funding cost, especially for foreign currency-denominated funds, to decline by 100bps or more. Third, the bank's competitiveness in fee-based income services should improve in the mid- and long term, in our opinion.

Maintain Hold with a target price of Won15,200. We believe that both upside and downside for the bank's share price is constrained by the tender offer price being set at Won15,500. Standard Chartered announced a plan to sell its entire 9.76% stake to Citigroup at Won15,500 per share on 23 April. This raises the possibility that the acquisition plan by Citigroup will end in success as scheduled. Our cost-of-equity (COE) assumption for Koram Bank is set at 11.5%, the same as Hana Bank's and Kookmin Bank's[a][g] 11.0%. Koram Bank will not be able to take advantage much of the potential upturn in domestic consumption and interest rates given its negative duration gap of less than 1 month. All in all, we are sceptical of any further price upside for Koram Bank. Based on our long-term 19.5% ROE estimate and assumed 11.5% COE, our target FY04F P/BV is set at 1.7x, vs Kookmin Bank's 1.85x and SFG's 1.7x. Thus, our 12-month target price is set at Won15,200 (ignoring the tender offer price). Maintain HOLD.

Koram Bank

South Korea

Share Price (Won):	15,200	**Reuters Code:**	016830.KS	**Shares Outstanding (m)**	203.067
52 Week Price Range:	6,700 -16,300	**Bloomberg Code:**	016830 KS	**Market Cap (US$m)**	2,661
				Won/US$ rate	1159.8

INCOME STATEMENT (Won bn)	**01**	**02**	**03**	**04E**	**05E**
Interest income	1,816	1,973	2,133	2,298	2,478
Interest expense	-1,325	-1,242	-1,362	-1,444	-1,559
Net interest income	**490**	**731**	**771**	**854**	**918**
Net non-interest income	349	161	119	290	314
Total operating income	**839**	**893**	**890**	**1,144**	**1,232**
SG&A	-359	-411	-420	-451	-487
Pre provision profit	**481**	**482**	**470**	**693**	**745**
Loan loss provisions	-271	-213	-455	-229	-218
Non-operating income	83	103	51	33	10
Pre tax profit	**293**	**371**	**66**	**497**	**537**
Tax	-98	-111	-20	-148	-150
Net profit	**195**	**260**	**46**	**349**	**387**

BALANCE SHEET (Won bn)	**01**	**02**	**03**	**04E**	**05E**
Gross loans	17,811	24,949	29,710	32,427	35,313
Loan loss reserves	*437*	*323*	*442*	*451*	*459*
Net loans	17,373	24,626	29,268	31,975	34,853
Total earning assets	26,441	34,436	39,965	42,734	46,014
Other assets	1,973	2,661	3,036	3,305	3,546
Total Assets	**28,415**	**37,097**	**43,001**	**46,040**	**49,560**
Deposits	17,756	20,790	25,007	26,558	28,455
Other paying liabilities	7,281	11,672	12,921	13,791	14,746
Other liabilities	2,136	3,020	3,460	3,887	4,291
Total Liabilities	27,172	35,482	41,387	44,237	47,493
Total Equity	**1,242**	**1,615**	**1,614**	**1,803**	**2,068**

ASSET QUALITY	**01**	**02**	**03**	**04E**	**05E**
Nonperforming assets	1,006	717	643	672	681
NPAs/total loans	4.9%	2.7%	2.2%	2.2%	2.0%
Reserve coverage of NPAs	52.4%	46.8%	70.7%	69.6%	69.8%

PER SHARE DATA (Won)	**01**	**02**	**03**	**04E**	**05E**
EPS	1,048.13	1,293.01	227.44	1,720.49	1,905.07
DPS	0.00	375.00	150.00	600.00	600.00
Effective payout ratio (%)	*0%*	*29%*	*66%*	*35%*	*31%*
BVPS	5,916.21	7,526.05	7,805.41	8,925.89	10,230.96

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04E**	**05E**
Loan-to-deposit	100%	120%	119%	122%	124%
Equity to assets	4.4%	4.4%	3.8%	3.9%	4.2%
Tier 1 CAR	7.1%	6.6%	6.6%	6.9%	7.3%
Total CAR	12.41%	12.22%	10.98%	10.91%	10.99%

VALUATION	**01**	**02**	**03**	**04E**	**05E**
Price to book value	2.6x	2.0x	1.9x	1.7x	1.5x
Price to earnings	14.5x	11.8x	66.8x	8.8x	8.0x
Price to underlying profit	5.9x	6.3x	6.6x	4.5x	4.1x
Yield at current price (%)	0.00%	2.47%	0.99%	3.95%	3.95%

LOAN MIX	**01**	**02**	**03**	**04E**	**05E**
Consumer (%)	22.52%	27.26%	23.11%	22.51%	21.91%
Mortgage (%)	18.49%	25.98%	28.53%	28.73%	28.93%
Corporate (%)	52.83%	45.03%	47.52%	48.02%	48.52%
Other (%)	1.42%	1.73%	0.84%	0.74%	0.64%

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04E**	**05E**
Net interest margin	2.84%	3.24%	2.70%	2.74%	2.76%
Yield on assets	N/A	7.03%	6.55%	6.65%	6.75%
Cost of liabilities	N/A	4.09%	3.63%	3.69%	3.77%
Non-int. inc (% Op income)	41.59%	18.08%	13.38%	25.33%	25.51%
Cost to income	42.73%	45.99%	47.16%	39.42%	39.53%
Overhead	1.27%	1.25%	1.05%	1.01%	1.02%
ROA	0.69%	0.80%	0.12%	0.78%	0.81%
ROE	19.17%	19.28%	2.93%	20.45%	19.99%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04E**	**05E**
Pre-provision earnings	102%	0%	-2%	47%	8%
Net profit	T/P	34%	-82%	656%	11%
EPS	T/P	23%	-82%	656%	11%
DPS	N/A	N/A	-60%	300%	0%
Net Loans	16%	42%	19%	9%	9%
Assets	1%	31%	16%	7%	8%
Deposits	2%	17%	20%	6%	7%

IBK

Growth at a discount

Rating: BUY

A niche play in SME banking. Industrial Bank of Korea (IBK) is a government bank specially established to provide credit to Korea's small and medium-sized enterprises (SMEs), and is the nation's second-largest SME lender, focusing on manufacturing companies. IBK's lending niche requires a great deal of experience and extremely complex credit modelling ability – two reasons why it is defensible against competitors.

Guaranteed survival. The government is currently required by law to cover any deficit incurred by IBK through losses that exceed the capital surplus, which indicates that IBK would remain in business and solvent no matter what the circumstances. This, together with the government's willingness to count IBK's debentures against other banks' mandatory SME lending requirements, allows the bank to issue its debentures approximately 5bp lower than those of its peer banks.

Earnings recovery, not necessarily a re-rating. We foresee a strong recovery in earnings in FY04-05 thanks to a sharp drop in loan-loss provisioning on IBK's credit card assets, which were reduced to Won1.8tr (or 2.5% of bank assets) in December 2003 from Won2.6tr (4.1%) in December 2002. With provisions set to fall 37% in FY04 and a further 16% in FY05, we forecast the bank's EPS to jump 146% and 39% in FY04 and FY05, respectively.

Excessive doubts about balance sheet quality. There is excessive caution over the bank's loan quality given its higher-than-industry-average non-performing loan (NPL) ratio and lower-than-industry-average NPL coverage. But its loan mix is more tightly secured and widely diversified by both size and sector. The bank is less leveraged, as proven by its better asset-to-equity and Tier I capital ratios.

Overly discounted to peers. IBK is trading at a deep discount of more than 20% to its peer banks in terms of FY04F P/BV, despite its expanded free-float, strong Tier I capital ratio, comparable long-term ROE outlook and average loan quality. Our experience in Asia is that banks trading near 2x underlying profit – as IBK currently is – are generally strong performers regardless of asset quality issues. Our 12-month target price is set at Won9,300, based on a target FY04F P/BV of 1.1x, given our long-term sustainable ROE estimate of 17.5% and assumed 16% cost of equity.

Potential positives not factored into earnings model. First, there is sizeable hidden value the bank can realise if needed: 1) huge written-off-but-not-sold loans (Won1.8tr); and 2) 19.5m KT&G shares that could yield a potential valuation gain of over Won100bn. Second, most Korean banks have asset-sensitive balance sheets to variations in interest rates. Like its peers, IBK should also benefit from an upturn in interest rates given its wide negative duration gap of 3.3 months. Third, IBK's net interest margin (NIM) is approximately 30bp lower than those of comparable SME-specialised banks, such as Kookmin Bank, Daegu Bank and Pusan Bank. This is attributable largely to its huge equity holding (KT&G shares worth Won481bn) as well as sizeable low-margin government-funded policy loans (of Won6tr). The sale of its holdings of KT&G shares could lead to a 5bp rise in NIM. Normalisation of the interest spread on its Won6tr policy loans could lead to another 25-30bp rise in NIM.

Industrial Bank of Korea

South Korea

Share Price (Won):	8,600	**Reuters Code:**	024110.KS	**Shares Outstanding (m)**	458
52 Week Price Range:	4,300 -8,600	**Bloomberg Code:**	024110 KS	**Market Cap (US$m)**	3,398
				Won/US$ rate	1159.8

INCOME STATEMENT (Won bn)	**01**	**02**	**03**	**04E**	**05E**
Interest income	3,402	3,486	3,780	4,092	4,436
Interest expense	-2,393	-2,153	-2,152	-2,319	-2,505
Net interest income	**1,008**	**1,333**	**1,628**	**1,773**	**1,931**
Net non-interest income	439	676	712	701	757
Total operating income	**1,447**	**2,009**	**2,340**	**2,474**	**2,688**
SG&A	-573	-682	-804	-868	-943
Pre provision profit	**874**	**1,327**	**1,536**	**1,606**	**1,745**
Loan loss provisions	-465	-635	-1,408	-908	-772
Non-operating income	73	28	184	88	93
Pre tax profit	**482**	**720**	**312**	**787**	**1,067**
Tax	-27	-139	-88	-234	-299
Net profit	**455**	**581**	**224**	**553**	**768**

BALANCE SHEET (Won bn)	**01**	**02**	**03**	**04E**	**05E**
Gross loans	36,325	47,268	52,677	57,132	67,835
Loan loss reserves	*695*	*883*	*936*	*993*	*1,136*
Net loans	*35,629*	*46,385*	*51,741*	*56,139*	*66,699*
Total earning assets	51,802	60,086	65,066	69,731	81,893
Other assets	3,888	4,950	6,518	7,104	7,747
Total Assets	**55,690**	**65,036**	**71,584**	**76,835**	**89,640**
Deposits	*28,944*	*32,144*	*34,215*	*36,778*	*42,498*
Other paying liabilities	19,699	24,508	27,405	28,776	32,241
Other liabilities	*4,161*	*4,942*	*6,512*	*7,414*	*9,772*
Total Liabilities	**52,804**	**61,595**	**68,132**	**72,968**	**84,511**
Total Equity	**2,886**	**3,442**	**3,452**	**3,867**	**5,129**

ASSET QUALITY	**01**	**02**	**03**	**04E**	**05E**
Nonperforming assets	4,256	4,381	4,159	4,144	4,373
NPAs/total loans	12.1%	9.5%	8.2%	7.6%	7.3%
Reserve coverage of NPAs	17.5%	20.5%	22.6%	24.1%	24.5%

PER SHARE DATA (Won)	**01**	**02**	**03**	**04E**	**05E**
EPS	993	1,269	489	1,207	1,676
DPS	500	350	200	300	400
Effective payout ratio (%)	*50%*	*28%*	*41%*	*25%*	*24%*
BVPS	6,297	7,510	7,532	8,439	9,715

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04E**	**05E**
Loan-to-deposit	126%	147%	154%	155%	160%
Equity to assets	5.2%	5.3%	4.8%	5.0%	5.7%
Tier 1 CAR	*9.06%*	*8.43%*	*8.16%*	*8.42%*	*9.41%*
Total CAR	*10.92%*	*10.43%*	*10.10%*	*10.25%*	*10.29%*

VALUATION	**01**	**02**	**03**	**04E**	**05E**
Price to book value	1.4x	1.1x	1.1x	1.0x	0.9x
Price to earnings	8.7x	6.8x	17.6x	7.1x	5.1x
Price to underlying profit	4.5x	3.0x	2.6x	2.5x	2.3x
Yield at current price (%)	5.81%	4.07%	2.33%	3.49%	4.65%

LOAN MIX	**01**	**02**	**03**	**04E**	**05E**
Consumer (%)	11.69%	12.46%	10.49%	10.29%	10.19%
Mortgage (%)	7.30%	7.62%	7.09%	6.79%	6.59%
Corporate (%)	79.92%	79.06%	82.23%	82.73%	83.03%
Other (%)	1.09%	0.86%	0.18%	0.18%	0.18%

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04E**	**05E**
Net interest margin	2.54%	2.95%	2.94%	2.95%	2.97%
Yield on assets	8.13%	7.22%	6.86%	6.90%	6.90%
Cost of liabilities	5.60%	4.29%	3.75%	3.86%	3.86%
Non-int. inc (% Op income)	30.34%	33.67%	30.42%	28.34%	28.16%
Cost to income	39.61%	33.95%	34.36%	35.09%	35.07%
Overhead	1.03%	1.13%	1.18%	1.17%	1.13%
ROA	0.87%	0.96%	0.33%	0.75%	0.96%
ROE	17.26%	18.38%	6.50%	15.11%	18.46%

* Based on Shinhan Bank only

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04E**	**05E**
Pre-provision earnings	36%	52%	16%	5%	9%
Net profit	13%	28%	-61%	147%	39%
EPS	13%	28%	-61%	147%	39%
DPS	0%	-30%	-43%	50%	33%
Net Loans	14%	30%	12%	9%	19%
Assets	12%	17%	10%	7%	17%
Deposits	13%	11%	6%	7%	16%

Daegu Bank

Valuation discount to continue

Rating: Hold

1Q04 results in line. Net profit came in at Won26b. vs our Won25bn estimate. Larger net interest income on a wider net interest margin (to 3.49% in 1Q04 vs 4Q03's 3.51% and 1Q03's 3.20%) and smaller G&A expenses were offset by weaker non-interest income and heavier long-loss provision pressure from a continued rise in delinquencies. We maintain our FY04-06 EPS estimates.

Easing caution on asset quality, but likely at a slower-than-expected pace. Caution over Daegu Bank has eased significantly since end-3Q03, given: 1) improved asset quality in terms of NPL ratio, LLP coverage, Tier I capital, simple equity-to-assets and vulnerability to the equity market; and 2) lower KAMCO repurchase liabilities. Nevertheless, we believe it will take time to see a sharp drop in LLP pressure given the continued rise in delinquencies in 1Q04. The delinquency ratio rose to 2.32% in March 2004 from 1.81% in December 2003, despite a sizeable Won53bn of NPL write-offs (vs 4Q03's Won55bn), led by all household, SME and card assets.

Improved earnings visibility. Daegu Bank's earnings visibility has recently improved due to its wider NIM and lower G&A expense outlook, as witnessed in 1Q04 results. This led us to cut our cost-of-equity (COE) assumption for Daegu Bank to 16% from 18%. But this is still much higher than that of major nation-wide banks such as Kookmin Bank (11.0%), Shinhan Financial Group (12.0%), Hana Bank (11%) and Koram Bank (11.5%). Questions remain over the bank's long-term competitiveness and growth potential relative to major nation-wide banks, though have eased marginally due to the bank's market expansion efforts and increasing M&A possibilities. This is also higher than Pusan Bank's 14%, which is justified by Pusan Bank's superior loan asset quality and better regional growth. The reasons are: 1) its confined business areas (mostly Daegu); 2) minimum SME loan extension requirement of up to 60% of newly financed funds; 3) a growing number of SME customers that have moved to China and Southeast Asian countries; and 4) weak cost management due to the lack of scale benefits and IT infrastructure.

Not as attractive on valuations. Foreign ownership has jumped to 50.6% from around 20% over the past 12 months. This has resulted in a narrowing of the valuation discount of Daegu Bank relative to nation-wide banks. But we believe the valuation discount of Daegu Bank to its peer banks will remain at 30%, or move higher (as experienced in the past 4 years) in the foreseeable future, in view of: 1) weak market leadership in terms of market share and market capitalisation; and 2) not-yet-strong-enough asset quality; and 3) questionable long-term growth potential.

Maintain BUY with a target price of Won7,500. Reflecting our upward earnings revision and lower COE assumption (made in the middle of April), we have raised our target price to Won7,500, from Won6,400 (on 14 April). This is based on our FY04F P/BV of 1.1x (vs the previous 0.95x), equivalent to an FY04F PER of 7.3x and an FY04F P/UP of 2.7x. The bank's dividend yield outlook, 4.1-4.8% for FY04-05F, is also not attractive enough to beat its peer banks'. Maintain HOLD.

Daegu Bank

South Korea

Share Price (Won):	7,230	**Reuters Code:**	005270.KS	**Shares Outstanding (m)**	132.125
52 Week Price Range:	4,355 -7,600	**Bloomberg Code:**	005270 KS	**Market Cap (US$m)**	824
				Won/US$ rate	1159.8

INCOME STATEMENT (Won bn)	**01**	**02**	**03**	**04E**	**05E**
Interest income	975	984	1,011	1,082	1,169
Interest expense	-633	-545	-493	-514	-554
Net interest income	**341**	**439**	**518**	**568**	**615**
Net non-interest income	88	92	96	99	109
Total operating income	**429**	**531**	**614**	**667**	**724**
SG&A	-192	-237	-262	-302	-327
Pre provision profit	**237**	**294**	**352**	**364**	**397**
Loan loss provisions	-82	-174	-211	-170	-162
Non-operating income	-125	-7	-27	0	0
Pre tax profit	**30**	**113**	**114**	**194**	**235**
Tax	0	0	-4	-58	-66
Net profit	**30**	**113**	**109**	**136**	**169**

BALANCE SHEET (Won bn)	**01**	**02**	**03**	**04E**	**05E**
Gross loans	8,286	9,017	10,313	11,222	12,223
Loan loss reserves	*141*	*150*	*176*	*172*	*179*
Net loans	*8,145*	*8,867*	*10,137*	*11,050*	*12,044*
Total earning assets	13,577	15,090	16,012	17,202	18,497
Other assets	974	931	897	928	994
Total Assets	**14,551**	**16,020**	**16,909**	**18,130**	**19,491**
Deposits	*10,456*	*11,737*	*12,649*	*13,554*	*14,623*
Other paying liabilities	2,683	2,821	2,786	2,997	3,228
Other liabilities	*853*	*750*	*670*	*729*	*793*
Total Liabilities	**13,991**	**15,308**	**16,104**	**17,228**	**18,473**
Total Equity	**560**	**712**	**805**	**901**	**1,018**

ASSET QUALITY	**01**	**02**	**03**	**04E**	**05E**
Nonperforming assets	594	466	536	567	590
NPAs/total loans	7.8%	4.9%	5.2%	5.0%	4.8%
Reserve coverage of NPAs	26.5%	33.2%	33.1%	30.6%	30.6%

PER SHARE DATA (Won)	**01**	**02**	**03**	**04E**	**05E**
EPS	255	1,023	838	1,030	1,279
DPS	0	250	250	300	400
Effective payout ratio (%)	*0%*	*24%*	*30%*	*29%*	*31%*
BVPS	4,654	5,390	6,091	6,818	7,697

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04E**	**05E**
Loan-to-deposit	79%	77%	82%	83%	84%
Equity to assets	3.9%	4.4%	4.8%	5.0%	5.2%
Tier 1 CAR	*7.56%*	*7.84%*	*8.22%*	*8.49%*	*8.84%*
Total CAR	*11.01%*	*10.85%*	*10.58%*	*10.39%*	*10.59%*

VALUATION	**01**	**02**	**03**	**04E**	**05E**
Price to book value	1.6x	1.3x	1.2x	1.1x	0.9x
Price to earnings	28.4x	7.1x	8.6x	7.0x	5.7x
Price to underlying profit	3.5x	2.7x	2.7x	2.6x	2.4x
Yield at current price (%)	0.00%	3.46%	3.46%	4.15%	5.53%

LOAN MIX	**01**	**02**	**03**	**04E**	**05E**
Consumer (%)	16.65%	23.07%	16.67%	16.17%	15.67%
Mortgage (%)	13.18%	14.56%	18.97%	19.37%	19.77%
Corporate (%)	65.09%	58.98%	60.92%	60.93%	60.94%
Other (%)	5.08%	3.38%	3.44%	3.53%	3.62%

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04E**	**05E**
Net interest margin	2.97%	3.15%	3.30%	3.35%	3.36%
Yield on assets	8.63%	7.81%	7.25%	7.20%	7.20%
Cost of liabilities	4.95%	3.67%	3.18%	3.20%	3.20%
Non-int. inc (% Op income)	20.43%	17.27%	15.57%	14.81%	15.06%
Cost to income	44.85%	44.60%	42.68%	45.37%	45.14%
Overhead	1.40%	1.55%	1.59%	1.73%	1.74%
ROA	0.22%	0.86%	0.67%	0.78%	0.90%
ROE	5.62%	20.62%	14.60%	15.96%	17.63%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04E**	**05E**
Pre-provision earnings	11%	24%	20%	4%	9%
Net profit	89%	284%	-4%	25%	24%
EPS	89%	302%	-18%	23%	24%
DPS	N/A	N/A	0%	20%	33%
Net Loans	24%	9%	14%	9%	9%
Assets	12%	10%	6%	7%	8%
Deposits	15%	12%	8%	7%	8%

Pusan Bank

Valuation discount to narrow

Rating: Buy

Doubts about long-term growth continue, but easing. Pusan Bank has a leading position in Pusan. But the bank still has little presence in neighbouring areas such as Ulsan and Kyungnam provinces, where it has been keen to expand market share by strengthening tie-ups with regional entities and extending its branch network. Moreover, increased foreign ownership amid increasing demand for the upsizing of banks should also improve Pusan Bank's profile as a long-term M&A candidate. Market doubts about its long-term growth potential should ease in view of its expanding market share and increasing M&A possibilities.

Superior asset quality with the lowest asset leverage. Pusan Bank boasts superior asset quality with not only the lowest asset leverage but also better-than-industry-average non-performing loan (NPL) and coverage ratios, though its delinquencies have increased in 1Q04, as witnessed at other banks. Pusan Bank's simple assets-to-equity ratio is the lowest, at 17.5x, vs the industry's 24.0x, and its Tier I capital ratio is the highest, at 9.3%, vs 6.7% for the industry. Its end-2003 NPL (substandard and below) and coverage ratios were 1.6% and 90%, respectively, vs the industry's 2.8% and 82%. A diversified loan mix and low non-manufacturing SME loan exposure also point to the bank's low earnings vulnerability to the credit risk cycle.

Strong profit momentum, as assumed for peer banks. We forecast the bank's net interest income will grow 10%, 10% and 9% during FY04-06, respectively, a bit faster than that of the nation-wide banks. We also expect non-interest income to rise moderately by 11%, 10% and 11%, respectively. Underlying profit (or profit before provisions and tax) should rise 16%, 9% and 10% during the same period. This, amid a sharp drop in loan-loss provisions (LLP), should lead to strong profit momentum in FY04-06, despite the lack of tax exemption benefits from FY04.

Comparison to Daegu Bank – we prefer Pusan Bank. We prefer Pusan Bank to Daegu Bank in view of its growth potential, asset quality and ROA outlook. The bank's franchise value in the region is weaker than Daegu Bank's. But this implies that the bank has a greater opportunity for market share expansion by enhancing its regional identity and brand recognition. Pusan Bank is also ahead of Daegu Bank in terms of its assets-to-equity, Tier I capital, NPL and coverage ratios. Considering credit costs (or LLP), the bank's adjusted net interest margin (NIM) should be a bit wider than Daegu Bank's. This, combined with its stronger capital base, makes Pusan Bank more attractive than Daegu Bank, in our view.

Reiterate BUY with a target price of Won8,800. Pusan Bank has traded at a 10-65% discount to the bank sector's average P/BV since FY99. The bank is now trading at an FY04F P/BV of 1.0x, a 22% discount to the banks under our coverage. We believe the valuation discount of Pusan Bank to nation-wide banks will narrow further given its superior asset quality and questionable-but-easing (to a greater extent relative to Daegu Bank) long-term growth concerns. Our target price is set at Won8,800, based on our 1.25x FY04F P/BV target, with 14.8-17.5% FY04-06F ROE and an assumed cost of equity of 14%. Based on our FY04-06 DPS forecasts of Won360, Won460 and Won580, respectively, or a payout ratio of 36-40%, the bank should also offer an attractive dividend yield of 5-8%.

Pusan Bank

South Korea

Share Price (Won):	7,430		**Reuters Code:**	005280.KS	**Shares Outstanding (m)**	146.683
52 Week Price Range:	4,700	- 7,590	**Bloomberg Code:**	005280 KS	**Market Cap (US$m)**	832
					Won/US$ rate	1159.8

INCOME STATEMENT (Won bn)	**01**	**02**	**03**	**04E**	**05E**
Interest income	908	906	915	989	1,083
Interest expense	-595	-470	-437	-462	-505
Net interest income	**313**	**436**	**478**	**527**	**579**
Net non-interest income	89	117	99	110	121
Total operating income	**402**	**553**	**577**	**637**	**700**
SG&A	-205	-241	-266	-293	-319
Pre provision profit	**197**	**311**	**311**	**344**	**382**
Loan loss provisions	-120	-111	-174	-142	-135
Non-operating income	-25	-53	-10	5	0
Pre tax profit	**52**	**148**	**126**	**207**	**246**
Tax	0	0	-5	-61	-69
Net profit	**52**	**148**	**121**	**145**	**177**

BALANCE SHEET (Won bn)	**01**	**02**	**03**	**04E**	**05E**
Gross loans	7,092	8,594	9,817	11,082	12,353
Loan loss reserves	*132*	*156*	*142*	*149*	*163*
Net loans	*6,960*	*8,438*	*9,675*	*10,933*	*12,190*
Total earning assets	5,261	5,319	5,556	5,843	6,147
Other assets	840	780	1,123	1,177	1,234
Total Assets	**13,062**	**14,537**	**16,355**	**17,953**	**19,571**
Deposits	*10,109*	*11,103*	*12,352*	*13,639*	*14,926*
Other paying liabilities	1,734	1,720	2,106	2,258	2,402
Other liabilities	*775*	*899*	*960*	*1,027*	*1,104*
Total Liabilities	**12,618**	**13,721**	**15,418**	**16,924**	**18,432**
Total Equity	**444**	**816**	**937**	**1,029**	**1,139**

ASSET QUALITY	**01**	**02**	**03**	**04E**	**05E**
Nonperforming assets	632	408	369	394	421
NPAs/total loans	9.0%	4.7%	3.8%	3.6%	3.4%
Reserve coverage of NPAs	22.0%	39.6%	38.7%	38.6%	39.4%

PER SHARE DATA (Won)	**01**	**02**	**03**	**04E**	**05E**
EPS	550	1,009	827	990	1,208
DPS	0	300	270	360	460
Effective payout ratio (%)	*0%*	*30%*	*33%*	*36%*	*38%*
BVPS	4,671	5,562	6,387	7,018	7,766

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04E**	**05E**
Loan-to-deposit	70%	77%	79%	81%	83%
Equity to assets	3.4%	5.6%	5.7%	5.7%	5.8%
Tier 1 CAR	*6.58%*	*9.21%*	*9.32%*	*9.64%*	*9.70%*
Total CAR	*10.26%*	*11.69%*	*11.66%*	*11.42%*	*11.40%*

VALUATION	**01**	**02**	**03**	**04E**	**05E**
Price to book value	1.6x	1.3x	1.2x	1.1x	1.0x
Price to earnings	13.5x	7.4x	9.0x	7.5x	6.1x
Price to underlying profit	5.5x	3.5x	3.5x	3.2x	2.9x
Yield at current price (%)	0.00%	4.04%	3.63%	4.85%	6.19%

LOAN MIX	**01**	**02**	**03**	**04E**	**05E**
Consumer (%)	21.87%	23.17%	21.94%	22.04%	22.14%
Mortgage (%)	6.81%	10.73%	12.08%	12.58%	13.08%
Corporate (%)	65.02%	61.59%	62.00%	61.75%	61.50%
Other (%)	6.29%	4.51%	3.98%	3.63%	3.28%

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04E**	**05E**
Net interest margin	2.87%	3.39%	3.22%	3.27%	3.29%
Yield on assets	8.79%	7.82%	7.20%	7.11%	7.14%
Cost of liabilities	5.13%	3.77%	3.33%	3.22%	3.23%
Non-int. inc (% Op income)	22.07%	21.15%	17.13%	17.25%	17.31%
Cost to income	50.93%	43.68%	46.14%	46.00%	45.50%
Overhead	1.64%	1.85%	1.93%	1.90%	1.86%
ROA	0.42%	1.07%	0.79%	0.85%	0.94%
ROE	12.30%	23.50%	13.84%	14.78%	16.35%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04E**	**05E**
Pre-provision earnings	67%	58%	0%	11%	11%
Net profit	412%	183%	-18%	20%	22%
EPS	412%	83%	-18%	20%	22%
DPS	N/A	N/A	-10%	33%	28%
Net Loans	21%	21%	15%	13%	12%
Assets	10%	11%	13%	10%	9%
Deposits	11%	10%	11%	10%	9%

Korea – Brokers

Need domestic drivers

Rating: UNDERWEIGHT

Overview

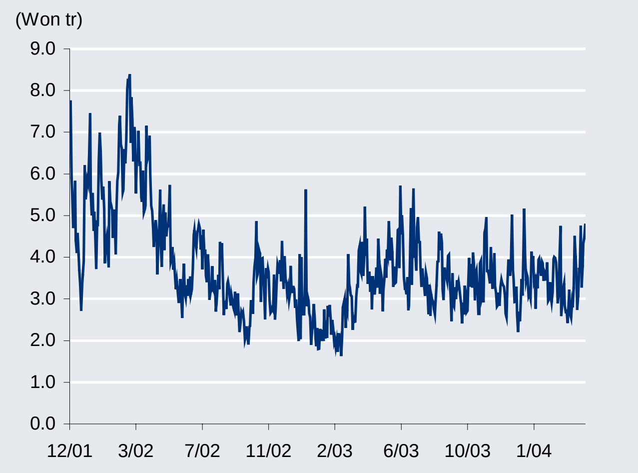
We remain cautious on the Korean brokerage sector on the back of limited participation in the market by domestic investors, intensifying competition, and expected difficulties in diversifying earnings away from brokerage commissions. Sector valuations are not overly attractive, currently at an FY3/05F P/BV of 0.9x with an ROE outlook of 6.8%. We maintain our view that until we see domestic investors return to the market and a subsequent rise in market trading value, it will be very difficult for the Korean brokerage sector to see a sustainable re-rating.

Based on this type of outlook, we recommend investors to focus on company-specific issues that could translate into higher valuation multiples. Our top pick in the sector is Hyundai Securities, as easing uncertainties over its HITC recap burden are expected to translate into a further contraction in its valuation discount relative to the sector. We also like Daishin Securities' preferred shares given the attractive dividend yield and steep discount to the common shares.

Domestic investors – still a no-show

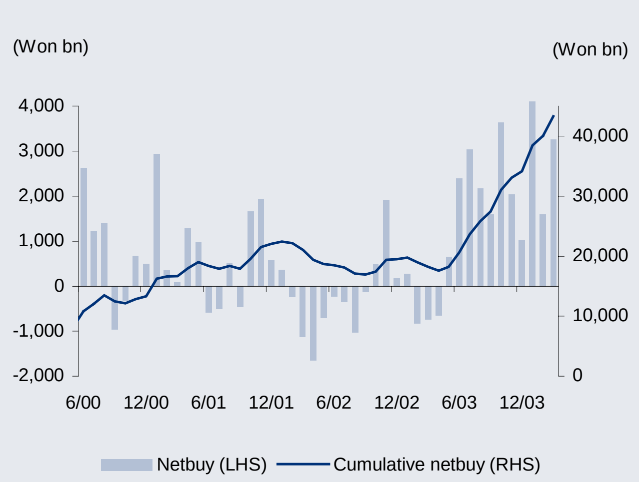
While combined daily market trading value has recovered from its low of Won2.5tr in March last year, it has had a very difficult time staying above Won3.6tr for a consistent period of time. We attribute this to domestic investors not participating in the market. As the following charts show, foreign investors have been huge net buyers in the Korean market, while domestic retail and institutional investors have continued to sell down. Until we see domestic investors become more active in the domestic market, we believe it will be very difficult for market trading value to rise to over Won4tr for a sustainable period of time.

Fig 122 Daily market trading value



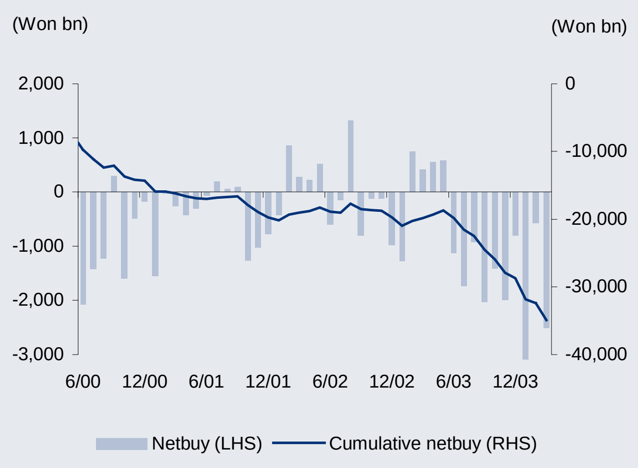
Source: KSE and KOSDAQ

Fig 123 Foreign net buying trend



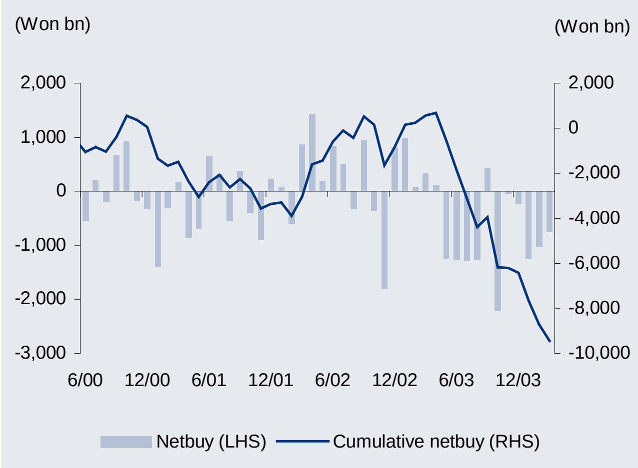
Source: KSE and KOSDAQ

Fig 124 Domestic institutional net buying trend



Source: KSE and KOSDAQ

Fig 125 Domestic retail net buying trend



Source: KSE and KOSDAQ

We attribute the lack of participation in the market by domestic investors to issues related to confidence in the domestic economy, a still large amount of outstanding credit card debt and continued interest in the real estate market. We are forecasting a gradual recovery in market trading value going forward (Won3.8tr in FY3/05 vs Won3.5tr in FY304), but we remain cautious on the extent to which and the speed at which domestic investors will become more active in the market. Assuming retail investors do return to the market, average daily trading value could rise to Won5~6tr. This would likely push up industry P/BV valuations to 1.5~2.0x.

Growing M&A speculation

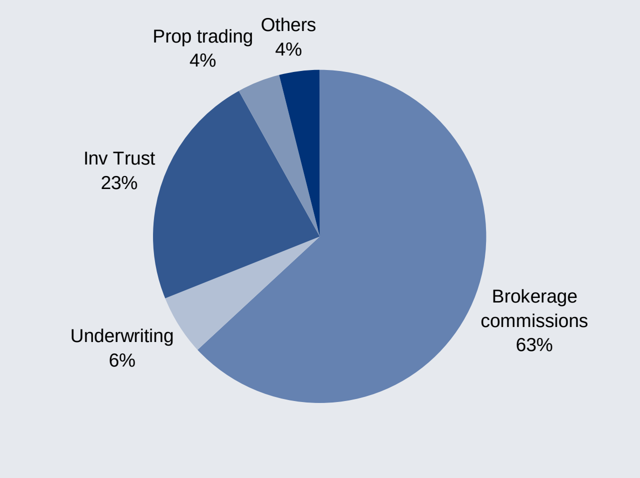
The M&A theme has gained momentum in the Korean brokerage industry this year, as creditor banks plan to sell a 21.2% stake in LG Inv & Sec to a third party. Various banks appear to be interested in purchasing certain brokerages as part of their longer-term holding company strategies. However, we question whether banks will pay the types of premiums that the sellers are looking for (P/BV of +1.5x). We do not foresee mergers between any of the major brokerages themselves, given the limited synergies that would be realised (ie, would be unable to cut labour costs, which is a brokerage firm's largest expense item). As such, we do not foresee major industry consolidation taking place anytime soon (currently 44 brokerages in Korea), meaning that competition is expected to remain very intense.

The one domestic brokerages that is currently up for sale is LG Inv & Sec. The LG Group has effectively transferred its 21.2% stake in LG Inv & Sec to creditor banks, which plan to auction off the company to potential buyers, with a large portion of the funds from sale going towards LG Card support. Daewoo Securities has been up for sale for a few years now, but it appears that the KDB (owns a 39.1% stake in Daewoo) wants to keep its stake and include Daewoo under a holding company structure. While there does appear to be interested parties in LG Inv & Sec (including Woori Finance Group), we do not foresee potential suitors paying outrageously high premiums over book value for them, even when taking into consideration a management control premium.

Uphill battle to diversify earnings

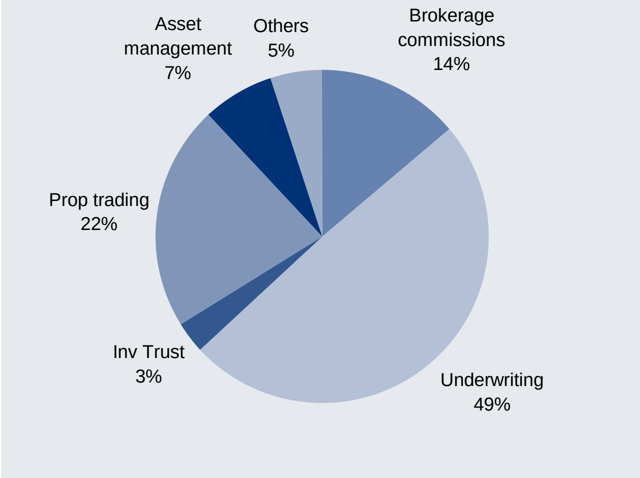
Most Korean brokerage firms continue to focus on diversifying their earnings stream away from brokerage commissions to more value-added services, especially in the area of asset management. As the following chart shows, Korean brokerages are still very dependent on straight brokerage commissions, which account for close to 63% of their operating revenue (vs 14% in the US). Hence, the strong correlation between sector P/BV and market trading value for Korean brokerage shares.

Fig 126 Operating revenue breakdown (Korea)



Source: KSDA

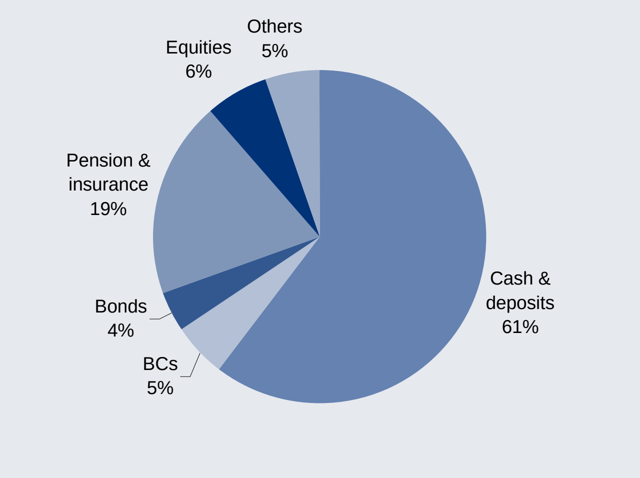
Fig 127 Operating revenue breakdown (US)



Source: Industry data

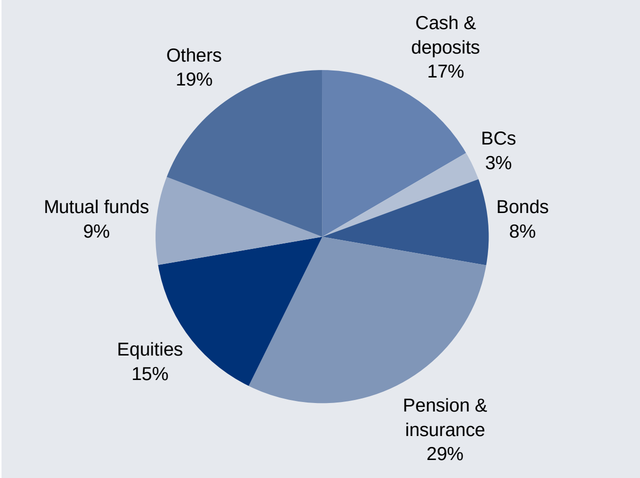
The asset management market in Korean is still very much underdeveloped, as Korean society overall remains very uncomfortable with other people managing its money. More importantly, the investment mentality in Korea is still very much short-term oriented. However, the asset management market in Korea does hold enormous longer-term potential, as 61% of Korean household assets are still in cash and deposits, vs 17% in the US, which has a much more developed asset management market.

Fig 128 Korean financial assets breakdown



Source: BOK

Fig 129 US financial assets breakdown



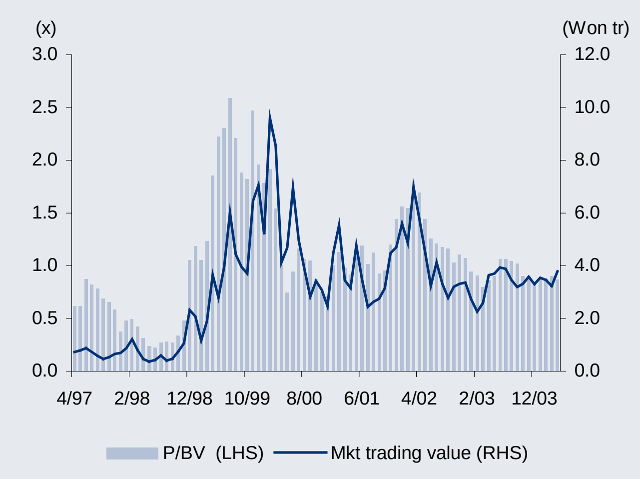
Source: Industry data

Despite the positive long-term outlook for the domestic asset management industry, we remain sceptical how much of this pie will go to the brokerages, as banks, insurance companies and foreign money management firms are all becoming more aggressive in their asset gathering efforts as well. As such, we believe it will be very difficult for the independent brokerages to compete, especially vs the financial holding companies, which are able to cross sell products and share client information.

Valuations

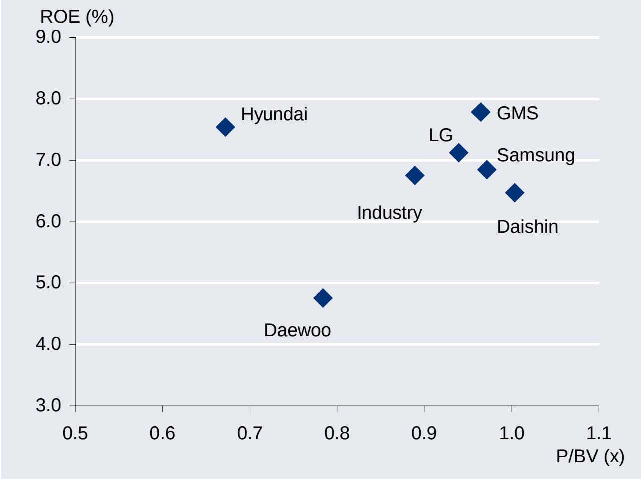
The Korean brokerage sector is currently trading at an FY3/05F P/BV of 0.9x with a prospective ROE of 6.8%, which is not compelling, in our opinion. If the sector was generating an ROE of 13~15%, then valuations would be far more appealing. But, in order for a Korean brokerage to generate this type of return, we estimate that market trading value would have to rise to Won5~6tr for an extended period of time (vs the current average of Won3.7tr). In order to reach this level of market trading value, there would have to be a significant increase in retail investor participation in the market than there currently is. However, we are still not convinced that retailers will return to the market in size anytime soon, or for a prolonged period of time, thus making it difficult to see a re-rating of the sector. As the figure below shows, there is a very strong correlation between market trading value and brokerage sector P/BV. This stems from the fact that Korean brokerages are still very dependent on brokerage commissions for a portion of their business (63% of operating revenue).

Fig 130 Sector 1yr fwd P/BV vs mkt trading value



Source: Company data, ING estimates

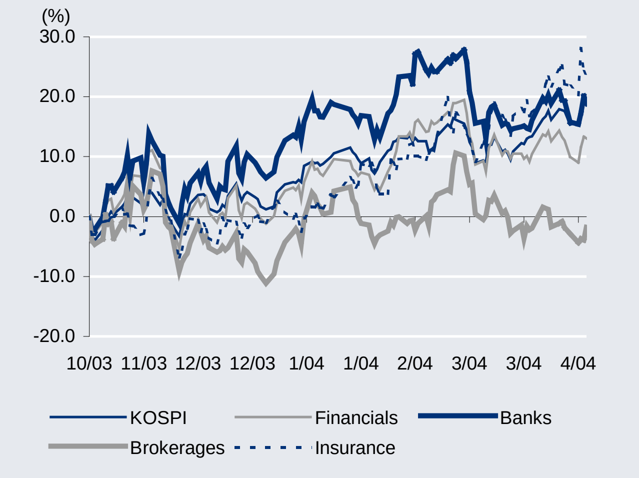
Fig 131 Sector valuations



Source: Company data, ING estimates

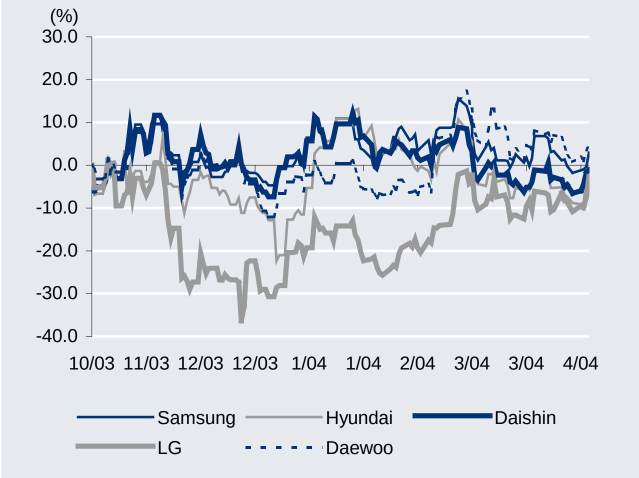
Despite the strong performance of the KOSPI over the past six-month period (+18.6%), and a recovery in the financial sector index (+13.1%), the Korean brokerage sector has continued to be a major underperformer (-1.8%). As we mentioned previously, we attribute this weak performance to limited domestic participation in the market (KOSPI performance driven almost entirely by foreign buying) and continued stiff competition. In terms of sector performance, there has been no clear outperformer in the sector.

Fig 132 Financial sector performance



Source: Bloomberg

Fig 133 Brokerage sector performance



Source: Bloomberg

Our top picks

Hyundai Securities remains one of our top picks in the Korean brokerage sector. Despite easing concerns over its HITC recap burden, the shares are still trading at a steep discount to the sector (FY3/05 P/BV of 0.7x vs 0.9x), which we believe is unjustified. Our BUY recommendation on Hyundai is not dependent on the return of the retail investor or the KOSPI rising to over the 1,000 level. Rather it is based on the view that the disappearance of the HITC issue should lead to a re-rating over the medium term. Our 12-month target price of Won8,000 is based on an FY3/05F P/BV of 0.9x.

Daishin Securities (preferred shares) is our other top pick in the sector given the attractive dividend yield (6.2%) and steep share price discount to the common shares (48.9%). We are looking for Daishin's net profit to continue to show steady growth going forward, and given that most provisioning for troubled affiliates has been completed, we believe management will have more flexibility to either increase its dividend and/or initiate another share buyback and cancellation going forward. We believe the best way to play this potential scenario is via the preferred shares, which have decent liquidity (150-day trading value of US$1.8m).

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Hyundai Securities

A new beginning

Rating: BUY

Hyundai Securities is one of our top picks in the Korean brokerage sector, as we believe easing uncertainties over its HITC (Hyundai Investment Trust & Securities Co.) recap burden will translate into a further contraction in its valuation discount relative to its peers. Hyundai is currently trading at an FY3/05F P/BV of 0.7x vs the sector's 0.9x and Samsung's 1.0x. Our target price of Won8,000 is based on an FY3/05F P/BV of 0.9x.

Hyundai Securities' HITC recap burden is roughly Won205.1bn, which will translate into a net loss of roughly Won197.9bn for FY3/04. However, we believe closure of the HITC saga is positive in the medium term for three key reasons. Firstly, it is expected to translate into improved sentiment toward Hyundai Securities, translating into a higher valuation multiple. Secondly, Hyundai Securities will likely get approval from the regulators to enter into new businesses, including OTC products (ie, equity linked securities) and discretionary wrap accounts. This will help the company further diversify its earnings stream away from brokerage commissions. Finally, Hyundai Securities' HITC recap burden is expected to translate into around Won60.9bn in tax benefits, which the company plans to realise over the next five years.

Prudential Financial has finally agreed to purchase an 80% stake in HITC for Won355.5bn. The purchase will also give Prudential control over HITMC (Hyundai Investment Trust Management Co.), which is 95.9% owned by HITC. We were previously cautious on Hyundai Securities given concerns over the potential size of its HITC recap burden and the resulting share dilution. However, now that these issues are out in the market, we feel more comfortable with the implications for Hyundai's earnings outlook and valuations.

Hyundai Merchant Marine was not allowed to participate in Hyundai Securities' recent rights issue. As such, the company' stake in the company declined to 12.7%. While Hyundai Securities is not officially up for sale, declining Hyundai Group ownership is the company should be viewed as a positive and could potentially spark M&A interest in the company.

Our BUY recommendation on Hyundai Securities is not dependent on a turnaround in market trading value and/or an increase in domestic participation in the market. Rather, our BUY recommendation is based on an expected contraction in Hyundai's valuation discount relative to the sector as its HITC recap uncertainties subside. We are forecasting a gradual recovery in daily market trading value in Korea, but even if this were not to materialise, we would still remain upbeat on Hyundai Securities' shares given the potential for further expansion in valuation multiples.

Hyundai Securities

Korea

Share Price:	6,080	**Reuters Code:**	003450.KS	**Shares Outstanding (m)** 139.353
52 Week Price Range:	4,158 -8,147	**Bloomberg Code:**	003450 KS	**Market Cap (US$m)** 730.53
				Won/US$ exchange rate: 1159.8

INCOME STATEMENT	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
Revenue	1,072.7	687.8	681.3	721.9	749.0
Commissions	553.7	405.4	364.3	396.0	433.1
Interest & dividends	151.8	103.3	49.6	54.6	60.0
Securities-related gains	273.6	71.7	218.7	229.6	218.1
Derivatives & others	93.7	107.5	48.8	41.8	37.8
Costs & expenses	924.5	736.2	557.0	589.1	600.9
Commissions	36.3	34.8	21.9	23.8	26.0
Financing expenses	98.7	65.5	45.9	42.6	44.8
Securities realted losses	320.5	172.3	102.8	137.8	139.6
Derivatives & other	73.5	84.9	42.0	31.7	28.5
G&A expenses	395.5	378.6	344.6	353.2	362.0
Net revenue	543.7	330.3	468.9	486.0	510.1
Operating profit	148.2	-48.4	124.3	132.9	148.1
Non-operaitng items	-14.6	-27.4	-259.0	-19.9	-18.8
Recurring profit	133.6	-75.8	-134.7	113.0	129.3
Pre-tax profit	37.3	-76.8	-134.7	113.0	129.3
Taxes	18.1	-17.0	40.8	21.4	23.4
Net profit	19.2	-59.7	-175.6	91.6	105.9

BALANCE SHEET	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
Current assets	3,049.3	2,506.4	2,201.3	2,040.9	2,142.9
Cash & deposits	2,314.5	1,588.5	1,503.1	1,307.7	1,373.1
Marketable securities	539.4	675.0	472.5	496.1	520.9
Others	195.4	242.9	225.8	237.0	248.9
Investment & other	379.3	306.0	264.1	275.0	286.3
Fixed assets	489.5	482.3	410.0	434.6	460.6
Total assets	3,918.1	3,294.7	2,875.4	2,750.4	2,889.8
Current liabilities	2,627.7	1,904.0	1,696.0	1,478.9	1,511.9
Long term liabilities	7.9	199.9	10.0	10.5	11.0
Total liabilities	2,635.6	2,103.9	1,706.0	1,489.4	1,523.0
Paid-in capital	536.0	536.0	696.8	696.8	696.8
Capital surplus	641.4	641.4	641.4	641.4	641.4
Retained earnings	118.9	59.1	(116.4)	(24.8)	81.1
Capital adjustment	(13.7)	(45.7)	(52.3)	(52.3)	(52.3)
Shareholders equity	1,282.5	1,190.8	1,169.4	1,261.0	1,366.9

NET REV BREAKDOWN (%)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
Net commissions	95.2	112.2	73.0	76.6	79.8
Net interest	9.8	11.4	0.8	2.4	3.0
Net securities gains	-8.6	-30.5	24.7	18.9	15.4
Net derivatives & others	3.7	6.8	1.4	2.1	1.8

PER SHARE DATA (HK$)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
EPS	179	(557)	(1,579)	657	760
DPS	350	0	0	0	0
Effective payout ratio (%)	*195%*	*0%*	*0%*	*0%*	*0%*
BVPS	11,964	11,109	8,391	9,049	9,809
BCPS	4,116	1,787	1,794	1,949	2,127

KEY RATIOS (%)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
G&A ratio	36.9%	55.0%	50.6%	48.9%	48.3%
Operating margin	13.8%	-7.0%	18.2%	18.4%	19.8%
Net margin	1.8%	-8.7%	-25.8%	12.7%	14.1%

VALUATION	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
Price to book value	0.6x	0.6x	0.7x	0.7x	0.6x
Price to earnings	38.4x	N/A	N/A	9.2x	8.0x
Yield at current price (%)	5.1%	0.0%	0.0%	0.0%	0.0%
Price to brokerage comm per sha	1.7x	3.9x	3.4x	3.1x	2.9x

PROFITABILITY RATIOS (%)	**FY302**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
ROA	0.5%	-1.7%	-5.7%	3.3%	3.8%
ROE	1.5%	-4.8%	-14.9%	7.5%	8.1%

GROWTH RATES (%,YoY)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
Net revenue	10.1%	-39.2%	42.0%	3.7%	5.0%
Net commissions	-18.9%	-28.4%	-7.6%	8.7%	9.4%
Net interest	24.4%	-28.7%	-90.1%	218.6%	27.9%
G&A expenses	-24.5%	-4.3%	-9.0%	2.5%	2.5%
Operating profit	T/P	T/N	T/P	6.9%	11.5%
Net profit	T/P	T/N	N/A	T/P	15.6%

Samsung Securities Looking for a catalyst

Rating: HOLD

Samsung Securities is one of Korea's leading brokerage firms. While its operations are still heavily dependent on brokerage commissions, the company has been actively trying to diversify its operations toward higher margin products, including client asset management. The company has begun to make inroads in this area, but brokerage commissions still account for 47.4% of its net revenue.

One area Samsung is beginning to make significant progress in is its discretionary wrap account business. Discretionary wrap accounts are products where professional money managers, based on discretionary contracts with clients, structure and manage customised investment portfolios according to client needs. Samsung started offering discretionary wrap accounts in the later part of 2003, and assets are now over Won820bn. The company expects its wrap account asset size to reach Won3tr by year-end, which would translate into a rough market share of 60%. Most of the funds flowing into Samsung's discretionary wrap accounts are not new money, but rather money leaving investment trust products. However, this is still a positive development for Samsung, as it is able to keep client assets within the firm, and is able to generate a much higher margin on wrap account assets vs investment trust assets. 3Q03 wrap account commissions rose to Won2.1bn vs Won0.4bn in 2Q03 and Won0.6bn in 3Q02. While this is still a very small portion of Samsung's net revenue (1.3%), the company is beginning to make inroads in this higher margin business.

Two things that we would like to see out of Samsung Securities is greater efforts to lower costs and to improve overall shareholder value. Samsung's labour costs rose dramatically last year as it increased wages in relation to its strategy shift away from a focus on brokerage commissions to client asset management services. However, this move appears to have been a little premature given that the asset management market in Korea is still very much in the development stages. Hence, it translated into lost market share on the brokerage side of the business, and a much higher cost base. In terms of improving shareholder value, the company did begin paying a dividend again last year, but we believe a lot more aggressive measures could be taken to deal with its overcapitalisation.

We are still cautious on the Korean brokerage sector, and believe it will be very difficult for the sector to see a sustainable re-rating without domestic investor participation in the market – there are still no signs of this. As such, we prefer brokerage shares with company specific issues that could translate into a re-rating (ie, Hyundai Securities and its HITC recap and Daishin Securities' preferred shares given attractive dividend yield and steep discount to the common shares). We do not see any such catalyst for Samsung Securities at this point. Samsung is currently trading at an FY3/05F P/BV of 1.0x, with a prospective ROE of 6.8%, which we do not view as overly attractive. Our target price of Won28,200 is based on an FY3/05F P/BV multiple of 1.1x.

Samsung Securities
Korea

Share Price:	25,600	**Reuters Code:**	016360.KS	**Shares Outstanding**	66.8352
52 Week Price Range:	22,350 -32,900	**Bloomberg Code:**	016360 KS	**Market Cap (US$m)**	1,475.24
				Won/US$ exchange rate:	1159.8

INCOME STATEMENT	FY3/02	FY3/03	FY3/04F	FY3/05F	FY3/06F
Revenue	1,087.7	856.8	1,091.2	1,085.1	1,107.1
Commissions	666.9	526.4	502.9	545.1	592.3
Interest & dividends	211.2	172.5	98.3	103.2	108.4
Securities-related gains	167.8	110.6	409.1	347.7	313.0
Derivatives & others	41.8	47.3	80.9	89.0	93.4
Costs & expenses	973.3	779.3	951.6	933.6	941.1
Commissions	35.0	25.2	23.4	25.3	27.5
Financing expenses	73.1	86.9	64.7	68.0	71.4
Securities realted losses	374.3	133.3	355.9	300.8	270.7
Derivatives & other	45.2	15.8	36.3	40.0	42.0
G&A expenses	445.8	517.8	471.2	499.5	529.5
Net revenue	560.1	595.8	610.8	651.0	695.5
Operating profit	114.4	78.0	139.6	151.5	166.0
Non-operaitng items	-10.0	11.2	29.8	15.9	16.0
Recurring profit	104.4	89.2	169.4	167.4	182.0
Pre-tax profit	104.4	89.2	169.3	167.4	182.0
Taxes	47.0	31.6	57.5	49.7	50.1
Net profit	57.4	57.5	111.7	117.7	132.0

BALANCE SHEET	FY3/02	FY3/03	FY3/04F	FY3/05F	FY3/06F
Current assets	4,341.6	4,351.5	5,135.1	5,274.5	5,418.0
Cash & deposits	2,462.4	2,139.3	2,032.3	2,072.9	2,114.4
Marketable securities	1,570.1	2,075.3	2,739.3	2,821.5	2,906.2
Others	309.1	137.0	363.4	380.0	397.4
Investment & other	335.1	349.2	357.9	375.8	394.6
Fixed assets	442.7	361.0	324.9	334.6	344.7
Total assets	5,119.3	5,061.7	5,817.8	5,984.9	6,157.2
Current liabilities	3,571.4	3,444.8	4,116.3	4,198.4	4,288.1
Long term liabilities	10.1	17.7	24.7	25.5	26.2
Total liabilities	3,581.6	3,462.4	4,141.0	4,223.8	4,314.3
Paid-in capital	346.2	346.2	346.2	346.2	346.2
Capital surplus	1,137.3	1,137.3	1,137.3	1,137.3	1,137.3
Retained earnings	410.3	106.6	184.8	269.1	351.0
Capital adjustment	(355.9)	9.3	8.5	8.5	8.5
Shareholders equity	1,537.8	1,599.3	1,676.8	1,761.1	1,842.9

NET REV BREAKDOWN (%)	FY3/02	FY3/03	FY3/04F	FY3/05F	FY3/06F
Net commissions	112.8	84.1	78.5	79.8	81.2
Net interest	24.7	14.4	5.5	5.4	5.3
Net securities gains	-36.9	-7.4	8.7	7.2	6.1
Net derivatives & others	-0.6	8.9	7.3	7.5	7.4

PER SHARE DATA (HK$)	FY3/02	FY3/03	FY3/04F	FY3/05F	FY3/06F
EPS	774	855	1,671	1,761	1,975
DPS	0	500	500	500	750
Effective payout ratio (%)	*0%*	*58%*	*30%*	*28%*	*38%*
BVPS	22,212	23,772	25,088	26,349	27,574
BCPS	5,932	5,196	4,948	5,422	5,867

KEY RATIOS (%)	FY3/02	FY3/03	FY3/04F	FY3/05F	FY3/06F
G&A ratio	41.0%	60.4%	43.2%	46.0%	47.8%
Operating margin	10.5%	9.1%	12.8%	14.0%	15.0%
Net margin	5.3%	6.7%	10.2%	10.8%	11.9%

VALUATION	FY3/02	FY3/03	FY3/04F	FY3/05F	FY3/06F
Price to book value	1.3x	1.2x	1.1x	1.1x	1.0x
Price to earnings	36.2x	32.7x	16.6x	15.4x	13.3x
Yield at current price (%)	0.0%	1.8%	1.8%	1.8%	2.7%
Price to brokerage comm per sha	4.7x	5.4x	4.4x	4.0x	3.6x

GROWTH RATES (%,YoY)	FY3/02	FY3/03	FY3/04F	FY3/05F	FY3/06F
Net revenue	-18.9%	6.4%	2.5%	6.6%	6.8%
Net commissions	-2.9%	-20.7%	-4.3%	8.4%	8.7%
Net interest	18.3%	-38.0%	-60.8%	5.0%	5.0%
G&A expenses	12.0%	16.2%	-9.0%	6.0%	6.0%
Operating profit	-60.9%	-31.8%	79.1%	8.5%	9.6%
Net profit	-70.5%	0.3%	94.2%	5.4%	12.1%

PROFITABILITY RATIOS (%)	FY302	FY3/03	FY3/04F	FY3/05F	FY3/06F
ROA	1.3%	1.1%	2.1%	2.0%	2.2%
ROE	3.8%	3.7%	6.8%	6.8%	7.3%

Daishin Securities Focus on the pref shares

Rating: HOLD

Daishin Securities is one of Korea's purest brokerage plays, as its earnings are heavily geared toward domestic retail investors – brokerage commissions account for 71.8% of total net revenue. As such, operations (and share price) are very much influenced by the direction of market trading value and domestic retail investor activity. Daishin has also been aggressively trying to clean up its bad assets, and has now finished the majority of its provisioning requirements. Finally, management has become more proactive in trying to improve shareholder value by increasing dividends as well as implementing a share buyback and cancellation. Most of these positives appear to have been reflected in its valuations already, as the shares are currently trading at an FY3/05F P/BV of 1.0x, with a prospective ROE of 6.5%. Our target price of Won18,200 is based on an FY3/05F P/BV of 1.1x.

We prefer Daishin Securities' preferred shares over the common shares. Firstly, the dividend yield on the preferred shares is 6.2% vs 2.9% for the common, assuming no increase in its FY3/04 dividend payment. Secondly, the preferred shares are trading at a steep discount (48.9%) to the common shares with decent liquidity (150-day average daily trading value of US$1.8m). In addition, given the continued gradual improvement in Daishin's net profit over the next few years, along with limited provisioning requirements, there is a growing possibility its dividend payment may be raised. While the company has not provided any guidance on this year's dividend, it maintains that its dividend payment is key to management efforts to improve shareholder value.

One longer-term concern we have with Daishin is that the industry is shifting (or at least trying to shift) from a brokerage commission-based business model toward a more asset management-type model. However, this is one area where Daishin Securities is very weak. While management is indicating it will continue to gradually focus on offering asset management related products, it stresses that its bread-and-butter business will remain retail and institutional brokerage. While this will be positive for earnings in a market upturn driven by domestic investors, it will translate into huge swings in earnings over the longer term. Such earnings volatility will effectively put a cap on its valuation multiple relative to its larger peers, which are being more proactive in diversifying their earnings streams.

Daishin's earnings are highly geared to market trading value, and we remain sceptical that domestic investors will return to the market anytime soon. As such, we believe it will be difficult for the shares to see a sustainable re-rating in the immediate future. That said, one potential non-operational share price catalyst would be a higher-than-expected dividend and/or the implementation of another share buyback and cancellation.

Daishin Securities

Korea

Share Price:	17,300 (Comm)	9,980 (Pref)	**Reuters Code:**	003540.KS	**Shares Outstanding (m)**	48.5864
52 Week Price Range:	14,650 - 23,600		**Bloomberg Code:**	003540 KS	**Market Cap (US$m)**	724.73
					Won/US$ exchange rate:	1159.8

INCOME STATEMENT	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
Revenue	638.3	479.7	432.1	455.3	482.7
Commissions	409.7	316.9	291.3	317.2	342.1
Interest & dividends	122.5	111.1	55.0	60.5	66.5
Securities-related gains	40.1	39.5	83.3	75.0	71.3
Derivatives & others	66.1	12.2	2.5	2.6	2.8
Costs & expenses	648.1	409.7	324.9	337.8	352.1
Commissions	42.3	29.8	24.3	26.5	28.6
Financing expenses	39.0	36.8	21.5	20.4	19.4
Securities realted losses	86.2	46.5	24.7	26.3	24.9
Derivatives & other	6.1	3.9	2.7	2.8	2.9
G&A expenses	474.5	292.8	251.8	261.8	276.2
Net revenue	464.7	362.8	359.0	379.4	406.8
Operating profit	-9.8	70.0	107.2	117.5	130.6
Non-operaitng items	34.5	-14.2	-22.1	-1.2	-1.2
Recurring profit	24.7	55.9	85.1	116.4	129.4
Pre-tax profit	24.7	55.9	85.1	116.4	129.4
Taxes	11.3	13.5	24.8	34.6	35.6
Net profit	13.4	42.3	60.3	81.8	93.8

BALANCE SHEET	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
Current assets	2,347.1	1,643.4	1,644.6	1,724.4	1,808.2
Cash & deposits	1,746.1	977.7	879.9	923.9	970.1
Marketable securities	343.6	547.4	531.0	557.6	585.4
Others	257.4	118.3	233.6	242.9	252.6
Investment & other	467.5	359.8	375.5	395.0	415.6
Fixed assets	637.0	575.1	546.3	573.6	602.3
Total assets	3,451.6	2,578.3	2,566.4	2,693.1	2,826.0
Current liabilities	2,144.5	1,332.9	1,289.5	1,368.2	1,440.7
Long term liabilities	72.0	23.5	35.3	38.8	42.7
Total liabilities	2,216.5	1,356.4	1,324.9	1,407.0	1,483.5
Paid-in capital	373.9	373.9	373.9	373.9	373.9
Capital surplus	610.4	610.4	610.4	610.4	610.4
Retained earnings	281.9	281.4	304.5	349.0	405.5
Capital adjustment	(31.1)	(43.8)	(47.3)	(47.3)	(47.3)
Shareholders equity	1,235.1	1,221.9	1,241.5	1,286.0	1,342.6

NET REV BREAKDOWN (%)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
Net commissions	79.1	79.1	74.4	76.6	77.1
Net interest	18.0	20.5	9.3	10.6	11.6
Net securities gains	-9.9	-1.9	16.3	12.9	11.4
Net derivatives & others	12.9	2.3	0.0	0.0	0.0

PER SHARE DATA (HK$)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
EPS	180	567	809	1,097	1,258
DPS	500	500	500	500	500
Effective payout ratio (%)	*278%*	*88%*	*62%*	*46%*	*40%*
BVPS	16,515	16,382	16,645	17,242	18,000
BCPS	5,108	4,065	3,781	4,132	4,458

KEY RATIOS (%)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
G&A ratio	74.3%	61.0%	58.3%	57.5%	57.2%
Operating margin	-1.5%	14.6%	24.8%	25.8%	27.1%
Net margin	2.1%	8.8%	14.0%	18.0%	19.4%

VALUATION	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
Price to book value	1.0x	1.1x	1.0x	1.0x	1.0x
Price to earnings	96.3x	30.5x	21.4x	15.8x	13.8x
Yield at current price (%)	2.9%	2.9%	2.9%	2.9%	2.9%
Price to brokerage comm per sha	3.4x	4.3x	4.6x	4.2x	3.9x

GROWTH RATES (%,YoY)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
Net revenue	-91.6%	-21.9%	-1.0%	5.7%	7.2%
Net commissions	-14.3%	-21.8%	-7.0%	8.9%	7.9%
Net interest	-23.7%	-11.0%	-54.9%	19.6%	17.7%
G&A expenses	27.0%	-38.3%	-14.0%	4.0%	5.5%
Operating profit	T/N	T/P	T/P	9.6%	11.1%
Net profit	-84.6%	215.1%	N/A	T/P	14.7%

PROFITABILITY RATIOS (%)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
ROA	0.5%	1.4%	2.3%	3.1%	3.4%
ROE	1.1%	3.4%	4.9%	6.5%	7.1%

LG Inv & Sec

M&A valuation not warranted

Rating: HOLD

Creditor banks are currently in the process of selling a 21.2% stake in LG Inv & Sec, with part of the funds going to support LG Card. Creditor banks are planning to hold an auction and choose a preferred bidder and finalise a deal by end-1H this year. There are reportedly numerous parties interested in purchasing this stake, including Woori Finance Holdings and Mirae Asset.

Creditor banks are hoping to sell a 21.2% stake in LG Inv & Sec for approximately Won550bn. Won200bn of this amount will go to the original LG Group holders of the stake in LG Inv & Sec (excluding the Koo family), which is based on the market price of the company when they transferred ownership to the creditor banks. The remaining Won350bn in 'premium' is to go to LG Card as part of its bail-out package. We roughly estimate that a Won350bn premium for a 21.2% stake in LG Inv & Sec translates into a share price of +Won20,000, which we believe is an overly aggressive target (translates into a P/BV of +2.0x). Hence, there are likely to be delays and further uncertainties regarding the sale of LG Inv & Sec, and this is one reason why we have not been upbeat on the shares.

Most of LG Inv & Sec's LG Card charges are expected to be realised in FY3/04, which is why we are forecasting net profit to turn negative to Won3.4bn. However, LG Card will no longer be a burden for LG Inv & Sec via equity method accounting.

The big question is where LG Inv & Sec's valuations would go if it were eventually sold. If LG Inv & Sec is taken over by a bank and included in a financial holding company, we could eventually see its P/BV go over 1.0x (assuming no change in market trading value). The reason being that under a financial holding company structure, LG Inv & Sec would be able to cross-sell products and share customer information with other financial affiliates in that holding company. If LG Inv & Sec were to remain independent or merged with another brokerage, it would not be able to realise these benefits.

Longer term, there is potential to see a gradual expansion in LG Inv & Sec's valuation multiple. However, this is dependent on not only the company being sold, but also it being sold to a bank that can put it inside a financial holding company. Given that the shares are trading in line with the industry average, and the uncertainties regarding the sale and a potential buyer, we believe it is still too early to recommend LG Inv & Sec. Our target price of Won11,400, is based on an FY3/05 target P/BV multiple of 1.0x.

LG Investment & Securities — Korea

Share Price:	10,700 (Comm)	4,490	(Pref)	**Reuters Code:**	005940.KS	**Shares Outstanding (m)**	122.116
52 Week Price Range:	7,140	- 15,300		**Bloomberg Code:**	005940 KS	**Market Cap (US$m)**	1,126.61
						Won/US$ exchange rate:	1159.8

INCOME STATEMENT	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
Revenue	1,089.3	899.9	896.5	901.5	925.3
Commissions	458.1	401.9	363.9	384.1	413.3
Interest & dividends	289.3	208.7	181.5	190.6	200.1
Securities-related gains	120.7	74.1	161.0	144.9	137.6
Derivatives & others	221.3	215.3	190.1	181.9	174.2
Costs & expenses	951.2	768.6	707.0	721.6	727.9
Commissions	43.5	36.9	33.1	35.0	37.6
Financing expenses	172.6	138.3	105.1	110.3	115.9
Securities realted losses	104.0	82.2	138.4	130.4	123.9
Derivatives & other	175.9	137.1	116.0	125.2	118.6
G&A expenses	455.2	372.1	314.4	320.7	332.0
Net revenue	593.3	503.5	503.9	500.7	529.3
Operating profit	138.1	131.4	189.4	179.9	197.3
Non-operaitng items	65.5	-55.0	-194.3	-18.4	-16.6
Recurring profit	203.6	76.3	-4.9	161.5	180.8
Pre-tax profit	203.6	76.3	-4.9	161.5	180.8
Taxes	67.0	24.2	-1.5	48.0	49.7
Net profit	136.6	52.1	-3.4	113.5	131.1

BALANCE SHEET	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
Current assets	4,655.5	3,802.4	3,480.0	3,654.0	3,836.7
Cash & deposits	2,654.7	1,833.1	1,503.1	1,578.3	1,657.2
Marketable securities	1,019.6	1,056.5	958.4	1,006.3	1,056.6
Others	981.3	912.8	1,018.4	1,069.4	1,122.8
Investment & other	1,573.3	1,184.9	1,230.9	1,269.2	1,309.0
Fixed assets	354.0	343.4	179.4	183.0	186.6
Total assets	6,582.9	5,330.7	4,890.3	5,106.2	5,332.3
Current liabilities	4,920.9	3,840.7	3,129.5	3,231.8	3,326.9
Long term liabilities	171.9	21.9	223.3	223.3	223.3
Total liabilities	5,092.8	3,862.6	3,352.8	3,455.1	3,550.2
Paid-in capital	724.8	724.8	724.8	724.8	724.8
Capital surplus	729.6	726.7	733.4	733.4	733.4
Retained earnings	72.8	47.7	44.3	157.8	288.9
Capital adjustment	(37.3)	(31.1)	35.0	35.0	35.0
Shareholders equity	1,490.0	1,468.1	1,537.5	1,651.0	1,782.1

NET REV BREAKDOWN (%)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
Net commissions	69.9	72.5	65.6	69.7	71.0
Net interest	19.7	14.0	15.2	16.0	15.9
Net securities gains	2.8	-1.6	4.5	2.9	2.6
Net derivatives & others	7.7	15.1	14.7	11.3	10.5

PER SHARE DATA (HK$)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
EPS	954	362	(24)	800	923
DPS	350	250	0	0	0
Effective payout ratio (%)	*37%*	*69%*	*0%*	*0%*	*0%*
BVPS	10,279	10,128	10,606	11,389	12,294
BCPS	2,538	2,088	2,068	2,223	2,384

KEY RATIOS (%)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
G&A ratio	41.8%	41.3%	35.1%	35.6%	35.9%
Operating margin	12.7%	14.6%	21.1%	20.0%	21.3%
Net margin	12.5%	5.8%	-0.4%	12.6%	14.2%

VALUATION	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
Price to book value	1.3x	1.2x	1.1x	1.1x	1.0x
Price to earnings	36.2x	32.7x	16.6x	15.4x	13.3x
Yield at current price (%)	0.0%	1.8%	1.8%	1.8%	2.7%
Price to brokerage comm per sha	4.7x	5.4x	4.4x	4.0x	3.6x

GROWTH RATES (%,YoY)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
Net revenue	18.7%	-15.1%	0.1%	-0.6%	5.7%
Net commissions	-15.7%	-12.0%	-9.4%	5.6%	7.6%
Net interest	54.4%	-39.7%	8.6%	5.0%	5.0%
G&A expenses	-43.2%	-18.3%	-15.5%	2.0%	3.5%
Operating profit	T/P	-4.8%	44.2%	-5.0%	9.7%
Net profit	T/P	-61.8%	T/N	T/P	15.4%

PROFITABILITY RATIOS (%)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
ROA	2.5%	0.9%	-0.1%	2.3%	2.5%
ROE	9.6%	3.5%	-0.2%	7.1%	7.6%

Daewoo Securities — No longer an M&A play

Rating: HOLD

Daewoo Securities has been up for sale for the past few years, as the Korean Development Bank has been trying to sell all or part of its 39.1% stake in the company. However, there appears to have been a recent change in strategy at KDB, which has hinted that it will retail control over Daewoo, and include it under a new KDB financial holding company. Daewoo has been aggressively trying to clean up its balance sheet over the last few years, and recently received a positive ruling on its outstanding contingent liabilities. Hence, the company is now a lot cleaner than it was in the past. However, we see no benefits to shareholders from KDB maintaining its stake in Daewoo. Hence, with the shares now trading at an FY3/05F P/BV of 0.8x (with an ROE of 4.8%), it appears the company's successful restructuring has been factored into valuations.

Assuming the KDB does maintain its 39.1% stake in Daewoo Securities, we believe there would be limited benefits to Daewoo Securities' minority shareholders. Continued control by the KDB would make it difficult for Daewoo to improve its brand image, which has fallen dramatically over the past few years.

In the event that the KDB does eventually sell its stake in Daewoo Securities to another party, there is longer-term potential for Daewoo's valuation multiple to rise above 1x book, in our opinion. But, this is dependent on the company being sold to a bank and included in a financial holding company structure. Under such a structure, Daewoo would be able to cross sell products and share client information with other financial holding group affiliates, allowing it to aggressively migrate its earnings stream away from lower-margin brokerage commissions toward higher margin client asset management products.

One major reason why we have been cautious on Daewoo Securities in the past is that it was burdened with significant non-operating risks. Daewoo Securities was named as a defendant in legal actions filed by 12 financial institutions with respect to redemption requests of beneficiary certificates amounting to approximately Won601bn. These financial institutions requested Daewoo to redeem these beneficiary certificates, which they purchased through it prior to the Daewoo Group crisis, at the carrying value of the underlying assets. Daewoo rejected this request, stating that the redemption value should be based on the fair value of the underlying assets, as the fair value is far below the carrying value. A ruling was finally made late last year, which was effectively in Daewoo's favour. However, we believe there is still more off-balance-sheet risk at Daewoo relative to its peers, which is one reason why the shares should continue to trade at a discount to the sector. Our 12-month target price of Won5,000 is based on an FY3/05F target P/BV multiple of 0.8x.

Daewoo Securities — Korea

Share Price:	4,715 (Comm)	2,200 (Pref)	**Reuters Code:**	006800.KS	**Shares Outstanding** 190.101
52 Week Price Range:	3,960 - 5,980		**Bloomberg Code:**	006800 KS	**Market Cap (US$m)** 772.83
					Won/US$ exchange rate: 1159.8

INCOME STATEMENT	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
Revenue	814.3	703.3	801.2	698.0	727.8
Commissions	475.2	347.1	333.2	359.2	391.4
Interest & dividends	156.2	129.2	91.8	93.6	97.3
Securities-related gains	70.6	43.0	249.6	124.8	118.6
Derivatives & others	112.3	183.9	126.6	120.4	120.4
Costs & expenses	866.6	681.6	664.6	631.3	653.3
Commissions	31.6	26.3	29.0	31.2	34.1
Financing expenses	139.6	86.6	87.5	89.2	92.8
Securities realted losses	130.6	82.3	112.3	68.7	71.1
Derivatives & other	78.7	156.6	122.5	116.4	116.4
G&A expenses	485.9	329.8	313.3	325.8	338.8
Net revenue	433.6	351.5	449.9	392.5	413.4
Operating profit	-52.4	21.7	136.6	66.7	74.5
Non-operaitng items	78.9	-82.0	-83.0	-9.4	-9.4
Recurring profit	26.5	-60.4	53.6	57.3	65.2
Pre-tax profit	51.4	-60.4	53.3	57.0	64.9
Taxes	0.0	0.0	0.0	0.0	0.0
Net profit	51.4	-60.4	53.3	57.0	64.9

BALANCE SHEET	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
Current assets	5,406.2	2,356.4	2,943.2	2,752.9	2,888.6
Cash & deposits	3,893.9	1,427.2	1,250.2	1,438.6	1,510.5
Marketable securities	671.7	821.5	1,478.8	1,095.5	1,150.3
Others	840.6	107.7	214.2	218.8	227.8
Investment & other	577.2	649.6	596.2	750.9	784.4
Fixed assets	800.7	393.0	381.2	309.5	325.0
Total assets	6,784.1	3,399.1	3,920.5	3,813.3	3,998.0
Current liabilities	5,340.5	1,833.2	2,320.3	2,001.8	2,063.2
Long term liabilities	236.2	476.8	429.1	529.8	535.0
Total liabilities	5,576.7	2,310.0	2,749.4	2,531.5	2,598.2
Paid-in capital	1,020.9	1,020.9	1,020.9	1,020.9	1,020.9
Capital surplus	250.7	250.7	250.7	250.7	250.7
Retained earnings	126.5	65.4	118.7	243.1	361.1
Capital adjustment	-190.6	-248.0	-219.2	-232.9	-232.9
Shareholders equity	1,207.4	1,089.1	1,171.1	1,281.8	1,399.8

NET REV BREAKDOWN (%)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
Net commissions	102.3	91.3	67.6	83.5	86.5
Net interest	3.8	12.1	0.9	1.1	1.1
Net securities gains	-13.9	-11.2	30.5	14.3	11.5
Net derivatives & others	7.7	7.8	0.9	1.0	1.0

PER SHARE DATA (HK$)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
EPS	283	(296)	261	503	578
DPS	0	0	0	0	0
Effective payout ratio (%)	*0%*	*0%*	*0%*	*0%*	*0%*
BVPS	5,914	5,334	5,736	6,278	6,856
BCPS	2,027	1,382	1,421	1,822	2,004

KEY RATIOS (%)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
G&A ratio	59.7%	46.9%	39.1%	46.7%	46.6%
Operating margin	-6.4%	3.1%	17.0%	9.6%	10.2%
Net margin	6.3%	-8.6%	6.7%	8.2%	8.9%

VALUATION	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
Price to book value	0.8x	0.9x	0.9x	0.8x	0.7x
Price to earnings	17.7x	N/A	13.6x	9.9x	8.7x
Yield at current price (%)	0.0%	0.0%	0.0%	0.0%	0.0%
Price to brokerage comm per sha	2.5x	3.6x	3.0x	2.7x	2.5x

GROWTH RATES (%,YoY)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
Net revenue	-20%	-19%	28%	-13%	5%
Net commissions	-10%	-28%	-5%	8%	9%
Net interest	-36%	157%	-90%	2%	4%
G&A expenses	9%	-32%	-5%	4%	4%
Operating profit	T/N	T/P	T/P	-51%	12%
Net profit	-15%	T/N	N/A	T/P	14%

PROFITABILITY RATIOS (%)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06F**
ROA	1.0%	-1.2%	1.5%	1.4%	1.5%
ROE	5.0%	-5.3%	4.7%	4.8%	5.1%

Korea – Insurance Better earnings outlook

Rating: NEUTRAL

Overview

We remain upbeat on the Korean non-life insurance sector as earnings are expected to improve on the back of: 1) the auto premium hike initiated last November and 2) continued healthy investment returns, especially in a rising interest rate environment (ING is forecasting the three-year bond yield in Korea to rise gradually to 5.5% over the next few years from the current level of 4.8%). While there are longer-term issues related to online auto insurance and growing competition with life insurance companies, we believe better earnings momentum will be the key share price driver over the next 6~9 months.

Korean Re's shares price has seen a nice run over the past year and the market now appears to be pricing in a lot of positives that we have been talking about. Hence, we would suggest looking at the primary insurance companies (ie, Samsung F&M and Oriental F&M), which are expected to generate relatively stronger earnings growth going forward. We like Samsung F&M given that it is the most liquid play in the sector, its market share continues to expand, and it appears to be finally taking steps to improve shareholder value. Oriental F&M is an attractive small-cap play given its improved earnings outlook, healthy dividend yield and attractive valuations.

Improved earnings outlook

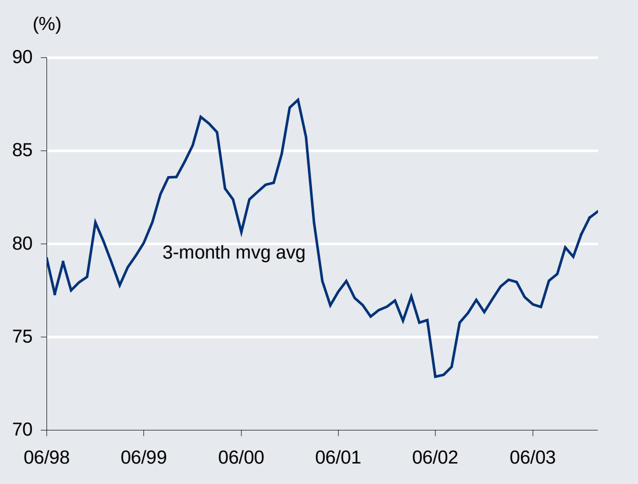
The key aspect of our overweight stance on the Korean non-life insurance sector is improved earnings growth. We believe this growth will come from both the underwriting and investment sides of the business. There is still a lot of market noise over growing competition from online auto insurance, but we believe improved earnings growth will continue to translate into better share price momentum over the next 6~9 months

Underwriting performance

Underwriting results for the non-life industry have deteriorated dramatically since 2H03 on the back of a higher auto loss ratio (low base effect from World Cup, rising auto accident rate and sluggish auto premium growth) and damage from Typhoon Maemi. However, we have begun to see signs of claim loss ratios beginning to stabilise, and we are looking for improved results going forward. This will initially be driven by the auto premium hike initiated last November (average increase of 3.5%). We are also looking for an overall upturn in the domestic underwriting cycle going forward. Finally, a gradual recovery in disposable income should also translate into increased demand for higher-margin LT protection products (ie, disease and personal accident coverage).

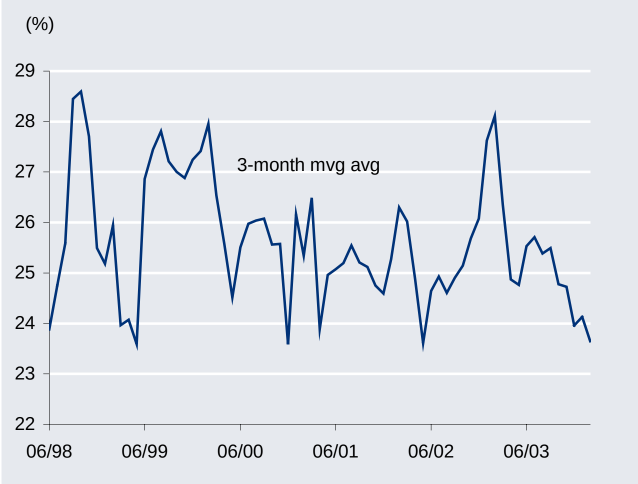
On the expense side, we have continued to see a gradual improvement in industry expense ratios, especially among the top-tier companies. We attribute this to a growing focus on cost cutting, and expect this trend to continue. Overall, we are looking for the combined ratio for the non-life industry to gradually stabilise and begin to improve as the domestic insurance cycle begins to recover.

Fig 134 Industry monthly claim loss ratio



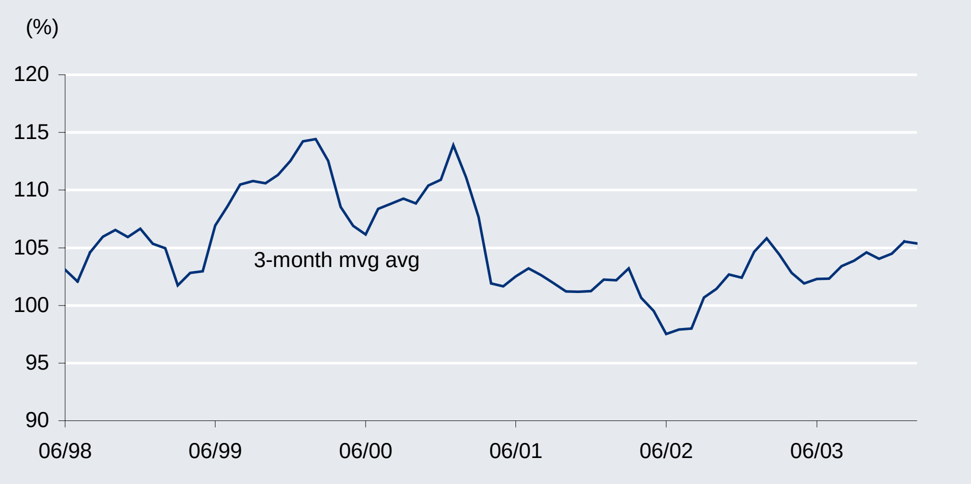
Source: Industry data

Fig 135 Industry monthly expense ratio



Source: Industry data

Fig 136 Industry monthly combined ratio



Source: Industry data

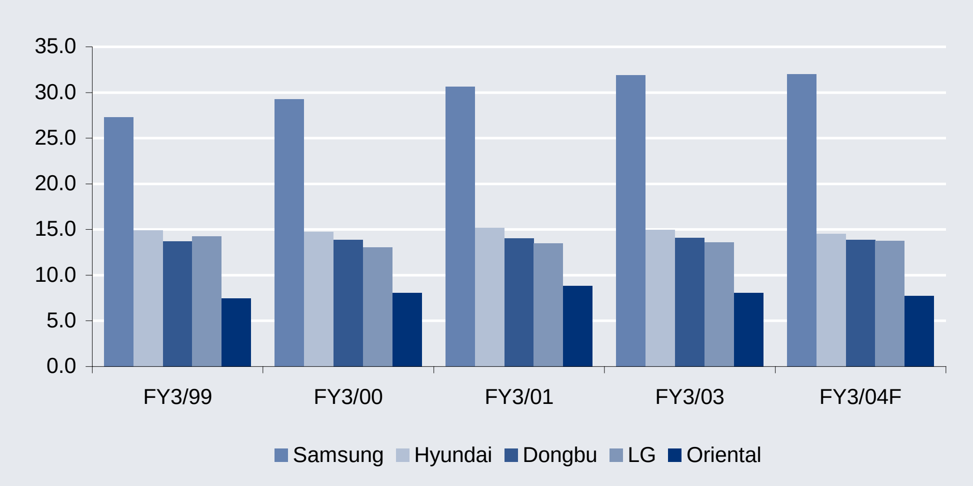
Investment performance

Another positive catalyst for better earnings growth will be improved investment returns. While this will initially be driven by higher equity markets, the key catalyst is expected to be a gradual rise in interest rates over the next few years. As Korean non-life insurance companies' invested asset portfolios are heavily weighted toward fixed income products (roughly 50% of invested asset portfolios), they would be longer-term beneficiaries of a rising interest rate environment. Most non-life insurance companies have lowered the duration on their bond portfolios in anticipation of higher rates. Another positive factor for investment results is efforts to improve asset quality by curtailing overall loan portfolios and improving the overall quality of the loan book. This should lead to less provisioning pressure in the future.

Continued flight to quality

We are expecting to continue to see a further flight to quality in the domestic non-life industry, as policyholders' money is now at risk in the event that a non-life insurance company has to be liquidated (regulations recently changed – formerly the cost of liquidation was shared among other non-life companies). While third-tier players have been aggressive in cutting prices in order to attract customers, this has deteriorated their solvency ratios to dangerously low levels. Samsung F&M is expected to continue to be the main beneficiary of a further flight to quality given its leading market position, diverse product mix and strong domestic franchise value.

Fig 137 Top-five players' market share trends



Source: Company data, ING estimates

Concerns over online auto insurance

Market concerns remain over growing competition from online auto insurance companies in Korea and the impact this will have on longer-term profitability. Online auto insurance currently accounts for roughly 5% of the entire auto insurance market in Korea, and many online auto insurance providers believe this number will rise to 7~8% by next year. While we agree that this trend is a longer-term threat to industry profitability (online players offer prices at an average 15% discount to their offline peers), the online auto insurance model in Korea still has numerous weaknesses, including a heavy reliance on telemarketing, which mitigates the cost advantage of offering products online (ie, unable to generate a superior expense ratio).

Korean Re is the least impacted by growing competition in auto insurance given the underwriting scheme it has with primary insurance companies that allows it to generate a pre-determined margin based on a pre-determined combined ratio. Among the primary insurance companies, Samsung F&M remains the best positioned to mitigate this rising trend of online auto insurance, as it has successfully diversified its business away from auto insurance to more profitable LT protection products (accounts for 56% of its recurring profit).

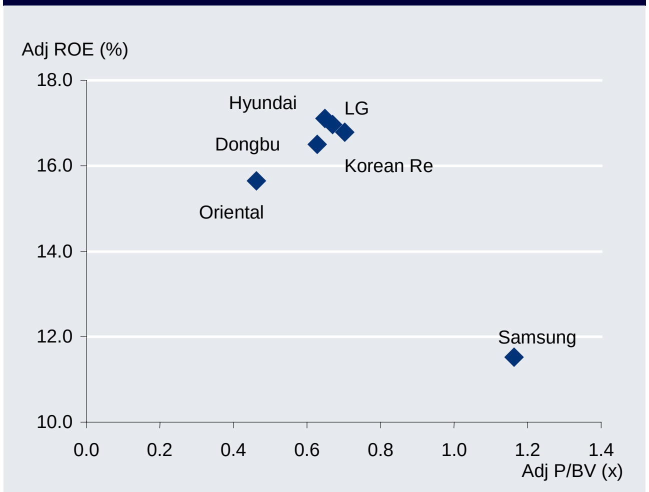
Valuations

Sector adj P/BV valuations remain attractive relative to prospective adj ROE and adj ROA. Oriental F&M remains one of the most attractive on a valuation basis alone, as it is still trading at a steep discount to its peers, despite its improving earnings outlook and a growing focus on higher margin LT protection products. While Oriental does deserve to trade at a moderate discount to its peers given its smaller size and uncertainties regarding its longer-term strategy, its current valuation discount appears excessive.

Samsung F&M appears to be trading at a significant premium in terms of adj P/BV, despite its relatively lower adj ROE. However, a lot of this is due to the fact that Samsung is overcapitalised. It is important to point out that one reason why SF&M's adj ROE is lower than its peers is due to its holdings in Samsung Electronics, with the valuation gains being reflected under shareholders' equity (capital adjustment account). Given Samsung's overcapitalisation, it is important to also compare its adj P/BV with adj ROA. Based on these variables, one can clearly see why Samsung deserves to trade at a premium to its smaller peers (see figures below).

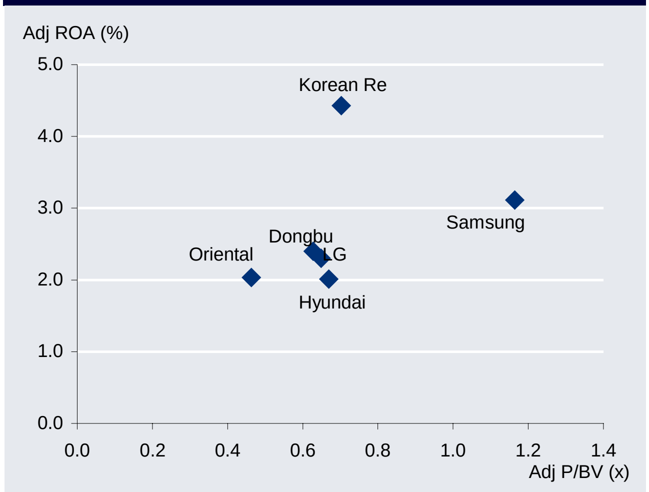
Korean Re has seen a huge re-rating over the past year, with its shares now trading at an FY3/05F adj P/BV of 0.7x (vs a low of 0.4x). While we believe there is room for its multiple to expand over the longer term, a lot of this will depend on the company's ability to effectively execute its strategy of focusing on more specialised products domestically, while continuing to expand overseas.

Fig 138 Adj P/BV vs adj ROE (FY3/05F)



Source: ING estimates, IBES consensus for LG, Dongbu and Hyundai

Fig 139 Adj P/BV vs adj ROA (FY3/05F)



Source: ING estimates, IBES consensus for LG, Dongbu and Hyundai

Our top picks

Korean Re's shares have had a nice run over the past year and the market appears to be pricing in a lot of positives that we have been talking about. Hence, we would suggest looking at the primary insurance companies (ie, Samsung F&M and Oriental F&M), which are expected to generate relatively stronger earnings growth going forward.

We like Samsung F&M given that it is the most liquid play in the sector, and hence, would benefit from improved sentiment toward the sector. In addition, the company continues to gain market share in all product areas, despite intensifying competition. While industry concerns persist over online auto insurance, the company's diversified earnings stream will help it mitigate this industry risk. On the non-operational side, management appears to be finally taking steps to improve shareholder value. The company already initiated a share buyback and cancellation in 2H03, and it does appear that it could begin to increase its dividend. This would not only improve shareholder value, but also help deal with its overcapitalisation issue. The shares are currently trading at an FY3/05F adj P/BV of 1.1x, with an adj ROE of 11.5% and an adj ROA of 3.1%.

Oriental F&M is an attractive small-cap play given its improved earnings outlook and attractive valuations (FY3/05F adj P/BV of 0.5x despite an adj ROE of 15.6%). While there are some issues regarding the company's longer-term strategy, the company is successfully focusing on higher margin LT protection products, and is beginning to become more aggressive in expanding its market share. OF&M is effectively part of the Hanjin Group, but there have never been any major corporate governance issues at the company.

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Samsung F&M

Improved earnings outlook

Rating: BUY

Samsung F&M is one of our top picks in the Korean non-life insurance sector, partly because it is the most liquid and hence the easiest play on the positive earnings trends we are anticipating in the sector going forward. In addition, we are expecting Samsung F&M to continue to pick up market share on the back of its strong brand image and diverse product availability. Samsung F&M has also successfully restructured its premium base away from auto insurance, making it less vulnerable to growing competition in this segment of the market. Management finally appears to be becoming more proactive in its efforts to improve shareholder value. The company initiated a share buyback and cancellation last year, and there are signs that it may bump up its dividend going forward. These steps would not only improve shareholder value, but would also deal with its overcapitalisation issue. Our 12-month target price of Won89,600 is based on an FY3/05F adj P/BV of 1.3x.

Market concerns remain over growing competition from online auto insurance companies in Korea and the impact this will have on longer-term profitability. Online auto insurance currently accounts for roughly 5% of the entire auto insurance market in Korea, and many online auto insurance providers believe this number will rise to 7~8% by next year. While we agree that this trend is a longer term threat to industry profitability, the online auto insurance model in Korea still has numerous weaknesses, including a heavy reliance on telemarketing, which mitigates the cost advantage of offering products online (ie, unable to generate a superior expense ratio). Among the primary insurance companies, Samsung F&M remains the best positioned to mitigate this rising trend of online auto insurance, as it has successfully diversified its business away from auto insurance to more profitable LT protection products (account for 56% of its recurring profit).

Samsung F&M would be a beneficiary of a rising interest rate environment, as 51.7% of its invested asset portfolio is weighted toward fixed income securities. While a rising interest rate environment would initially translate into valuation losses, the company would be able to gradually roll over its bond portfolio to lock in higher rates. Currently, 13% of Samsung's bond portfolio is classified as marketable securities with a duration of under one year. The remaining 87% of its bond portfolio is classified as investment securities with a bond duration of around two years.

A key aspect of our BUY recommendation on SF&M is the expectation of better earnings growth going forward, which we believe will be the main share price catalyst over the next 6~9 months. We are looking for better earnings growth from FY3/05 on the back of: 1) the recent auto premium hike, which should begin to be reflected in its results from March 2004; and 2) healthy investment returns, which will be triggered by a rising interest rate environment and easing provisioning pressure.

Samsung Fire & Marine

Korea

Share Price:	82,100 (Comm) 31,600 (Pref)	**Reuters Code:**		**Shares Outstanding**	49.6048
52 Week Price Range:	54,000 -89,200	**Bloomberg Code:**		**Market Cap (US$m)**	3,511.43
				Won/US$ exchange rate:	1159.8

INCOME STATEMENT	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
Earned premiums	4,549.5	5,261.6	5,566.8	5,928.7	6,403.0
Incurred losses	3,345.5	3,855.6	4,272.9	4,538.8	4,893.1
Net underwriting expenses	1,232.8	1,393.6	1,339.2	1,393.4	1,492.1
Dividend to policyholders	40.3	23.5	23.5	23.5	24.7
Contingency reserves	38.6	43.1	44.1	46.7	49.2
Underwriting profit	-107.6	-54.1	-112.8	-73.7	-56.1
Investment income	644.3	685.6	683.0	797.6	889.9
Investment expenses	135.8	227.6	261.3	173.7	182.4
Investment profit	508.5	458.0	421.7	623.9	707.5
Operating profit	400.8	404.0	309.0	550.2	651.5
Net non-operating income	-2.8	-19.0	-45.6	-41.9	-38.2
Recurring profit	398.0	385.0	263.4	508.3	613.3
Pre-tax profit	398.0	385.0	263.4	508.3	613.3
Taxes	123.2	117.2	79.0	151.0	168.6
Net profit	274.8	267.8	184.4	357.3	444.6

PER SHARE DATA (HK$)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
EPS	5,190.1	5,057.5	3,507.9	6,849.9	8,522.8
Adjusted EPS	5,918.6	5,870.7	4,346.6	7,744.5	9,464.9
DPS	1,000.0	1,000.0	1,000.0	1,000.0	1,000.0
Effective payout ratio (%)	*0.2*	*0.2*	*0.3*	*0.1*	*0.1*
BVPS	38,778.7	39,368.3	48,006.5	53,770.2	61,182.2
Adjusted BVPS	52,009.2	53,412.0	63,823.0	70,567.4	79,032.4

VALUATION	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
Price to adjusted book value	1.6x	1.5x	1.3x	1.2x	1.0x
Price to adjusted earnings	13.9x	14.0x	18.9x	10.6x	8.7x
Yield at current price (%)	1.2%	1.2%	1.2%	1.2%	1.2%

PROFITABILITY RATIOS (%)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
ROE	15.9%	12.9%	8.0%	13.3%	14.6%
Adj ROE	13.0%	11.1%	7.4%	11.5%	12.7%
ROA	3.1%	2.6%	1.6%	2.8%	3.1%
Adj ROA	3.5%	3.0%	1.9%	3.1%	3.4%

BALANCE SHEET	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
Cash & deposits	319.8	297.0	325.8	342.1	352.4
Loans	2,385.9	2,949.8	2,825.9	2,882.4	2,968.9
Marketable securities	5,323.6	5,760.8	7,085.8	8,219.6	9,534.7
Real estate	824.4	859.5	871.5	889.0	906.7
Underwriting receivables	174.2	317.6	301.7	310.7	320.1
Others	839.9	910.5	937.8	956.5	975.7
Total assets	9,867.8	11,095.2	12,348.6	13,600.4	15,058.5
Reserves	6,972.5	8,154.9	8,748.8	9,675.2	10,703.6
Underwriting payables	192.6	223.7	283.0	297.2	312.0
Other liabilities	649.4	632.2	775.0	781.0	803.4
Total liabilities	7,814.6	9,010.8	9,806.8	10,753.4	11,819.1
Paid-in capital	26.5	26.5	26.5	26.5	26.5
Capital surplus	726.9	726.9	727.3	727.3	727.3
Retained earnings	612.1	894.5	1,026.3	1,331.5	1,723.9
Capital adjustment	687.8	436.6	761.7	761.7	761.7
Shareholders equity	2,053.2	2,084.4	2,541.8	2,847.0	3,239.4

UNDERWRITING RATIOS	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
Loss ratio (%)	73.5%	73.3%	76.8%	76.6%	76.4%
Expense ratio (%)	26.0%	26.1%	24.0%	23.4%	23.2%
Combined ratio (%)	99.5%	99.3%	100.7%	100.0%	99.6%

INVESTED ASSET MIX	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
Cash & deposits	3.6%	3.0%	2.9%	2.8%	2.6%
Loans	26.9%	29.9%	25.4%	23.4%	21.6%
Marketable securities	60.1%	58.4%	63.8%	66.6%	69.3%
Real estate	9.3%	8.7%	7.8%	7.2%	6.6%

GROWTH RATES (%,YoY)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
Earned premiums	13.7%	15.7%	5.8%	6.5%	8.0%
Operating profit	346.2%	0.8%	-23.5%	78.1%	18.4%
Net profit	185.5%	-2.6%	-31.2%	93.8%	24.4%
Invested assets	25.1%	11.4%	12.6%	11.0%	11.6%
EPS	144.5%	-2.6%	-30.6%	95.3%	24.4%
BVPS	45.5%	1.5%	21.9%	12.0%	13.8%

Korean Re

The price of success

Rating: HOLD

Korean Re's shares have risen 84.8% over the past year on the back of: 1) strong earnings growth, thanks to a hard global reinsurance market; 2) strong foreign buying, as investors became more aware of the company's overall strategy, business model and industry dynamics (foreign ownership in Korean Re has risen to 41.7% from 16.5% a year ago); 3) easing concerns over domestic competition (Warburg Pincus decided not to enter the domestic reinsurance market); and 4) limited exposure to LG Card.

Korean Re is now trading at an FY3/05F adjusted P/BV of 0.7x (vs 0.4x six months ago), which we believe has factored in the bulk of the positives we have been talking about for the past one-and-a-half years. We continue to like Korean Re and its longer-term strategy of focusing on more specialised products in the domestic market (casualty and liability insurance) and the continued expansion of its overseas business. But, we would like to see more tangible evidence that its business strategy will result in an improvement in earnings growth, even in a softer reinsurance market, before awarding the company an even higher valuation multiple.

One growing concern we have is the market's increasingly higher expectations for Korea Re in terms of earnings growth and strategy execution. This is expected to translate into more volatility for Korean Re's share price than in the past, as management now has less room for error. Korean Re has been enjoying the benefits of a hard market (rising reinsurance rates and the undersupply of reinsurance) in the global reinsurance industry for the past three years. This has translated into a huge improvement in its underwriting performance. However, this hard market will not last forever, and there have been growing signs of softness for certain products. While Korean Re would benefit from a rising interest rate environment given that its invested asset portfolio is heavily weighted towards fixed income products, this could be counteracted by a softer reinsurance market, which would translate into a deterioration of its underwriting profit.

We are forecasting a deceleration in Korean Re's earnings growth as we believe that it will be difficult for the company to maintain its combined ratio at the current level of slightly over 94%. We are forecasting Korean Re's FY3/05-06F adjusted EPS to grow 12.7% and 8.1%, respectively (vs 17.6% in FY3/04). Based on this outlook, we are also forecasting that its adjusted ROE will contract moderately during the same period to 16.8% and 15.8% (vs 17.1% in FY3/04).

Our 12-month target price for Korean Re is Won49,800, which is based on an FY3/05F adjusted P/BV of 0.8x. Korean Re is confident that its medium-term strategy of focusing on more specialised products in the domestic market (ie, casualty and liability insurance) and growing its overseas business will translate into continued healthy earnings growth. But we would like to see tangible evidence of this before awarding the company a higher valuation multiple. Our target adjusted P/BV multiple of 0.8x and sustainable adjusted ROE forecast of 16.5% translate into an implied COE assumption of 20.7%. This is the lowest in the sector after Samsung F&M. We believe that Korean Re should have a lower COE than other smaller-sized non-life companies because it has a larger capital base and a more stable earnings flow.

Korean Reinsurance

Korea

Share Price:	43,700	**Reuters Code:**	003690.KS	**Shares Outstanding (m)** 10.703
52 Week Price Range:	21,359 -49,417	**Bloomberg Code:**	003690 KS	**Market Cap (US$m)** 403.28
				Won/US$ exchange rate: 1159.8

INCOME STATEMENT	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
Earned premiums	1,182.2	1,411.9	1,531.9	1,685.1	1,870.5
Incurred losses	782.1	920.8	1,034.1	1,145.9	1,281.3
Net underwriting expenses	344.0	434.8	430.9	469.8	523.4
Dividend to policyholders					
Contingency reserves	18.0	21.2	24.4	26.4	29.1
Underwriting profit	38.1	35.1	42.6	43.1	36.6
Investment income	71.2	64.0	69.2	83.6	93.9
Investment expenses	14.6	16.8	15.1	15.6	16.1
Investment profit	56.6	47.2	54.1	68.0	77.8
Operating profit	94.7	82.3	96.7	111.1	114.5
Net non-operating income	3.2	0.4	-0.7	-0.1	1.1
Recurring profit	97.9	82.7	96.0	111.0	115.6
Pre-tax profit	97.9	82.7	96.0	111.0	115.6
Taxes	29.8	25.2	27.7	33.0	31.8
Net profit	68.1	57.5	68.2	78.1	83.8

PER SHARE DATA (HK$)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
EPS	6,363	5,374	6,375	7,292	7,829
Adjusted EPS	8,042	7,359	8,657	9,757	10,552
DPS	1,000	1,300	1,600	1,800	1,800
Effective payout ratio (%)	*16%*	*24%*	*25%*	*25%*	*23%*
BVPS	31,173	33,964	38,813	44,474	50,671
Adjusted BVPS	42,663	46,942	54,073	62,199	71,119

VALUATION	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
Price to adjusted book value	1.0x	0.9x	0.8x	0.7x	0.6x
Price to adjusted earnings	5.4x	5.9x	5.0x	4.5x	4.1x
Yield at current price (%)	2.3%	3.0%	3.7%	4.1%	4.1%

PROFITABILITY RATIOS (%)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
ROE	23.6%	16.9%	17.5%	17.5%	16.5%
Adj ROE	21.6%	16.8%	17.1%	16.8%	15.8%
ROA	4.0%	2.9%	3.1%	3.3%	3.4%
Adj ROA	5.1%	3.9%	4.2%	4.4%	4.5%

BALANCE SHEET	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
Cash & deposits	195.1	163.8	172.0	178.9	184.2
Loans	7.2	5.9	6.4	6.5	6.6
Marketable securities	770.7	890.6	1,015.3	1,127.0	1,251.0
Real estate	98.9	99.1	98.3	98.3	98.3
Underwriting receivables	682.2	929.5	910.9	929.1	947.7
Others	63.2	83.0	84.7	86.4	88.1
Total assets	1,817.3	2,171.9	2,287.5	2,426.1	2,575.9
Reserves	757.1	851.9	954.8	1,028.7	1,124.9
Underwriting payables	640.1	887.7	799.0	799.0	799.0
Other liabilities	100.9	68.7	118.3	122.5	109.7
Total liabilities	1,498.1	1,808.4	1,872.1	1,950.1	2,033.6
Paid-in capital	51.2	53.5	53.5	53.5	53.5
Capital surplus	103.7	103.7	103.7	103.7	103.7
Retained earnings	169.9	214.8	267.6	328.1	394.5
Capital adjustment	-5.6	-8.6	-9.4	-9.4	-9.4
Shareholders equity	319.2	363.5	415.4	476.0	542.3

UNDERWRITING RATIOS	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
Loss ratio (%)	66.2%	65.2%	67.5%	68.0%	68.5%
Expense ratio (%)	27.8%	29.8%	26.4%	26.3%	26.4%
Combined ratio (%)	93.9%	95.0%	93.9%	94.3%	94.9%

INVESTED ASSET MIX	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
Cash & deposits	18.2%	14.1%	13.3%	12.7%	12.0%
Loans	0.7%	0.5%	0.5%	0.5%	0.4%
Marketable securities	71.9%	76.8%	78.6%	79.9%	81.2%
Real estate	9.2%	8.5%	7.6%	7.0%	6.4%

GROWTH RATES (%,YoY)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
Earned premiums	12.2%	19.4%	8.5%	10.0%	11.0%
Operating profit	168.5%	-13.1%	17.4%	15.0%	3.0%
Net profit	160.6%	-15.5%	18.6%	14.4%	7.4%
Invested assets	28.8%	8.2%	11.4%	9.2%	9.2%
EPS	160.6%	-15.5%	18.6%	14.4%	7.4%
BVPS	23.5%	9.0%	14.3%	14.6%	13.9%

Oriental F&M

Too cheap to ignore

Rating: BUY

Oriental F&M is an attractive small-cap name in the Korean non-life insurance sector. While the company's FY3/04 results are expected to suffer due to relatively larger exposure to Typhoon Maemi, we are looking for improved earnings momentum going forward. This is on the back of: 1) a recent hike in auto premium rates; 2) a growing focus on higher margin LT protection products; 3) more proactive measures to increase market share now there are signs that the industry underwriting cycle is beginning to improve; and 4) healthier investment returns, especially in a rising interest rate environment. Another attractive aspect of Oriental F&M is its valuations and dividend yield. The shares are currently trading at an FY3/05F adj P/BV of 0.5x, despite a prospective adj ROE of 15.6%.

Oriental F&M is associated with the Hanjin Group, but we do not view this as a major concern. We have begun to see significant restructuring of share ownership within the Hanjin Group. This is a result of the death of the Hanjin Group founder a few years ago, which resulted in the splitting up of the *chaebol* among his sons. In the case of OF&M, CH Cho (the fourth son of the Hanjin Group founder) is the largest shareholder with a 23.7% stake, which is up from 16.7% in Sept 01. OF&M management has recently mentioned to us that it may split from the Hanjin Group in 2005.

While we remain upbeat on OF&M's earnings outlook, a concern we still do have is the company's longer-term strategy in terms of competing against its larger peers in the domestic market. OF&M is currently Korea's fifth largest non-life insurance company in terms of market share (7.9% YTD). While we do believe the company has the potential to increase its market share gradually over the next few years, it is probably not going to be enough to enable it to catch up to its larger peers. Due to growing competition in the non-life market and the potential for industry consolidation, OF&M's relatively small market share could be seen as a competitive disadvantage for the company. Given the growing likelihood of consolidation in the non-life industry over the longer term, the easiest way for OF&M to increase its market share would be to purchase one of its competitors. The problem is that the overall financial quality of third tier players in the industry is very poor. A strategic partnership with a foreign insurance company could be another option, but it remains to be seen if company management would be willing to consider such a strategy.

Oriental Fire & Marine

Korea

Share Price:	17,600	**Reuters Code:**	000060.KS	**Shares Outstanding (m)**	8.58
52 Week Price Range:	10,300 -21,100	**Bloomberg Code:**	000060 KS	**Market Cap (US$m)**	130.20
				Won/US$ exchange rate:	1159.8

INCOME STATEMENT	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
Earned premiums	1,051.8	1,187.3	1,195.6	1,231.5	1,280.8
Incurred losses	824.3	938.9	964.7	974.8	1,009.9
Net underwriting expenses	253.6	281.4	298.1	303.4	314.2
Dividend to policyholders					
Contingency reserves	9.2	10.1	10.1	10.4	10.9
Underwriting profit	-35.3	-43.0	-77.2	-57.1	-54.3
Investment income	136.9	137.4	130.4	135.7	143.2
Investment expenses	33.6	45.7	18.3	22.9	21.5
Investment profit	103.3	91.7	112.2	112.7	121.7
Operating profit	68.0	48.7	34.9	55.6	67.5
Net non-operating income	-4.3	-8.6	-2.2	-2.4	-2.7
Recurring profit	63.7	40.1	32.7	53.2	64.8
Pre-tax profit	63.7	48.6	32.7	53.2	64.8
Taxes	20.0	14.5	0.0	0.0	0.0
Net profit	43.7	34.1	23.1	37.5	47.0

PER SHARE DATA (HK$)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
EPS	5,089	3,970	2,690	4,371	5,479
Adjusted EPS	6,159	5,151	3,871	5,587	6,744
DPS	1,000	1,000	600	1,000	1,000
Effective payout ratio (%)	*20%*	*25%*	*22%*	*23%*	*18%*
BVPS	17,160	20,942	22,164	25,562	30,068
Adjusted BVPS	26,036	31,000	33,403	38,017	43,788

VALUATION	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
Price to adjusted book value	0.7x	0.6x	0.5x	0.5x	0.4x
Price to adjusted earnings	2.9x	3.4x	4.5x	3.1x	2.6x
Yield at current price (%)	5.7%	5.7%	3.4%	5.7%	5.7%

PROFITABILITY RATIOS (%)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
ROE	36.3%	20.8%	12.5%	18.3%	19.7%
Adj ROE	27.6%	18.1%	12.0%	15.6%	16.5%
ROA	2.4%	1.7%	1.0%	1.6%	1.9%
Adj ROA	2.9%	2.2%	1.5%	2.0%	2.3%

BALANCE SHEET	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
Cash & deposits	166.8	202.2	171.6	176.8	179.5
Loans	154.3	252.7	208.0	234.4	246.8
Marketable securities	1,147.9	1,216.7	1,381.2	1,470.2	1,570.4
Real estate	210.3	215.5	250.4	249.3	246.8
Underwriting receivables	87.8	84.5	114.8	117.0	120.4
Others	171.4	178.9	167.4	170.8	173.2
Total assets	1,938.5	2,150.5	2,293.3	2,418.5	2,537.0
Reserves	1,608.0	1,741.1	1,833.7	1,916.5	1,985.1
Underwriting payables	84.2	89.5	131.5	137.3	142.8
Other liabilities	99.0	140.2	138.0	145.3	151.1
Total liabilities	1,791.3	1,970.8	2,103.2	2,199.2	2,279.0
Paid-in capital	42.9	42.9	42.9	42.9	42.9
Capital surplus	26.5	25.9	26.5	26.5	26.5
Retained earnings	82.0	108.1	126.2	155.4	194.0
Capital adjustment	-4.1	2.7	-5.4	-5.4	-5.4
Shareholders equity	147.2	179.7	190.2	219.3	258.0

UNDERWRITING RATIOS	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
Loss ratio (%)	77.9%	78.7%	80.7%	79.2%	78.9%
Expense ratio (%)	22.3%	24.8%	25.3%	25.0%	24.9%
Combined ratio (%)	100.2%	103.5%	106.0%	104.2%	103.8%

INVESTED ASSET MIX	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
Cash & deposits	9.9%	10.7%	8.5%	8.3%	8.0%
Loans	9.2%	13.4%	10.3%	11.0%	11.0%
Marketable securities	68.4%	64.5%	68.4%	69.0%	70.0%
Real estate	12.5%	11.4%	12.4%	11.7%	11.0%

GROWTH RATES (%,YoY)	**FY3/02**	**FY3/03**	**FY3/04F**	**FY3/05F**	**FY3/06**
Earned premiums	17.1%	12.9%	0.7%	3.0%	4.0%
Operating profit	T/P	-28.4%	-28.3%	59.2%	21.4%
Net profit	T/P	-22.0%	-32.2%	62.5%	25.3%
Invested assets	17.6%	12.4%	6.6%	5.9%	5.3%
EPS	T/P	-22.0%	-32.2%	62.5%	25.3%
BVPS	58.2%	22.0%	5.8%	15.3%	17.6%

Malaysia

Leverage to improving assets

Rating: NEUTRAL

2004 outlook

The Malaysian banking sector is expected to record 15% net profit growth in FY04. However, like its peers in Singapore, the bulk of the improvement is expected to arise from lower bad and doubtful debt charges (B&DD) with some improvement in underlying profit. The latter is forecast to show a 4% YoY improvement for the banks under our coverage. At the same time, B&DD charges are estimated to contract by 20% YoY, thereby boosting net profit. Lower non-performing loans (NPLs) are expected in light of the improving fundamentals as economic growth gathers pace in Malaysia. The improvement in underlying profit should arise from stronger loan growth, currently estimated at 7.2% in 2004 for the sector. We discuss details driving this growth below.

Aside from an improvement in earnings, other key factors to watch in FY04 are:

Benign interest rate environment. We share the bankers' view that interest rates are not expected to trend up in FY04, at least not until end-2004, while the recent interest rate liberalisation is not expected to result in a rate war, in the near term. Nonetheless, competitive pressure is expected to keep margins under pressure.

Improving asset quality. As mentioned earlier, NPLs are expected to trend down for the Malaysian banks. Collectively, the seven banks under our coverage are estimated to see gross NPLs of RM37.9bn in FY04, or 10% of gross loans. This is down from the previous year's RM40.2bn or 11% of gross loans. Individually, Public Bank will maintain its lead with the lowest NPL ratio while AMMB Holdings is estimated to have the highest NPL ratio.

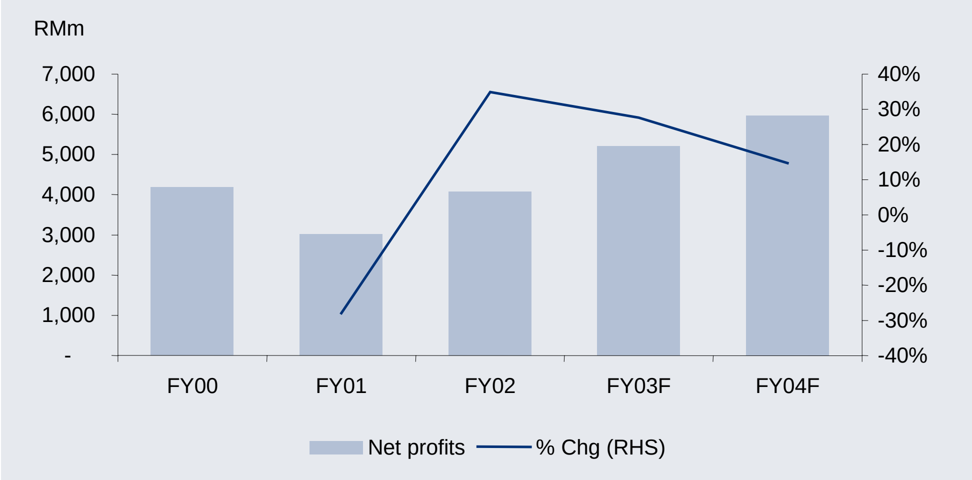
Regulatory changes. Bank Negara Malaysia (BNM) has pushed ahead with the consolidation of the finance companies into banks, by amending the Banking and Financial Institutions Act (BAFIA) to allow the banks to hold both a banking and a finance company licence, which took effect in January this year. Already, we saw several banks taking steps in FY03 to privatise and amalgamate some of the operations of their finance subsidiaries. The latest were AMMB Holdings and Affin Holdings, both of which are proposing to privatise their finance subsidiaries. Aside from this, we believe further progress should be made as prescribed by the Financial Masterplan set out several years ago. In particular, 2004 should be easier for foreign banks to branch in Malaysia.

Mergers and acquisitions. While 2003 saw the initial emergence of a second round of consolidation among the Malaysian banks, it fizzled out as AMMB Holdings turned away two potential suitors. We believe the Malaysian banks are in no hurry to engage in another round of consolidation, with the priority being their own finance companies. Nonetheless, recent media reports that Temasek Holdings of Singapore may be taking a stake in Alliance Bank could provide the catalyst for the banks to re-think about their long-term strategies.

Improving profits

The Malaysian banks are expected to report a 15% YoY rise in net profit to RM5.97bn in FY04. This follows the steeper 35% and 28% YoY rises seen in FY02 and FY03. As seen in the chart below, FY01 saw a bottoming-out of the banks' net profit, due in part to the global slowdown in that calendar year.

Fig 140 Malaysian banks – net profit

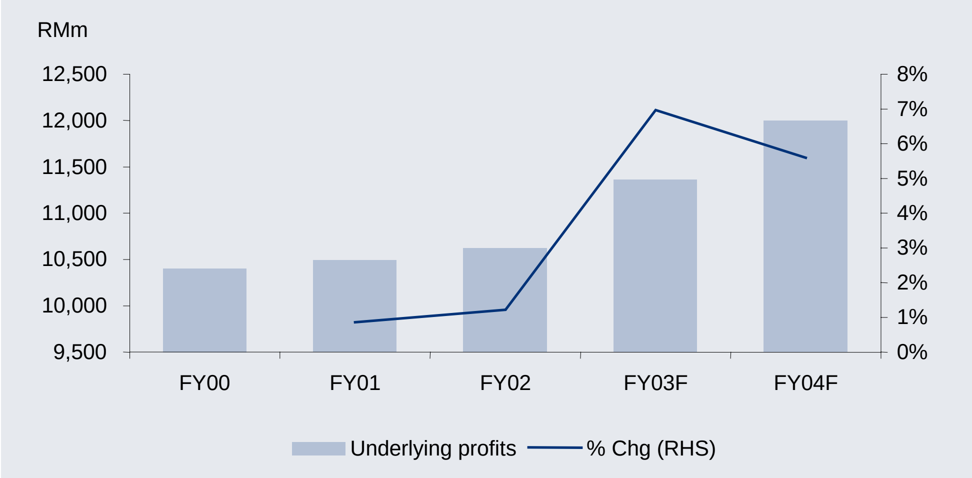


Source: Company data, ING estimates

However, the stronger net profit in FY04 is due to a combination of lower bad and doubtful debt (B&DD) charges and improving underlying profit.

As shown in the chart below, underlying profit is estimated to grow by 4% YoY to RM11.9bn in FY04 as stronger loan growth is partially offset by margin pressure. Nonetheless, we should note that the improvement comes on the back of a 7% YoY rise in underlying profit in FY03. Given the progressively higher base, incremental underlying profit will need to come from new sources rather than the traditional net interest income.

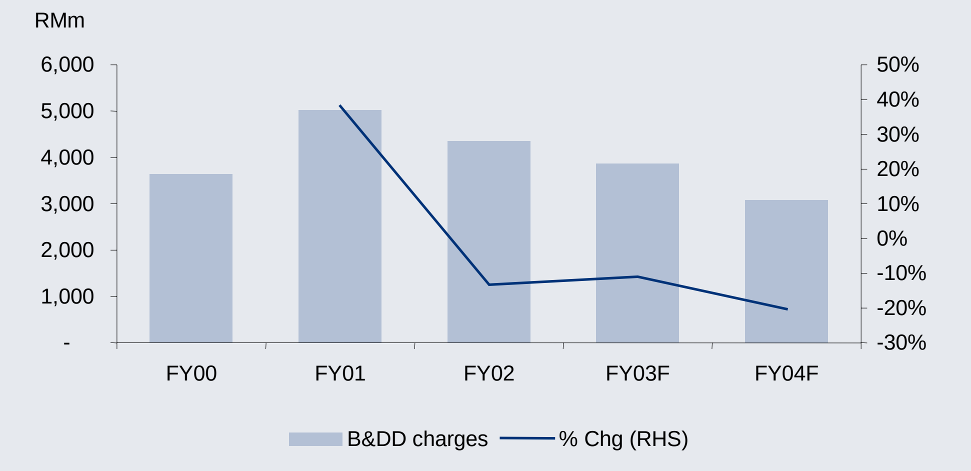
Fig 141 Malaysian banks – underlying profit



Source: Company data, ING estimates

The other, and perhaps more important, determinant of stronger net profit for FY04 is lower B&DD charges. As illustrated in the chart below, B&DD charges are forecast to contract by 20% YoY to RM3.08bn as the improving economy provides a boost to businesses. Again, we point to the peaking of B&DD charges in FY01 as banks experienced a second bout of problems associated with a global slowdown then. We discuss details of the sector and individual banks' NPLs and loans loss coverage later.

Fig 142 Malaysian banks – B&DD charges



Source: Company data, ING estimates

We discuss our view of sector loan growth and margin trends in detail below.

Broadening loan growth

We currently estimate loan growth of 7.2% in 2004 for the sector. Key growth sectors remain in retail, ie, housing and consumption credit. Note that the latter is almost entirely made up of vehicle financing loans. However, we do expect the commerce and manufacturing sectors to begin showing signs of recovery. Already, loans to the commerce sector were growing at 3.6% YoY at the end of December 2003. However, we expect the manufacturing sector to turn around with 2.0% YoY growth in 2004.

Fig 143 Loan growth by sector (% chg YoY)

YoY	1998	1999	2000	2001	2002	2003	2004F	2005F	2006F
Total loans	1.3	1.0	5.4	3.5	4.3	4.8	7.2	7.5	8.1
Agriculture	2.4	21.7	25.8	3.6	-1.4	0.5	3.0	4.0	4.5
Mining & quarrying	20.1	-1.9	4.6	-11.0	-18.9	2.0	2.5	1.0	3.5
Manufacturing	3.0	1.6	3.4	0.0	-1.8	1.0	2.0	5.0	5.5
Commerce	3.1	3.0	4.1	1.4	1.5	3.6	5.5	6.5	7.0
Broad property sector	7.0	3.7	5.2	7.7	6.1	5.9	8.9	9.2	10.1
- Building & construction	6.2	-3.8	-5.3	-2.6	-4.1	-7.2	-4.0	-2.0	1.0
- Housing	10.2	11.8	17.7	17.2	16.3	15.7	16.0	14.5	14.0
- Real estate	4.1	1.3	-1.8	1.8	-3.6	-7.5	-2.5	-1.5	0.5
Transport & storage	15.8	3.0	-12.5	-8.9	-5.4	2.0	2.2	3.0	2.5
Electricity	32.8	26.9	5.0	-31.9	29.4	10.0	3.5	2.0	4.0
Fin/insur/bus.svcs	5.5	-10.5	1.3	2.7	-7.6	1.5	3.0	4.0	3.8
Consumption credit	-7.6	3.8	16.3	16.2	17.3	11.0	11.0	10.0	10.5
Stocks & shares	-3.0	-11.2	-0.2	-9.6	0.7	-1.7	3.0	3.5	2.5
Others	-28.6	-2.7	9.4	-4.2	0.0	4.8	5.5	5.2	4.8

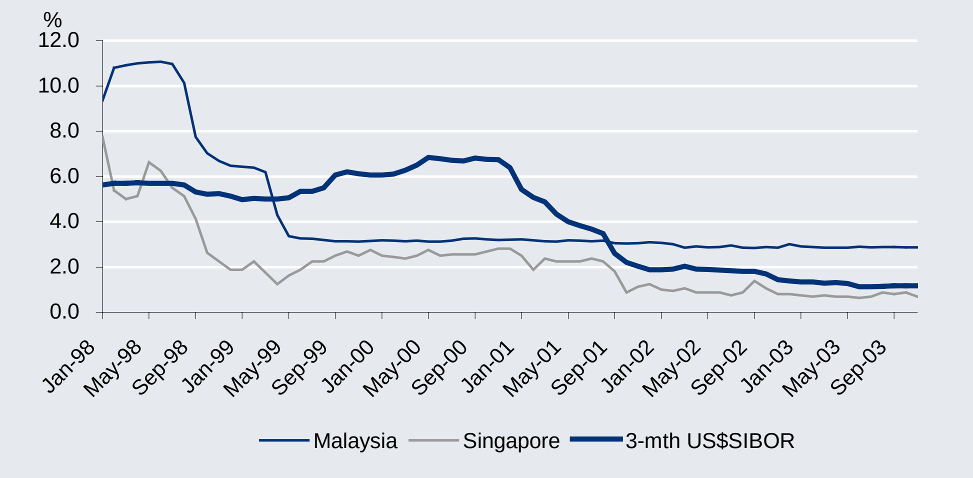
Source: Bank Negara Malaysia, ING estimates

As mentioned earlier, the retail sector is expected to remain the main growth driver, with housing and consumption credit estimated to contribute 54% and 29% to 2004 loan growth. Collectively, retail loans will remain the largest component of bank loans, accounting for 46% of the total in 2004, up from 43% in 2003. Manufacturing sector loans are estimated to account for 12% of total loans, the second-largest component after retail. Lastly, loans to the commerce sector are estimated to account for the third-largest share of total loans at 8% in 2004. Finally, the broad property sector, which captures loans for building and construction and to the real estate sector as well as housing loans, remains among the largest in terms of sector exposure, with 40% of total loans in 2004.

Benign interest rate environment

As illustrated in the chart below, the current Malaysian three-month interbank interest rate is lower than Singapore's and the US dollar SIBOR. We believe this provides Bank Negara Malaysia with a buffer as far as raising interest rates is concerned. We expect interest rates to remain relatively unchanged until end-2004. At the same time, in light of the recent liberalisation of interest rates, whereby Bank Negara has done away with the BLR formula and allowed free pricing of assets, we expect reaction from the banks to be neutral in the short term. Longer term, banks will differentiate themselves via their lending rates, depending on their ability to price based on their own cost of funds, and operational efficiency. Although the failure by Bank Negara to liberalise deposit rates – ie, lift the minimum fixed deposit rates for retail deposits of RM1m and below – limits the ability of the banks to adjust their funding costs, we believe it is just a matter of time before full liberalisation takes place. Near term, the use of the Overnight Policy Rate (OPR) by Bank Negara is expected to prevent foreign banks from benefiting from cheaper interbank rates and launching raids on the domestic banks' market shares.

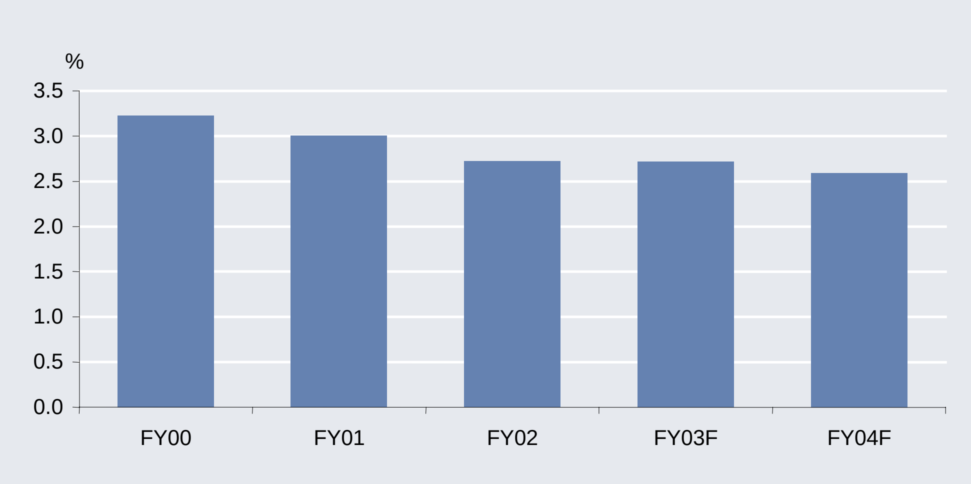
Fig 144 3-month interbank interest rates



Source: Bank Negara Malaysia, Monetary Authority of Singapore

While interest rates are expected to remain relatively unchanged for most of 2004, we believe competitive pressure will keep margins in check. We estimate average net interest margin will decline by 17bp to 2.55%. However, the broader interest rate environment is not expected to see an upturn.

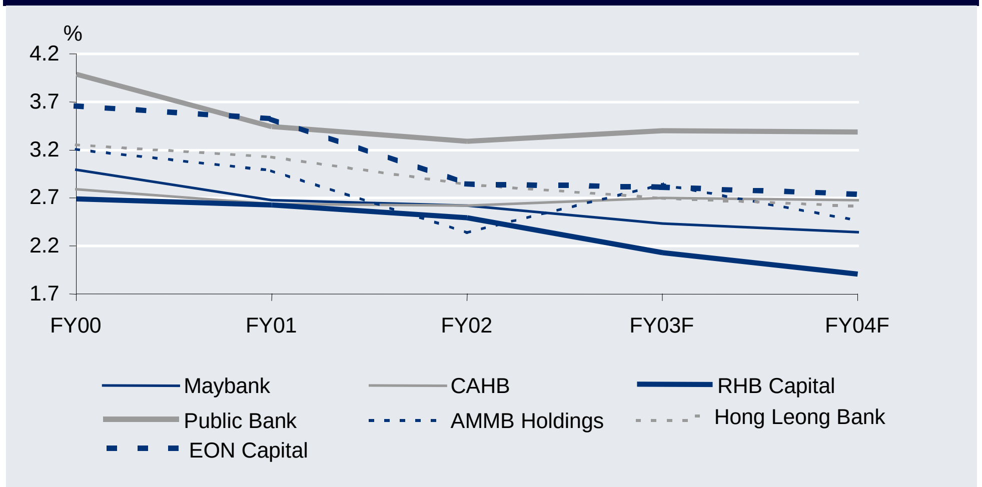
Fig 145 Malaysian banks – net interest margin



Source: Company data, ING estimates

Individually, our forecasts indicate that Public Bank will remain the most profitable among its peers, with the highest net interest margin, while RHB Capital is expected to remain the least profitable.

Fig 146 Malaysian banks' net interest margins

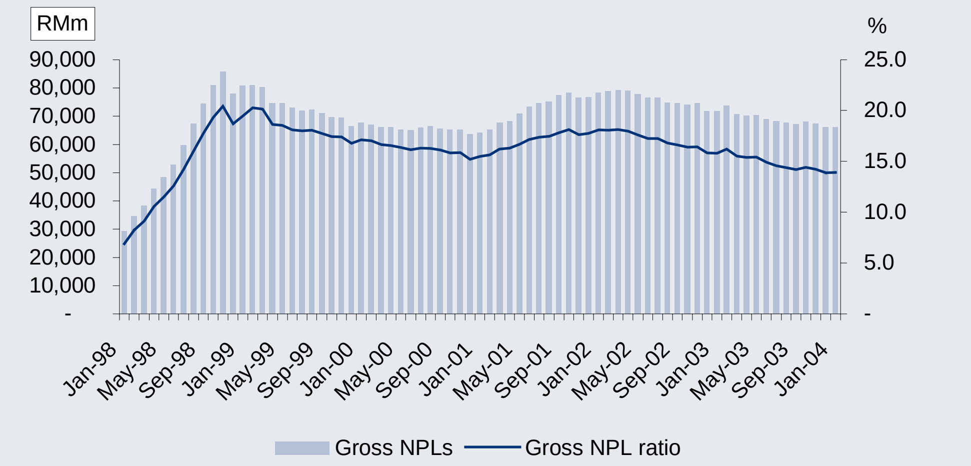


Source: Company data, ING estimates

Improving asset quality

Gross non-performing loans (NPLs) for the banking sector have been gradually declining since the second peak in 2002. As of January 2004, gross NPLs amounted to RM66.1bn, or 13.9% of gross loans. We believe that further reductions in NPLs can be expected in light of the strengthening economic growth.

Fig 147 Malaysian banks' NPLs



Source: Bank Negara Malaysia

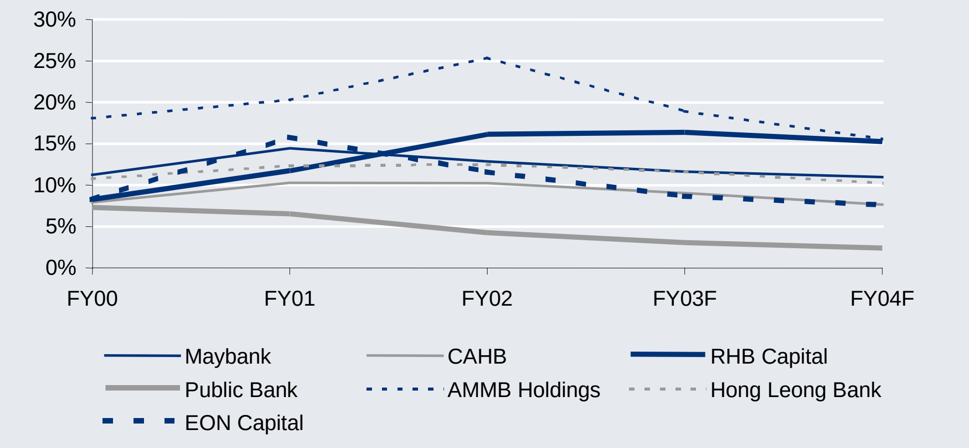
In terms of loan loss provisioning as a percentage of gross NPLs, or the coverage ratio, we note that the sector has progressively seen an increase to the current (January 2004) ratio of 52.6%. We note that the coverage ratio should continue to improve as the sector experiences a decline in NPLs, coupled with higher recoveries.

Fig 148 Malaysian banking sector – loan loss provisions & coverage

Source: Bank Negara Malaysia

Individually, we note that Public Bank will retain the highest asset quality in FY04, with an estimated gross NPL ratio of 2.4%. This is expected to be followed by EON Capital and Commerce Asset-Holding with tied ratios of 7.6% each. AMMB Holdings and RHB Capital are expected to maintain poorer asset quality, with ratios of 15.6% and 15.3%, respectively (see chart next page).

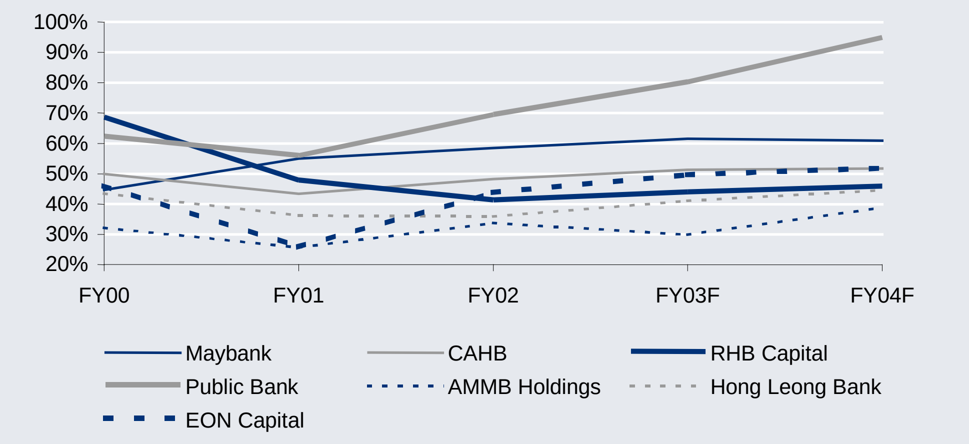
Fig 149 Malaysian banks' NPL ratios



Source: Company data, ING estimates

Public Bank is also forecast to maintain the best coverage ratio among its peers in FY04. At 95% of NPLs, Public Bank will have a comfortable lead over its nearest rival, Maybank, which we estimate will have a coverage ratio of 61%. EON Capital and CAHB are third highest with a coverage ratio of 52% each.

Fig 150 Malaysian banks' coverage ratios



Source: Company data, ING estimates

Regulatory changes

In Bank Negara Malaysia's (BNM) Financial Masterplan issued in 2001, the liberalisation of the financial services sector was envisaged to take up to seven years, ending with the eventual introduction of new foreign players in the banking sector.

The Masterplan, to be implemented over three phases is, in our view, entering Phase 2, even though there are still some recommendations in Phase 1 that remain outstanding. BNM had indicated earlier in 2003 that it would be amending the Banking and Financial Institutions Act (BAFIA) to allow for the merger of the banks with their finance companies, along with the merger between merchant banks, discount houses and stock broking companies to form investment banks in 2003. In February this year, BNM did amend the BAFIA to allow for the bank and finance company to be held under one universal licence (the amendment was made retroactive to January 2004). As far as we know, the investment banking licence has yet to be finalised. In the merger of the banks with their finance companies, we believe the impact will not be significant (except that the merged entities may see lower cost of funds in light of the disparity in deposit interest rates between the banks and finance companies) given that most banks have begun to share products across branches and rationalise their network.

All the banks except for AMMB Holdings and Affin Holdings do not have a publicly listed finance company, which suggests that a merger will not be difficult. In addition, the banks already took steps last year to progressively integrate their finance company operations into the bank. In the case of AMMB Holdings, its finance company is publicly listed AMFB Holdings. Recently, AMMB Holdings has proposed a restructuring whereby AMFB Holdings will be privatised and Arab-Malaysian Merchant Bank will take the former's listing status via a Restricted Offer of Sale of shares to existing AMMB Holdings shareholders. In our view, post the privatisation of AMFB Holdings, a merger of its bank with the finance company may result in a reverse takeover given that the bank is a much smaller entity than its finance company.

Aside from the mergers, other outstanding changes include the introduction of deposit insurance. However, we believe this will take some time. Finally, a progressive liberalisation of the banking sector via the lifting of branching restrictions and allowing foreign banks to share a common ATM network are upcoming events.

The implication of the above regulatory changes is simply that competition should intensify, although a rebound in economic growth may allow banks some breathing room in terms of asset expansion.

Mergers and acquisitions

As indicated above, we believe the banks' priorities in 2004 will be merging their banking operations with those of their finance companies. In some banks, we believe that this will be relatively painless given that prior rationalisation of their branch networks has already taken place.

While the merger of Commerce Asset-Holding or EON Capital with AMMB Holdings would have been a potent catalyst for the rest of the sector to engage in a second round of consolidation, the failure suggested that the voluntary mergers will not be as easy to execute as 'forced' mergers. Disagreements over valuations and control are likely to be sticking points.

Again, in our view, we believe that the potential candidates remain the smaller banks, with Southern Bank standing out in terms of quality and potential value to an acquirer. At the same time, we cannot rule out AMMB Holdings being approached again.

More recently, media reports have indicated that Temasek Holdings of Singapore may be interested in taking a minority stake in Alliance Bank. If so, we believe this may provide the other banks with the catalyst to think about their long-term strategies, given that the government may be signalling that it is prepared to let a few of the smaller banks become foreign-owned.

Valuations

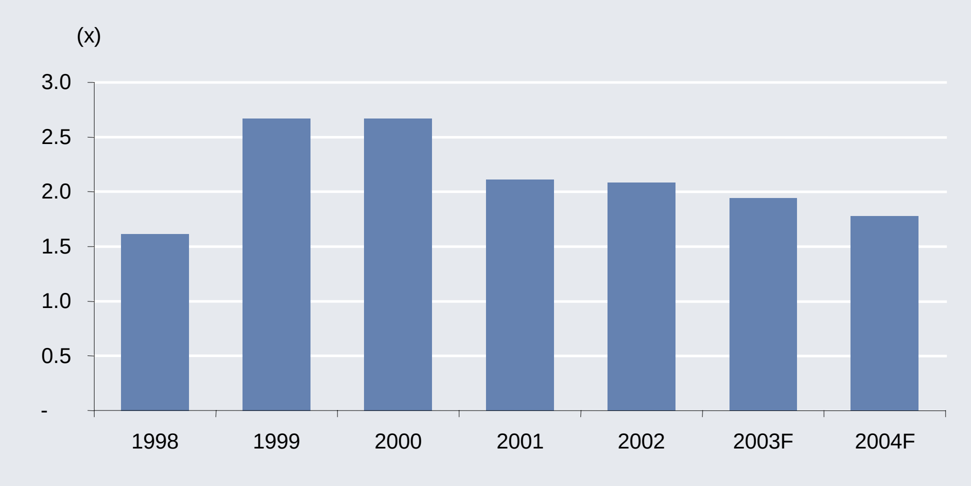
The banking sector is currently trading at an FY04 P/BV of 2.3x, or 1.9x if we exclude Maybank. The corresponding FY04 valuation multiples for PUP and PER are 9.3x and 16.9x, respectively. Excluding Maybank, the PUP and PER multiples are 8.0x and 15.8x, respectively.

Compared with historical annualised multiples, the sector is not yet near previous peaks. We examine each multiple below.

P/BV

Using an annualised average P/BV, the sector is currently trading at a 2004 multiple of 1.8x, which is still a long way from the peak of 2.7x seen in 1999 and 2000.

Fig 151 Banking sector P/BV

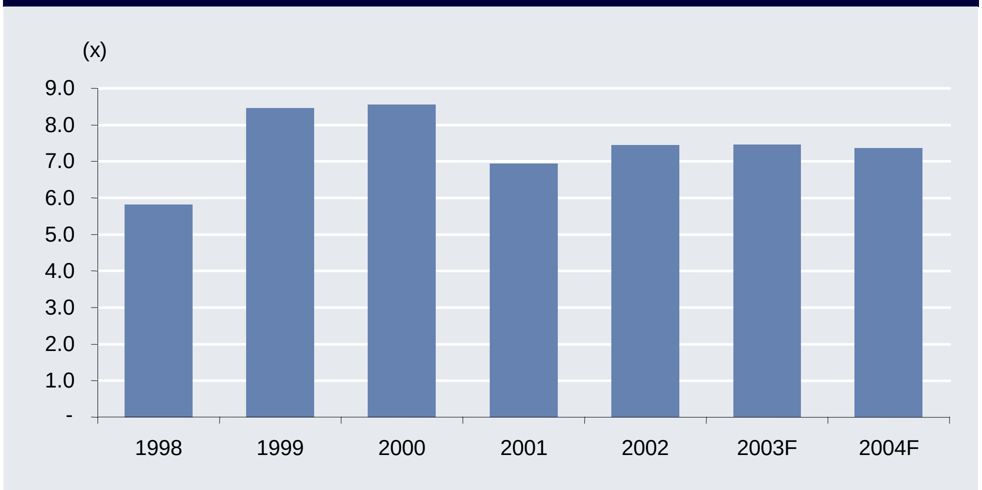


Source: Company data, ING estimates

PUP

On an annualised average PUP multiple, the sector is currently trading at 7.4x 2004 underlying profit. Compared with its previous peak of 8.6x, there is still 16% upside from here.

Fig 152 Banking sector PUP

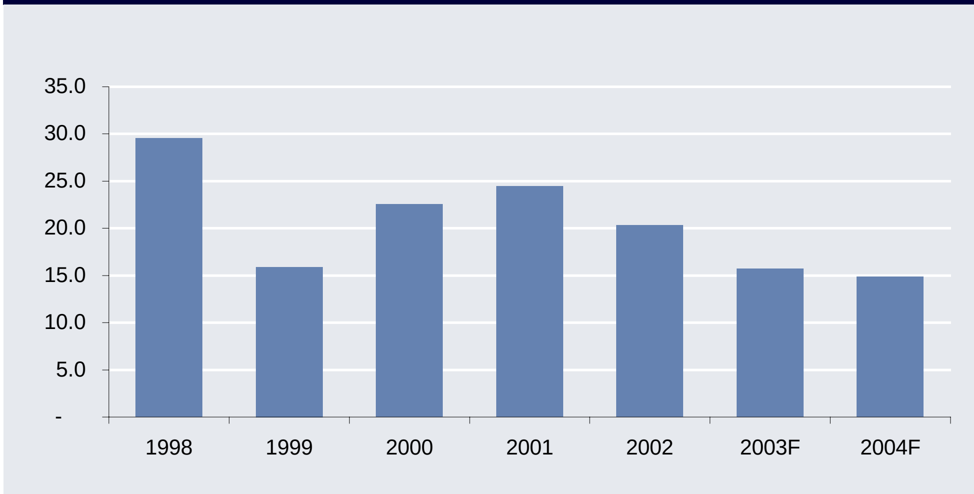


Source: Company data, ING estimates

PER

Finally, the annualised average sector PER multiple for the sector is currently 15.0x 2004 net profit. Again, this is a far cry from the peak of 24.4x in 2001, although the latter is not the highest in the past six years. The previous peak of 29.5x captured the after-effects of the Asian financial crisis and may not be representative of a normalised peak.

Fig 153 Banking sector PER



Source: Company data, ING estimates

Recommendations

We retain our Overweight on the Malaysian banks relative to the domestic market given their broad-based exposure to stronger economic growth of the country, although we have reduced the weighting to Neutral in our regional financials portfolio. As illustrated above, current sector valuations are still not near the peaks seen in 2000-01.

Our top picks for the sector, in order of preference, are Commerce Asset-Holding, Hong Leong Bank and EON Capital. For investors with a larger risk appetite, AMMB Holdings and RHB Capital offer potential gains, barring any unforeseen events and on the back of their higher betas. We remain unconvinced that Maybank deserves the premium rating and do not expect it to outperform its smaller peers.

Fig 154 Top stock recommendations

Bank	B'berg code	Rec	Price (22/4/04) (RM)	Price to u'lying profit (x)	x	U'lying profit-ability (%)	x	Lever-age (x)	=	Price to book (x)	÷	U'lying ROE (%)	=	Price to u'lying profit (x)	PER (x)	Yield (%)
CAHB	COMM MK	BUY	5.20	6.4	x	2.04	x	12.0	=	1.6	÷	24.6	=	6.4	13.9	1.9
Hong Leong Bank	HLBK MK	BUY	5.35	9.0	x	1.91	x	10.4	=	1.8	÷	19.8	=	9.0	15.6	4.5
EON Capital	EON MK	BUY	5.25	5.3	x	1.97	x	13.1	=	1.4	÷	25.9	=	5.3	9.5	1.9
Public Bank	PBKF MK	BUY	3.50	10.5	x	3.01	x	7.6	=	2.4	÷	22.8	=	10.5	17.4	3.6
AMMB Holdings	AMM MK	BUY	3.98	4.8	x	2.11	x	14.9	=	1.5	÷	31.5	=	4.8	17.5	1.3
RHB Capital	RHBC MK	BUY	2.27	4.7	x	1.45	x	17.8	=	1.2	÷	25.9	=	4.7	15.4	2.2
Maybank	MAY MK	SELL	11.10	11.0	x	1.94	x	13.1	=	2.8	÷	25.5	=	11.0	18.6	5.0
Sector		**Overwt**		**9.2**	x	**2.04**	x	**12.1**	**=**	**2.3**	÷	**24.8**	**=**	**9.2**	**16.9**	**3.7**
Sector (w/o Maybank)		**Overwt**		**8.0**	x	**2.0.50**	x	**11.7**	**=**	**1.9**	÷	**24.5**	**=**	**8.0**	**15.8**	**2.9**

Source: Bloomberg, ING estimates

Maybank

Tough at the top

Rating: HOLD

Changing balance sheet mix

Maybank continues to fight an uphill task in changing its balance sheet mix towards greater consumer exposure. As at December 2003, retail loans accounted for an estimated 30.4% of total group gross loans and 35.8% of its gross loans in Malaysia. This compares with the sector average of 39% and is among the lowest compared with its peers. While Commerce Asset-Holding's 26% retail loan exposure would seem to be low, we believe CAHB will be able to increase its exposure through its recent joint venture with Proton. In addition, CAHB's loan book is about half that of Maybank, which suggests that for Maybank to increase its retail loan exposure, it will take twice as much loans, everything else being equal. Consequently, Maybank's large exposure (40% of total loans according to management) to the corporate sector it remains vulnerable to the ongoing disintermediation in the industry. Finally, we noted that as at 1H04, its Singapore loan book grew by about 8.4% QoQ, which we believe was driven by retail loans. However, these loans are expected to be lower yielding than domestic ones given the more competitive landscape and lower interest rate environment in Singapore.

Second-round consolidation

Unlike its smaller peers, we do not believe that Maybank will participate in a second round of consolidation, given that any potential acquiree will add very little in terms of revenue synergies. Consequently, any benefits will have to be derived from driving costs down, which, in the context of its already extensive branch network, suggests closure of duplicated branches and retrenchments. However, given that the giant has very little it can add through a consolidation of the sector, the same cannot be said for its smaller peers. A closure of the gap between the smaller peers like Commerce Asset-Holding with Maybank will only mean more equal and intense competition. This will have implications on the valuations of Maybank, which we discuss below.

Capital management

In the last financial year, Maybank paid out gross dividends of RM0.52 per share. In conjunction with the release of its 1H04 results, Maybank indicated that it would pay higher dividends to run-down its CAR to about 11-12% over the next few years. This turnaround in policy suggests that the group is recognising that asset growth will not be significant given the large base. We estimate FY04 dividends of RM0.55 per share, which provides a decent yield for investors.

Valuations remain rich but …

We maintain our HOLD recommendation with a target price of RM10.09 based on DDM. While the group's forward valuation multiples remain at a premium to the sector, investors can look forward to a steady dividend flow. Consequently, while the group is not expected to provide strong underlying profit growth, its dividend yield is expected to provide share price support.

Maybank

Malaysia

Share Price:	11.10	**Reuters Code:**	MBBM.KL	**Shares Outstanding**	3,550
52 Week Price Range:	7.85 - 11.70	**Bloomberg Code:**	MAY.MK	**Market Cap (US$m)**	10,370

INCOME STATEMENT (RMm)	**01**	**02**	**03**	**04**	**05**
Interest income	7,921	7,387	7,187	7,244	8,381
Interest expense	-3,926	-3,451	-3,290	-3,153	-4,074
Net interest income	**3,995**	**3,936**	**3,897**	**4,091**	**4,307**
Non-interest income	1,627	1,976	1,960	2,014	2,088
Total operating income	**5,622**	**5,911**	**5,857**	**6,105**	**6,395**
Non-interest expense	-2,118	-2,181	-2,336	-2,478	-2,607
Pre provision profit	**3,504**	**3,731**	**3,521**	**3,627**	**3,788**
Loan loss provisions	-1,995	-1,379	-901	-586	-332
Non-operating income	1	2	0	1	1
Pre tax profit	**1,510**	**2,354**	**2,620**	**3,042**	**3,458**
Tax	-711	-658	-563	-822	-940
Net profit	**840**	**1,659**	**1,996**	**2,148**	**2,431**

BALANCE SHEET (RMm)	**01**	**02**	**03**	**04**	**05**
Gross loans	108,991	105,091	112,397	117,546	123,937
Loan loss reserves	*10,897*	*9,638*	*9,909*	*9,933*	*9,867*
Net loans	98,094	95,453	102,488	107,613	114,070
Total earning assets	138,452	140,710	150,171	164,884	172,584
Other assets	7,885	9,946	10,784	12,171	12,306
Total Assets	**146,337**	**150,656**	**160,955**	**177,056**	**184,891**
Deposits	96,485	102,572	109,393	121,427	127,498
Other paying liabilities	26,089	23,473	23,338	24,429	24,377
Other liabilities	13,724	11,952	14,738	16,982	17,922
Total Liabilities	136,297	137,998	147,470	162,837	169,797
Total Equity	**10,040**	**12,658**	**13,485**	**14,218**	**15,094**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	15,775	13,532	13,037	12,914	11,407
NPAs/total loans	14.5%	12.9%	11.6%	11.0%	9.2%
Reserve coverage of NPAs	55.0%	58.4%	61.5%	60.9%	68.5%

PER SHARE DATA (RM)	**01**	**02**	**03**	**04**	**05**
EPS	0.24	0.47	0.56	0.60	0.68
DPS	0.08	0.12	0.52	0.55	0.60
Effective payout ratio (%)	*34%*	*26%*	*93%*	*92%*	*89%*
BVPS	2.85	3.57	3.76	3.95	4.19

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	102%	93%	94%	89%	89%
Equity to assets	6.9%	8.4%	8.4%	8.0%	8.2%
Tier 1 CAR	9.2%	10.3%	10.2%	10.1%	10.1%
Total CAR	13.04%	15.56%	15.25%	14.86%	14.70%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	3.9x	3.1x	3.0x	2.8x	2.6x
Price to earnings	46.6x	23.7x	19.8x	18.6x	16.4x
Price to underlying profit	11.2x	10.6x	11.2x	11.0x	10.5x
Yield at current price (%)	0.72	1.08	4.68	4.95	5.41

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	10%	11%	12%	12%	12%
Mortgage (%)	14%	17%	17%	18%	18%
Corporate (%)	30%	28%	28%	27%	27%
Other (%)	46%	44%	43%	43%	43%

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	2.68%	2.62%	2.43%	2.34%	2.36%
Yield on assets	5.31%	4.91%	4.49%	4.15%	4.59%
Cost of liabilities	1.67%	2.88%	2.61%	2.27%	2.82%
Non-int. inc (% Op income)	28.94%	33.42%	33.46%	32.99%	32.65%
Cost to income	37.67%	36.89%	39.89%	40.59%	40.76%
Overhead	1.35%	1.36%	1.37%	1.33%	1.34%
ROA	0.51%	1.06%	1.20%	1.19%	1.29%
ROE	8.36%	13.12%	14.81%	15.11%	16.11%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	-4%	6%	-6%	3%	4%
Net profit	-38%	98%	20%	8%	13%
EPS	-39%	96%	20%	7%	13%
DPS	-33%	50%	333%	6%	9%
Net Loans	23%	-3%	7%	5%	6%
Assets	15%	3%	7%	10%	4%
Deposits	18%	6%	7%	11%	5%

Public Bank

Still going strong

Rating: BUY

Still going strong

Public Bank remains focused on its core retail franchise following an expected whopping year for loan growth. The latter registered a 21% YoY rise in FY03. The strength of the loan growth stems from its aggressive housing and vehicle financing strategies, coupled with its strong relationships with vehicle dealers and property developers. In light of the stronger economic growth expected this year, we believe that Public Bank can continue to build on this. However, margin pressure is also expected to remain an issue not only for Public Bank but also for the industry. Nonetheless, Public Bank should remain ahead of its peers in terms of margins.

Capital management

Capital management remains firmly in the sights of management, as evidenced by the ongoing share buyback programme that is expected to be renewed following shareholder approval. At the same time, the group's proposal to raise its par value to RM1.00 from RM0.50 is expected to reduce the number of outstanding shares by half. While this is not expected to have a financial impact, we believe a smaller share base and higher absolute share price will not impact its liquidity. At the same time, higher dividends are expected to remain a cornerstone of capital management. While the group had a payout ratio of 68% in FY03, we believe a higher payout ratio is both possible and sustainable. Finally, given its capital adequacy ratio is still skewed heavily towards Tier-1 capital (17.6% in FY03), raising Tier-2 capital via a subordinated debt issue is another potential event that is expected to complement its other capital management initiatives.

Hong Kong potential

While the privatisation of JCG Holdings in Hong Kong failed last year, we believe the recovery in the Hong Kong economy will lift the burden off parent Public Bank in terms of potential provisions. Moreover, with the new Hong Kong banking licence, Public Bank will be able to scale up its operations there subsequently. One possibility, in our view, could be the injection of JCG Holdings' branches into the banking licence, thereby allowing it to achieve scale in both its lending and deposit-taking operations.

Valuations remain attractive

We maintain our BUY recommendation with a target price of RM3.96 based on DDM. While Public Bank trades at a premium to the sector, we believe this premium is justified given the strong fundamentals. However, it remains at a discount to Maybank's valuations. We expect Public Bank to build on its already strong earnings base in FY04, which will be complemented by further capital management initiatives.

Public Bank

Malaysia

Share Price:	3.50	**Reuters Code:**	PUBME.KL	**Shares Outstanding**	4,629
52 Week Price Range:	1.84 - 3.70	**Bloomberg Code:**	PBKF.MK	**Market Cap (US$m)**	4,088

INCOME STATEMENT (RMm)	**01**	**02**	**03**	**04**	**05**
Interest income	3,117	3,213	3,354	3,788	4,432
Interest expense	-1,224	-1,241	-1,258	-1,491	-1,886
Net interest income	**1,893**	**1,971**	**2,096**	**2,297**	**2,546**
Non-interest income	675	756	930	1,008	1,159
Total operating income	**2,568**	**2,728**	**3,026**	**3,305**	**3,705**
Non-interest expense	-1,008	-1,140	-1,171	-1,174	-1,247
Pre provision profit	**1,560**	**1,588**	**1,855**	**2,131**	**2,458**
Loan loss provisions	-310	-349	-404	-317	-198
Non-operating income	1	3	4	4	5
Pre tax profit	**1,251**	**1,241**	**1,455**	**1,818**	**2,265**
Tax	-331	-322	-367	-471	-590
Net profit	**700**	**769**	**1,003**	**1,286**	**1,608**

BALANCE SHEET (RMm)	**01**	**02**	**03**	**04**	**05**
Gross loans	32,226	39,031	46,928	55,231	62,908
Loan loss reserves	*1,513*	*1,456*	*1,308*	*1,400*	*1,540*
Net loans	30,713	37,575	45,620	53,832	61,368
Total earning assets	50,354	58,523	60,390	66,474	73,274
Other assets	2,888	3,343	4,250	4,427	4,568
Total Assets	**53,242**	**61,866**	**64,640**	**70,900**	**77,843**
Deposits	39,782	47,986	50,217	54,235	58,302
Other paying liabilities	3,238	2,677	2,264	2,684	2,554
Other liabilities	3,933	4,212	3,483	4,597	6,686
Total Liabilities	46,953	54,875	55,965	61,515	67,542
Total Equity	**6,289**	**6,990**	**8,676**	**9,385**	**10,300**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	2,113	1,662	1,422	1,346	1,227
NPAs/total loans	6.6%	4.3%	3.0%	2.4%	2.0%
Reserve coverage of NPAs	56.0%	69.5%	80.3%	95.0%	117.5%

PER SHARE DATA (RM)	**01**	**02**	**03**	**04**	**05**
EPS	0.13	0.13	0.16	0.20	0.25
DPS	0.06	0.07	0.11	0.13	0.15
Effective payout ratio (%)	*45%*	*54%*	*68%*	*62%*	*60%*
BVPS	1.10	1.21	1.35	1.51	1.71

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	77%	78%	91%	99%	105%
Equity to assets	11.8%	11.3%	13.4%	13.2%	13.2%
Tier 1 CAR	23.4%	21.1%	20.9%	20.0%	20.2%
Total CAR	23.80%	21.69%	20.90%	20.35%	20.77%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	3.2x	2.9x	2.6x	2.3x	2.1x
Price to earnings	27.6x	26.5x	21.8x	17.4x	14.0x
Price to underlying profit	12.4x	12.8x	11.7x	10.5x	9.1x
Yield at current price (%)	1.65	2.06	3.14	3.57	4.29

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	25%	32%	34%	34%	34%
Mortgage (%)	20%	21%	21%	21%	21%
Corporate (%)	26%	24%	22%	22%	22%
Other (%)	29%	24%	23%	23%	22%

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	3.44%	3.29%	3.40%	3.39%	3.40%
Yield on assets	5.67%	5.36%	5.44%	5.58%	5.93%
Cost of liabilities	2.90%	2.50%	2.42%	2.65%	3.14%
Non-int. inc (% Op income)	26.29%	27.73%	30.73%	30.51%	31.28%
Cost to income	39.26%	41.80%	38.71%	35.53%	33.65%
Overhead	1.89%	1.84%	1.81%	1.66%	1.60%
ROA	1.73%	1.49%	1.68%	1.90%	2.15%
ROE	11.14%	11.01%	11.57%	13.30%	14.71%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	10%	2%	17%	15%	15%
Net profit	-2%	10%	30%	28%	25%
EPS	-14%	4%	22%	25%	25%
DPS	56%	25%	53%	14%	20%
Net Loans	31%	22%	21%	18%	14%
Assets	20%	16%	4%	10%	10%
Deposits	17%	21%	5%	8%	8%

Commerce Asset-Holding Foreign gains

Rating: BUY

Reaping gains from Niaga

Commerce Asset-Holding's (CAHB) acquisition of Bank Niaga in Indonesia in late 2002 is beginning to bear fruit, as the latter is estimated to contribute 17% of the group's underlying profit in FY04. Bank Niaga reported 3Q03 underlying profit of RM353.2m, up 381% YoY, driven a 23% rise in non-bank loans and margin improvement. Given the ongoing economic recovery in the Indonesian economy, we believe Bank Niaga will be leveraged into it. As at FY03, consumer loans accounted for 21% of the total, a three percentage point increase over a year ago. Lending to small and medium-sized enterprises accounted for a larger 45% of the total, with the remaining 34% of total loans being to corporate customers. To date, CAHB has not tapped into its outsourcing vehicle EPIC-I to reap efficiency gains from centralising certain back office and IT functions.

Enlarging consumer book

CAHB's joint venture with national car distributor Proton Edar is expected to bring incremental loan growth as well as income. We should note that the joint venture, Proton Commerce Sdn Bhd, will not be a significant contributor to group earnings immediately given its start-up costs. Nonetheless, we expect the group to benefit from near-term bridge financing of the vehicle as it builds up its vehicle hire purchase portfolio to a sufficient size to allow it to securitise it via a debt instrument later this year. We estimate that CAHB could see its retail loan portfolio rise by at least RM2bn this year, on account of the new vehicle financing loans brought about by the joint venture.

Capital for growth

Recent media reports indicated the possibility that Bank Niaga could raise up to Rp1tr (RM451.1m) via a rights issue. If so, we estimate that CAHB's share of the additional capital should be in the region of RM230m. Given the rapid build-up of Bank Niaga's loan book, we believe this is a possibility but, at the same time, would not treat it as a negative event. Further along, even parent CAHB will need to examine its own capital requirements as Bank Niaga continues expanding its assets. CAHB reported a CAR of 11.7% and Tier-1 ratio of 10.0% at the end of September 2003.

Valuations remain attractive

We maintain our BUY recommendation with a target price of RM6.54 based on DCF. CAHB's forward multiples remain at discounts of between 11-29% to its peers.

Commerce Asset-Holding

Malaysia

Share Price:	5.20	**Reuters Code:**	COMM.KL	**Shares Outstanding**	2,586
52 Week Price Range:	2.87 - 5.65	**Bloomberg Code:**	CAHB.MK	**Market Cap (US$m)**	3,539

INCOME STATEMENT (RMm)	**01**	**02**	**03**	**04**	**05**
Interest income	3,877	4,072	5,080	5,668	6,327
Interest expense	-2,016	-1,993	-2,534	-3,020	-3,462
Net interest income	**1,861**	**2,079**	**2,547**	**2,648**	**2,865**
Non-interest income	886	750	1,032	1,165	1,290
Total operating income	**2,747**	**2,829**	**3,579**	**3,813**	**4,156**
Non-interest expense	-1,252	-1,280	-1,704	-1,688	-1,746
Pre provision profit	**1,495**	**1,548**	**1,874**	**2,125**	**2,409**
Loan loss provisions	-993	-813	-645	-512	-415
Non-operating income	14	12	11	15	17
Pre tax profit	**516**	**748**	**1,241**	**1,627**	**2,012**
Tax	-34	-34	-172	-189	-208
Net profit	**342**	**565**	**782**	**984**	**1,236**

BALANCE SHEET (RMm)	**01**	**02**	**03**	**04**	**05**
Gross loans	44,606	51,902	57,623	63,963	69,299
Loan loss reserves	*2,391*	*3,131*	*3,126*	*2,865*	*2,774*
Net loans	42,215	48,772	54,497	61,098	66,525
Total earning assets	68,233	84,928	91,160	96,084	101,254
Other assets	6,138	6,539	6,774	8,130	8,557
Total Assets	**74,370**	**91,467**	**97,934**	**104,215**	**109,811**
Deposits	46,878	60,757	63,154	70,339	74,669
Other paying liabilities	11,834	12,579	13,560	11,304	10,834
Other liabilities	10,102	10,962	13,321	13,876	14,662
Total Liabilities	68,814	84,298	90,034	95,520	100,165
Total Equity	**5,556**	**7,169**	**7,900**	**8,695**	**9,646**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	4,579	5,320	5,212	4,888	4,657
NPAs/total loans	10.3%	10.2%	9.0%	7.6%	6.7%
Reserve coverage of NPAs	43.3%	48.2%	51.2%	51.6%	53.6%

PER SHARE DATA (RM)	**01**	**02**	**03**	**04**	**05**
EPS	0.15	0.22	0.30	0.37	0.47
DPS	0.03	0.05	0.10	0.10	0.15
Effective payout ratio (%)	*20%*	*23%*	*33%*	*27%*	*32%*
BVPS	2.29	2.64	3.00	3.31	3.67

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	90%	80%	86%	87%	89%
Equity to assets	7.5%	7.8%	8.1%	8.3%	8.8%
Tier 1 CAR	9.7%	10.7%	10.5%	11.1%	11.6%
Total CAR	12.42%	12.53%	12.12%	12.72%	13.23%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	2.3x	2.0x	1.7x	1.6x	1.4x
Price to earnings	34.3x	23.4x	17.3x	13.9x	11.1x
Price to underlying profit	9.1x	8.5x	7.2x	6.4x	5.6x
Yield at current price (%)	0.58	0.96	1.92	1.92	2.88

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	9%	9%	11%	11%	12%
Mortgage (%)	18%	17%	15%	16%	16%
Corporate (%)	32%	32%	35%	35%	35%
Other (%)	41%	42%	39%	38%	37%

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	2.64%	2.62%	2.70%	2.68%	2.75%
Yield on assets	5.49%	5.13%	5.39%	5.73%	6.08%
Cost of liabilities	3.43%	3.04%	3.35%	3.70%	4.05%
Non-int. inc (% Op income)	32.26%	26.50%	28.84%	30.56%	31.05%
Cost to income	45.59%	45.26%	47.62%	44.27%	42.02%
Overhead	1.68%	1.57%	1.74%	1.62%	1.59%
ROA	0.51%	0.74%	0.97%	1.13%	1.32%
ROE	6.16%	7.89%	9.91%	11.32%	12.81%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	13%	4%	21%	13%	13%
Net profit	-32%	65%	38%	26%	26%
EPS	-29%	46%	35%	25%	26%
DPS	0%	67%	100%	0%	50%
Net Loans	15%	16%	12%	12%	9%
Assets	6%	23%	7%	6%	5%
Deposits	2%	30%	4%	11%	6%

AMMB Holdings

Leveraged play

Rating: BUY

Leveraged into recovery

AMMB Holdings' 50% exposure to the retail sector via its vehicle financing, housing and personal consumption loans puts it in a position to benefit from the ongoing economic growth and expected strength in consumption. In particular, its vehicle financing loans accounted for 33% of total loans as at 31 December 2003, the second highest in the sector. While there are lingering fears on the group's ability to grow its portfolio due to its exposure to the national cars, we believe the launch of new models may provide the impetus for growth. In addition, its 3Q04 interim results indicated broadening loan growth, with its manufacturing and commerce sector loans rising 10% and 11% HoH, respectively. We believe AMMB Holdings will also benefit from an improvement in lending to small and medium-sized enterprises (SMEs).

Second-round consolidation

While the failed merger talks between AMMB Holdings and EON Capital as well as Commerce Asset-Holding were a disappointment, we cannot rule out potential talks in the future. Given that pricing is expected to remain an issue, the recent run-up in the share price may provide its owners with a more attractive argument. More recently, media reports of Temasek Holdings' potential acquisition of a stake in Alliance Bank suggests that the banks may have to contend with foreign ownership. This could provide a catalyst for the banks to stake their claims before the foreigners are allowed more stakes. Further along, we believe the eventual liberalisation of the sector and adoption of the Basle 2 capital requirements are additional catalysts for mergers.

Restructuring

AMMB holdings has proposed a restructuring which will see the privatisation of AMFB Holdings and the listing of its investment banking operations. The latter will consist of the merchant bank, stock broking and asset management companies. AMMB Holdings will pay RM7.20 per AMFB Holding share, with RM3.12 paid in cash and one share of AMMB Holdings. We view the offer price as fair given that it is in line with historical valuations. Additionally, AMMB Holdings' proposed listing of the investment banking group leaves money on the table for minority shareholders.

Valuations remain attractive

We maintain our BUY recommendation with a target price of RM5.03 based on DCF. Relative to its peers, AMMB Holdings remains the most attractive on PUP multiples.

AMMB Group Holdings

Malaysia

Share Price:	3.98	**Reuters Code:**	AMMB.KL	**Shares Outstanding**	1,002
52 Week Price Range:	1.87 - 4.14	**Bloomberg Code:**	AMM.MK	**Market Cap (US$m)**	1,049

INCOME STATEMENT (RMm)	**01**	**02**	**03**	**04**	**05**
Interest income	2,720	2,598	3,218	2,984	3,461
Interest expense	-1,489	-1,497	-1,670	-1,609	-2,093
Net interest income	**1,231**	**1,101**	**1,548**	**1,375**	**1,368**
Non-interest income	654	788	867	1,211	1,337
Total operating income	**1,885**	**1,889**	**2,415**	**2,585**	**2,705**
Non-interest expense	-705	-934	-1,132	-1,304	-1,341
Pre provision profit	**1,180**	**955**	**1,283**	**1,281**	**1,363**
Loan loss provisions	-533	-523	-877	-829	-730
Non-operating income	3	0	-4	2	-1
Pre tax profit	**650**	**432**	**402**	**454**	**633**
Tax	-104	-93	-123	-172	-132
Net profit	**347**	**201**	**263**	**334**	**321**

BALANCE SHEET (RMm)	**01**	**02**	**03**	**04**	**05**
Gross loans	32,195	43,026	42,274	44,271	54,844
Loan loss reserves	*2,757*	*5,649*	*4,157*	*4,819*	*7,311*
Net loans	29,437	37,377	38,118	39,452	47,533
Total earning assets	41,257	50,833	54,475	55,773	58,176
Other assets	2,789	4,423	4,241	4,898	5,695
Total Assets	**44,047**	**55,257**	**58,717**	**60,671**	**63,871**
Deposits	21,056	32,202	31,350	32,291	34,551
Other paying liabilities	17,126	16,530	19,173	18,794	18,448
Other liabilities	3,615	4,036	4,730	5,507	5,753
Total Liabilities	41,797	52,768	55,253	56,592	58,752
Total Equity	**2,250**	**2,488**	**3,464**	**4,079**	**5,118**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	6,534	10,915	8,000	6,904	5,910
NPAs/total loans	20.3%	25.4%	18.9%	15.6%	10.8%
Reserve coverage of NPAs	25.6%	33.8%	29.9%	38.8%	49.7%

PER SHARE DATA (RM)	**01**	**02**	**03**	**04**	**05**
EPS	0.23	0.13	0.16	0.23	0.17
DPS	0.03	0.03	0.03	0.05	0.05
Effective payout ratio (%)	*13%*	*23%*	*19%*	*22%*	*30%*
BVPS	1.41	1.46	1.92	2.08	2.53

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	140%	116%	122%	122%	138%
Equity to assets	5.1%	4.5%	5.9%	6.7%	8.0%
Tier 1 CAR	7.2%	6.3%	8.5%	8.9%	8.4%
Total CAR	12.82%	12.19%	12.83%	13.75%	12.71%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	2.8x	2.7x	2.1x	1.9x	1.6x
Price to earnings	17.0x	30.0x	25.1x	17.5x	23.6x
Price to underlying profit	5.0x	6.3x	5.0x	4.8x	6.5x
Yield at current price (%)	0.76	0.76	0.76	1.26	1.26

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	22%	28%	35%	35%	36%
Mortgage (%)	8%	12%	15%	15%	15%
Corporate (%)	20%	18%	13%	13%	13%
Other (%)	50%	42%	38%	36%	36%

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	2.98%	2.34%	2.84%	2.46%	2.35%
Yield on assets	6.60%	5.52%	5.91%	5.35%	5.95%
Cost of liabilities	4.32%	3.39%	3.34%	3.15%	3.95%
Non-int. inc (% Op income)	34.70%	41.71%	35.91%	46.83%	49.43%
Cost to income	37.40%	49.43%	46.88%	50.45%	49.59%
Overhead	1.60%	1.96%	1.93%	2.15%	2.10%
ROA	1.03%	0.62%	0.66%	0.83%	0.71%
ROE	15.45%	8.30%	7.60%	8.19%	6.30%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	-15%	-19%	34%	0%	6%
Net profit	-36%	-42%	31%	27%	-4%
EPS	-41%	-43%	20%	43%	-26%
DPS	0%	0%	0%	65%	0%
Net Loans	13%	27%	2%	3%	20%
Assets	14%	25%	6%	3%	5%
Deposits	21%	53%	-3%	3%	7%

Hong Leong Bank

Reverse gear

Rating: BUY

Returning to vehicle financing

Hong Leong Bank's new CEO, Yvonne Chia, has reversed the group's earlier strategy to reduce its exposure to vehicle financing. As at 31 December 2003, Hong Leong Bank had 26% of its loans in this segment, which had contracted by 22% YoY as a result of its deliberate strategy. However, with the prospect of stronger car sales this year, and predicated on a stronger economy and clarity on the government's stand on import and excise duties for imported cars, Hong Leong Bank will join its peers in building a larger loan book for new cars. Given that this segment remains the largest in terms of its loan book, a return to growth is expected to aid in rebuilding its earnings.

Cost advantage and focus

Hong Leong Bank's new CEO is also aware of the bank's competitive edge in having the most efficient cost structure. At its cost-to-assets ratio of 1.0% (FY04), Hong Leong Bank remains the most efficient relative to its peers. This cost advantage will provide strong leverage when it lifts its income yield, everything else being constant. Aside from cost considerations, the group remains focused on its exposure to small and medium-sized enterprises (SMEs) with an estimated 9% of its loans to the manufacturing sector. Finally, the group will seek to build on its other services, including treasury. Further along, Hong Leong Bank will be able to build on its Hong Kong operations following the recent successful application for a banking licence there.

Capital management

Aside from rebuilding its income streams, we believe Hong Leong Bank's excess capital will not escape the new CEO. With a CAR and Tier-1 ratio of 18.0% and 16.5%, respectively, the ratios are significantly above its peers'. While the stronger income streams will help lift its ROA, we believe its ROE will be enhanced by higher leverage through capital management. Consequently, we believe Hong Leong Bank could offer higher dividends as part of its capital management.

Valuations remain attractive

We maintain our BUY recommendation with a target price of RM6.75 based on DCF. Its share price has lagged its peers, rising only 4.8% year to date. As a result, Hong Leong Bank now trades at a discount to the sector multiples on all valuation metrics. Additionally, it no longer shares the same P/BV multiples that it once did with Public Bank or Maybank. Given the laggard performance and the potential for a turnaround, particularly in terms of earnings potential and capital management, we believe the stock offers the best upside potential for investors.

Hong Leong Bank

Malaysia

Share Price:	5.35	**Reuters Code:**	HLBB.KL	**Shares Outstanding**	1,433
52 Week Price Range:	4.00 - 5.85	**Bloomberg Code:**	HLBK.MK	**Market Cap (US$m)**	2,018

INCOME STATEMENT (RMm)	**01**	**02**	**03**	**04**	**05**
Interest income	2,345	2,256	2,174	2,157	2,535
Interest expense	-1,130	-1,080	-1,035	-1,052	-1,287
Net interest income	**1,216**	**1,176**	**1,139**	**1,105**	**1,249**
Non-interest income	283	383	345	314	364
Total operating income	**1,499**	**1,559**	**1,484**	**1,419**	**1,613**
Non-interest expense	-482	-503	-471	-478	-521
Pre provision profit	**1,017**	**1,057**	**1,014**	**940**	**1,092**
Loan loss provisions	-413	-351	-212	-187	-138
Non-operating income	0	0	0	0	0
Pre tax profit	**604**	**706**	**802**	**753**	**954**
Tax	-209	-203	-221	-211	-270
Net profit	**394**	**503**	**581**	**542**	**684**

BALANCE SHEET (RMm)	**01**	**02**	**03**	**04**	**05**
Gross loans	24,389	25,086	24,311	24,610	25,889
Loan loss reserves	*1,568*	*1,704*	*1,775*	*1,623*	*1,523*
Net loans	22,821	23,382	22,536	22,987	24,366
Total earning assets	38,913	41,444	42,263	47,949	50,722
Other assets	1,324	1,577	1,306	1,362	1,419
Total Assets	**40,237**	**43,021**	**43,569**	**49,311**	**52,141**
Deposits	31,169	34,080	35,999	37,079	38,563
Other paying liabilities	3,206	1,544	417	2,175	2,286
Other liabilities	2,847	4,007	3,244	5,305	6,129
Total Liabilities	37,222	39,630	39,661	44,559	46,978
Total Equity	**3,015**	**3,390**	**3,908**	**4,753**	**5,163**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	3,016	3,138	2,819	2,529	2,315
NPAs/total loans	12.4%	12.5%	11.6%	10.3%	8.9%
Reserve coverage of NPAs	36.2%	35.9%	41.0%	39.2%	37.8%

PER SHARE DATA (RM)	**01**	**02**	**03**	**04**	**05**
EPS	0.28	0.35	0.40	0.34	0.43
DPS	0.14	0.11	0.35	0.24	0.24
Effective payout ratio (%)	*48%*	*31%*	*87%*	*70%*	*55%*
BVPS	2.11	2.37	2.72	3.01	3.27

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	73%	69%	63%	62%	63%
Equity to assets	7.5%	7.9%	9.0%	9.6%	9.9%
Tier 1 CAR	12.5%	13.8%	15.0%	16.1%	16.5%
Total CAR	14.24%	15.38%	16.38%	17.30%	17.70%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	2.5x	2.3x	2.0x	1.8x	1.6x
Price to earnings	19.0x	15.2x	13.2x	15.6x	12.4x
Price to underlying profit	7.4x	7.2x	7.6x	9.0x	7.7x
Yield at current price (%)	2.52	2.06	6.54	4.49	4.49

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	36%	39%	33%	32%	33%
Mortgage (%)	18%	16%	22%	22%	23%
Corporate (%)	20%	19%	20%	20%	21%
Other (%)	26%	25%	25%	25%	23%

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	3.13%	2.84%	2.70%	2.31%	2.46%
Yield on assets	6.03%	5.44%	5.14%	4.50%	5.00%
Cost of liabilities	3.29%	3.03%	2.84%	2.68%	3.15%
Non-int. inc (% Op income)	18.88%	24.59%	23.25%	22.12%	22.58%
Cost to income	32.15%	32.23%	31.72%	33.71%	32.32%
Overhead	1.20%	1.17%	1.08%	0.97%	1.00%
ROA	0.98%	1.17%	1.33%	1.10%	1.31%
ROE	13.08%	14.84%	14.87%	11.42%	13.25%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	10%	4%	-4%	-7%	16%
Net profit	-12%	28%	15%	-7%	26%
EPS	-14%	25%	15%	-15%	26%
DPS	100%	-19%	218%	-31%	0%
Net Loans	12%	2%	-4%	2%	6%
Assets	14%	7%	1%	13%	6%
Deposits	8%	9%	6%	3%	4%

EON Capital

Driving earnings

Rating: BUY

Vehicle financing growth

Despite a difficult year for the national cars, EON Capital managed to grow its vehicle financing portfolio by 5.6% in FY03, evidence that it has managed to diversify from its traditional reliance on national cars. While still maintaining this strategy, we believe a slight rebound in national car sales in 2004, predicated on the successful launch of new models, will provide EON Capital with an additional growth driver for its loans. At the same time, the joint venture set up by rival Commerce Asset-Holdings together with Proton Edar is not expected to have a material impact on EON Capital. With 33% of its loans in vehicle financing, we believe near-term prospects will be boosted by higher consumption, driven by stronger economic growth and greater clarity on the government's stand on imported vehicles.

Buy or sell

EON Capital's bid for AMMB Holdings may have been a failure, but we believe this does not rule out future attempts to consolidate with another bank. At the same time, there is no change in EON Bhd's, EON Capital's parent, commitment to distribute its stake in EON Capital to its shareholders. This suggests that if there is an attractive offer, EON Bhd may decide to take the cash or share in a larger group instead of distributing the shares to its shareholders. We should note that beyond providing a platform for stronger asset expansion, EON Capital's CAR will be more than sufficient to support further expansion via other means.

Diversification

EON Capital is attempting to diversify both its balance sheet as well as income stream. Management is currently growing its exposure to the small and medium-sized enterprises (SMEs), which is estimated at 12%. Aside from this, its 17% contribution from non-interest income remains below industry peers, but steps have been taken to grow it via bancassurance and unit trust sales. Additionally, it has built a sizeable base of credit cards. Finally, EON Capital will be examining its funding structure to lower its funding costs.

Valuations remain attractive

We maintain our BUY recommendation with a target price of RM6.00 based on DCF. The group remains the most attractive with the lowest PER among its peers. It is also the third most attractive on PUP multiples. While its share price has performed well so far, we believe there is room for further re-rating as the group builds on its more diversified income stream.

EON Capital

Malaysia

Share Price:	5.25	**Reuters Code:**	EON.KL	**Shares Outstanding**	693
52 Week Price Range:	2.64 - 5.75	**Bloomberg Code:**	EON.MK	**Market Cap (US$m)**	958

INCOME STATEMENT (RMm)	**01**	**02**	**03**	**04**	**05**
Interest income	1,483	1,573	1,662	1,709	2,032
Interest expense	-685	-762	-832	-817	-1,051
Net interest income	**798**	**811**	**831**	**892**	**980**
Non-interest income	190	214	267	280	318
Total operating income	**987**	**1,024**	**1,097**	**1,172**	**1,299**
Non-interest expense	-438	-473	-471	-487	-509
Pre provision profit	**549**	**551**	**627**	**685**	**789**
Loan loss provisions	-221	-158	-176	-153	-131
Non-operating income	0	0	0	0	0
Pre tax profit	**328**	**393**	**451**	**532**	**658**
Tax	-128	-139	-122	-147	-190
Net profit	**201**	**254**	**328**	**385**	**467**

BALANCE SHEET (RMm)	**01**	**02**	**03**	**04**	**05**
Gross loans	18,320	22,061	22,550	24,185	26,722
Loan loss reserves	*932*	*1,488*	*1,262*	*1,193*	*1,202*
Net loans	17,388	20,574	21,288	22,991	25,520
Total earning assets	22,660	28,501	29,540	32,569	35,340
Other assets	2,061	2,205	2,101	2,251	2,407
Total Assets	**24,721**	**30,706**	**31,641**	**34,820**	**37,747**
Deposits	17,311	18,523	20,878	23,488	26,306
Other paying liabilities	3,913	8,393	6,457	6,447	5,845
Other liabilities	1,421	1,941	1,992	2,236	2,578
Total Liabilities	22,646	28,857	29,327	32,171	34,730
Total Equity	**2,075**	**1,850**	**2,314**	**2,649**	**3,017**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	1,530	1,571	1,403	1,349	1,345
NPAs/total loans	8.4%	7.1%	6.2%	5.6%	5.0%
Reserve coverage of NPAs	25.8%	43.8%	49.6%	51.9%	55.3%

PER SHARE DATA (RM)	**01**	**02**	**03**	**04**	**05**
EPS	0.17	0.37	0.47	0.56	0.67
DPS	0.00	0.00	0.07	0.10	0.20
Effective payout ratio (%)	*0%*	*0%*	*14%*	*18%*	*30%*
BVPS	1.39	2.67	3.34	3.82	4.35

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	100%	111%	102%	98%	97%
Equity to assets	8.4%	6.0%	7.3%	7.6%	8.0%
Tier 1 CAR	20.0%	10.0%	13.4%	13.6%	13.9%
Total CAR	12.54%	11.20%	14.79%	19.26%	18.97%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	3.8x	2.0x	1.6x	1.4x	1.2x
Price to earnings	31.7x	14.3x	11.1x	9.5x	7.8x
Price to underlying profit	11.6x	6.6x	5.8x	5.3x	4.6x
Yield at current price (%)	0.00	0.00	1.24	1.90	3.81

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	33%	37%	39%	38%	38%
Mortgage (%)	15%	16%	18%	19%	17%
Corporate (%)	21%	19%	18%	19%	19%
Other (%)	30%	29%	26%	24%	25%

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	3.52%	2.85%	2.81%	2.74%	2.77%
Yield on assets	6.55%	5.52%	5.63%	5.25%	5.75%
Cost of liabilities	3.23%	2.83%	3.04%	2.73%	3.27%
Non-int. inc (% Op income)	19.20%	20.86%	24.30%	23.86%	24.50%
Cost to income	44.41%	46.20%	42.89%	41.58%	39.23%
Overhead	1.78%	1.54%	1.49%	1.40%	1.35%
ROA	0.81%	0.83%	1.04%	1.11%	1.24%
ROE	9.67%	13.74%	14.20%	14.53%	15.50%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	33%	0%	14%	9%	15%
Net profit	-23%	27%	29%	17%	21%
EPS	-28%	121%	29%	17%	21%
DPS	NM	NM	NM	54%	100%
Net Loans	49%	18%	3%	8%	11%
Assets	39%	24%	3%	10%	8%
Deposits	46%	7%	13%	13%	12%

RHB Capital

Beta play

Rating: BUY

Best exposure to manufacturing

RHB Capital's bank has the best exposure to the manufacturing sector as measured by its 21% share of total loans. This is the second-largest exposure after retail, which accounted for 31% of total loans. Collectively, the group has the ability to participate in the ongoing consumption rebound, as well as a recovery in the manufacturing sector. We note that the group continues to have the largest exposure to the corporate sector, with SME and retail segments taking the remaining loans. In comparison, Commerce Asset-Holding, which has the second-largest exposure to manufacturing, has about 20% of its total loans to the sector.

Still in transition

With the recent news of the departure of RHB Bank's CEO, Michael Hague, the group has three vacant CEO positions, including the merchant bank and stock broking subsidiaries. While we do not expect any near-term financial impact, we believe that should the search for a new CEO become long-drawn and there are further disruptions with respect to key personnel leaving the group, there may be an impact. In the meantime, we believe the market has already priced in the news given that the group still trades at a significant discount to the sector P/BV and PUP multiples.

Second-round consolidation

In light of the vacancies in the group, there remains the question as to whether this can be read as an indicator that the group may be open to a merger. We note that there is a common shareholder in RHB Capital's parent, RHB Bhd, and Commerce Asset-Holding. The common shareholder is the Employees' Provident Fund (EPF), which owns 31.7% of RHB Bhd and 28% of Commerce Asset-Holding. Accordingly, we cannot rule out the possibility that EPF may decide to merge the second- and third-largest banking groups in the country. The issue is whether the current substantial shareholder of RHB Bhd, Utama Banking Group, will be amenable to the merger.

Beta play

We maintain our BUY recommendation with a target price of RM3.33 based on DCF using a 16% cost of equity. We note that RHB Capital attracts one of the highest betas of 1.7x against the broader market. This suggests that given our view of a rebound in the broader market, we should expect further share price movements to be partly driven by the former. While valuations on P/BV and PUP remain the most attractive among the peers, its PER is not the most attractive. Accordingly, the stock may not be suitable for investors who are more risk averse. Fundamentally, the discount to the sector may remain given the risks over a change in management.

RHB Capital — Malaysia

Share Price:	2.27	**Reuters Code:**	RHBC.KL	**Shares Outstanding**	1,823
52 Week Price Range:	1.37 - 2.73	**Bloomberg Code:**	RHBC.MK	**Market Cap (US$m)**	1,089

INCOME STATEMENT (RMm)	**01**	**02**	**03**	**04**	**05**
Interest income	2,855	2,614	2,673	2,641	3,011
Interest expense	-1,382	-1,210	-1,290	-1,302	-1,554
Net interest income	**1,473**	**1,404**	**1,383**	**1,340**	**1,457**
Non-interest income	582	624	763	798	852
Total operating income	**2,055**	**2,028**	**2,145**	**2,138**	**2,309**
Non-interest expense	-883	-857	-969	-1,078	-1,102
Pre provision profit	**1,172**	**1,172**	**1,176**	**1,060**	**1,207**
Loan loss provisions	-547	-773	-655	-499	-447
Non-operating income	-3	3	0	1	1
Pre tax profit	**622**	**401**	**521**	**561**	**760**
Tax	-213	-166	-181	-158	-161
Net profit	**199**	**127**	**251**	**290**	**408**

BALANCE SHEET (RMm)	**01**	**02**	**03**	**04**	**05**
Gross loans	40,667	41,485	47,232	48,617	50,516
Loan loss reserves	*3,017*	*3,724*	*4,785*	*4,897*	*5,047*
Net loans	37,650	37,761	42,447	43,720	45,469
Total earning assets	53,807	53,555	64,402	66,875	69,220
Other assets	3,561	3,965	5,084	6,001	6,272
Total Assets	**57,368**	**57,520**	**69,486**	**72,876**	**75,492**
Deposits	37,881	37,279	48,521	50,705	52,733
Other paying liabilities	5,472	6,066	7,120	7,154	7,048
Other liabilities	10,550	10,439	9,970	10,919	11,284
Total Liabilities	53,903	53,784	65,611	68,778	71,065
Total Equity	**3,465**	**3,737**	**3,874**	**4,098**	**4,427**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	4,769	6,696	7,737	7,432	6,820
NPAs/total loans	11.7%	16.1%	16.4%	15.3%	13.5%
Reserve coverage of NPAs	47.9%	41.3%	44.0%	45.9%	51.0%

PER SHARE DATA (RM)	**01**	**02**	**03**	**04**	**05**
EPS	0.10	0.07	0.13	0.15	0.20
DPS	0.05	0.02	0.08	0.05	0.06
Effective payout ratio (%)	*48%*	*27%*	*58%*	*34%*	*30%*
BVPS	1.75	1.90	1.47	2.25	2.43

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	99%	101%	87%	86%	86%
Equity to assets	6.0%	6.5%	5.6%	5.6%	5.9%
Tier 1 CAR	11.1%	12.1%	9.3%	9.0%	9.7%
Total CAR	12.75%	13.74%	10.58%	10.21%	10.92%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	1.3x	1.2x	1.5x	1.0x	0.9x
Price to earnings	21.7x	31.2x	17.5x	15.4x	11.3x
Price to underlying profit	4.3x	4.3x	4.3x	4.7x	4.1x
Yield at current price (%)	2.20	0.88	3.30	2.20	2.64

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	5%	6%	7%	8%	8%
Mortgage (%)	13%	17%	21%	22%	22%
Corporate (%)	45%	42%	39%	38%	39%
Other (%)	37%	35%	33%	33%	31%

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	2.63%	2.49%	2.13%	1.91%	2.00%
Yield on assets	5.09%	4.64%	4.11%	3.76%	4.14%
Cost of liabilities	3.21%	2.79%	2.53%	2.25%	2.60%
Non-int. inc (% Op income)	28.34%	30.76%	35.54%	37.34%	36.91%
Cost to income	42.97%	42.23%	45.19%	50.44%	47.73%
Overhead	1.54%	1.49%	1.50%	1.48%	1.46%
ROA	0.72%	0.51%	0.67%	0.61%	0.75%
ROE	5.76%	3.40%	6.47%	7.07%	9.21%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	-6%	0%	0%	-10%	14%
Net profit	-44%	-36%	97%	16%	41%
EPS	-46%	-30%	78%	14%	36%
DPS	-50%	-60%	275%	-33%	20%
Net Loans	7%	0%	12%	3%	4%
Assets	4%	0%	21%	5%	4%
Deposits	6%	-2%	30%	4%	4%

Taiwan

Year of reform, year of recovery

Rating: OVERWEIGHT

Taiwan is now our favourite market for Asian financials, having taken over the rotation from Malaysia. We believe that Taiwan offers an intriguing mix of value, operating leverage and technical/political catalysts that are difficult to match elsewhere in our universe.

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.
- Consolidation of the Taiwanese banking industry.

Macro catalysts

Multi-year upcycle for NT$

We believe that the NT$ is significantly undervalued – in particular against the US$. 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]

QFII liberalisation and MSCI reweighting

On 30 September, Taiwan's Securities and Futures Commission (SFC) announced that it would implement QFII reform immediately. Among the specific QFII reforms are:

- Foreign investors no longer need to apply for approvals for equity investments and 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 are allowed to dispose of their securities holdings through overseas depository receipt issues.
- Investors may 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.

For most of a year we have been awaiting the results of MSCI's review of its weightings in Taiwan. Currently, the market is weighted at only 55% of its theoretical market capitalisation due to limited investability factors. However, in part due to the QFII liberalisation steps detailed above, MSCI released a public consultation document in April which revealed that the firm is considering two options to increase Taiwan's weighting: one which would raise the weight to 75% in November 2004 and then conduct a further review, and one which would raise the weighting to 75% in November and then 100% in May 2005.

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

Although ING's Taiwan strategist has long forecast such a review, we feel that this news is better than our original expectations for two reasons. First, it is now apparent that political developments since March have not had a material impact on MSCI's decision. Second, we originally believed that MSCI in 2Q would announce an increase from 55% to between 70% and 80% with implementation in 4Q04 – essentially, the alternative proposal. However, our assumption had been that MSCI would not raise Taiwan's LIF to 100% until the pre-funding issue had been solved.

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 was in 4Q03 – to 23-24%.
- Second, indications are that there is 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 substantial index weighting that has underperformed. Foreign investors are already underweight banks; we think this will reverse.

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—failing to pass legislative reading again in April—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

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

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-capitalised 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); and we 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 convertible 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 of banks to amortise 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 behaviour 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 that 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 sterilised 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.

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 sterilisation is comparable to levels in Taiwan's asset bubble from 1986-90.

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%.

Rapid growth in bank consumer lending since the mid-1990s is properly 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.

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

High credit growth

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 the 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.

As of year-end, card transaction values are back into positive YoY territory – remember that the SARS epidemic earlier in 2003 took a huge chunk out of card spending, particularly overseas spending as most flights were cut. Local spending is nevertheless showing an 11.7% annualised gain for the year through November, not far below the 2002 level and pretty resilient on the whole.

Cash advances are increasing faster than regular charge volume – a potential danger sign but not one which is so far worrisome; we suspect that it is more a reaction to low teaser rate programs than anything else.

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, and believe that card balances in Taiwan can grow at a 15%+ CAGR over the next five years, especially on the back of improved macroeconomic performance and real income growth for consumers.

Fig 155 Credit card transactions and receivables: 1995-2003

NT$m	1995	1996	1997	1998	1999	2000	2001	2002	2003/11
Total transaction value:									
Local	N/A	227,386	322,480	441,505	545,830	660,934	716,162	813,489	908,936
Overseas	N/A	45,001	51,945	49,592	51,956	58,836	55,700	60,107	56,371
Total	190,653	272,387	374,425	491,097	597,786	719,770	771,862	873,596	884,864
% increase		42.9	37.5	31.2	21.7	20.4	7.2	13.2	1.3
% increase, local			41.8	36.9	23.6	21.1	8.4	13.6	11.7
% increase, overseas			15.4	-4.5	4.8	13.2	-5.3	7.9	-6.2
Cash advances									
Local	N/A	13,453	24,456	38,172	49,682	77,820	101,601	130,376	174,733
Overseas	N/A	1,249	1,286	1,466	1,706	1,948	2,178	2,110	2,153
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	34.0
% increase, overseas			3.0	14.0	16.4	14.2	11.8	-3.1	2.1
Total receivables outstanding	N/A	N/A	88,420	124,908	152,768	205,656	259,875	316,328	368,381
% increase, YoY				41.3	22.3	34.6	26.4	21.7	16.5

Note: 2003 figures are annualised.

Source: CBC

Key credit card 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, 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 156 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

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 that 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 157 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.

Loan growth takes a turn for the better

After two straight calendar years of declining loan balances, Taiwanese financials picked up the pace dramatically in 2H03 to finish the year strongly in the black. At the end of July, aggregate lending was rising at a meagre 2.3% annual rate; however, a strong finish to the year made the final tally a very respectable 5.1% increase – well above our estimate of 3.6% growth for the full year and the strongest year since 2000.

Although the growth is still patchy, with numerous areas of weakness, strength in the critical retail mortgage (+8.0%) and personal lending (+15.5%) areas, which collectively account for some 42% of total loans, is carrying the market. Trade finance also did creditably, up 9.7% on the year.

A big surprise was the slowdown in manufacturing lending, which had been up 0.7% at mid-year. Some seasonality may be at work here, but recent years' data are ambiguous on the subject. Government loans also shrank; not a concern for us as they are marginally profitable anyway.

Fig 158 Loans by category (% growth YoY)

	1996	1997	1998	1999	2000	2001	2002	2003
Commercial and SOES	(3.5)	15.5	16.7	12.2	4.8	(2.5)	(1.7)	1.7
Agricultural, forestry, fishing and animal husbandry	(3.3)	2.4	33.3	(17.8)	7.7	(50.6)	8.2	27.1
Mining and quarrying	12.5	22.8	0.4	15.7	6.5	(55.7)	(14.2)	(7.3)
Manufacturing	(2.5)	15.1	11.4	16.9	11.8	(1.7)	(2.1)	(0.0)
Electricity, gas, and water supply	(3.3)	1.5	5.5	(6.6)	9.6	4.2	0.6	(1.5)
Construction	(13.4)	9.1	19.7	(5.8)	(12.1)	(22.2)	(9.0)	(2.2)
Trade	(6.2)	17.0	7.4	7.6	(0.2)	(11.3)	(3.0)	9.7
Accommodation and eating-drinking places	2.0	(15.5)	54.4	(2.9)	19.5	71.2	(10.6)	5.0
Transport, storage, and communication	1.0	23.6	0.5	24.7	36.3	(1.1)	31.5	9.6
Finance and insurance	52.2	24.3	73.7	28.4	(26.3)	83.7	4.7	2.4
Real estate, rental, and leasing	(2.2)	18.6	23.9	18.5	9.5	10.9	(14.0)	(5.1)
Services	(6.8)	32.1	44.3	14.7	(1.1)	(37.9)	(8.6)	1.0
Government agencies	22.0	19.9	11.0	12.3	18.5	2.4	(10.5)	(0.0)
Social security insurance, pension fund, and non-profit institutions	19.6	(27.2)	17.2	13.8	13.1	30.1	49.5	9.8
Individuals	12.7	20.8	8.0	3.5	3.4	(2.2)	0.4	10.6
Total loans	6.5	18.2	12.0	8.5	6.3	(1.4)	(2.1)	5.1

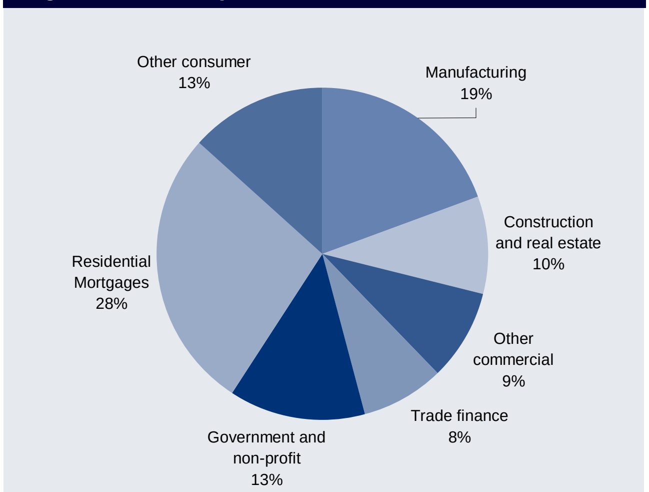
Source: CBC

Remember that loan growth has been fighting an offsetting tide of write-downs of bad loans: since YE1998, domestic banks together have written-off over NT$1tr in bad debt, or fully 8% of the current loan base.

Stable loan mix

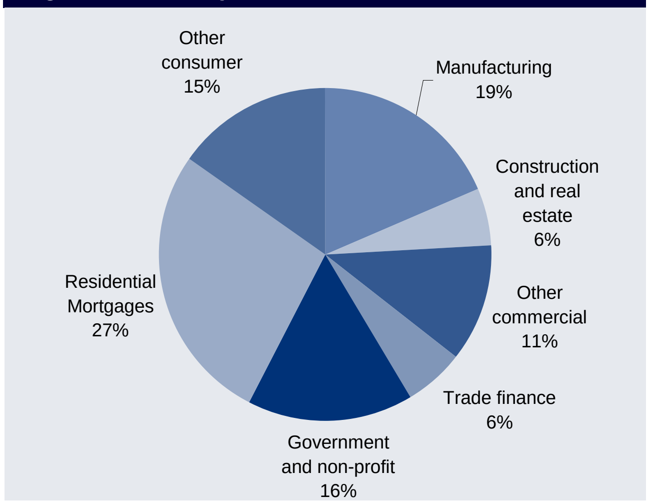
Taiwanese industry loan mix has remained fairly constant over the past decade, with the major changes being the relative contraction in importance of the construction sector and trade finance, and the increase in non-mortgage consumer lending and loans to service-sector businesses.

Fig 159 Industry loan mix: 1995



Source: CBC

Fig 160 Industry loan mix: 2003



Source: CBC

Targets now look conservative

Our original estimate of 3.6% having been handily exceeded, our 2004-06 forecasts of 5.7%, 5.8%, and 5.0% growth are now starting to look a little conservative. In particular, we expect added growth next year to come as manufacturing lending picks up to 7% growth from its current flat status, while the consumer should continue to be strong.

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 potentially leading to recapture of Taiwanese corporates on the mainland.

As before, we forecast a 7% increase in manufacturing loans in 2004 (versus 0% 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%.

We project that lending to individuals 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.

Bear in mind that consumption generally follows unemployment; with a consistent fall in this measure over the past four months and fifteen months past the peak level, the effects should be kicking in right about ... now.

Fig 161 Total loans (NT$m)

	2002	2003	2004F	2005F	2006F
Commercial and SOEs	4,964,234	5,050,335	5,218,730	5,491,858	5,782,946
Agricultural, forestry, fishing, and animal husbandry	14,475	18,401	19,597	20,773	22,019
Mining and quarrying	5,733	5,312	5,046	5,147	5,353
Manufacturing	2,256,434	2,255,761	2,413,664	2,618,826	2,802,144
Electricity, gas, and water supply	207,283	204,166	212,537	225,289	236,553
Construction	312,249	305,435	299,326	305,313	312,946
Trade	653,757	717,275	763,898	813,551	854,229
Accommodation and eating-drinking places	50,685	53,206	52,674	53,727	55,877
Transport, storage, and communication	366,583	401,948	418,026	438,927	458,679
Finance and insurance	448,299	459,025	422,303	401,188	413,223
Real estate, rental, and leasing	415,570	394,206	372,525	360,418	364,022
Services	233,166	235,600	239,134	248,699	257,901
Government agencies	1,839,738	1,839,384	1,912,959	1,874,700	1,771,592
Social security insurance, pension fund, and non-profit institutions	107,481	117,989	129,788	136,277	143,091
Individuals	4,670,589	5,163,531	5,602,431	6,106,650	6,595,182
Total loans	11,582,042	12,171,239	12,863,909	13,609,486	14,292,811

Source: CBC

Fig 162 Loans by category (% growth YoY)

	2002	2003	2004F	2005F	2006F
Commercial and SOEs	(1.7)	1.7	3.3	5.2	5.3
Agricultural, forestry, fishing, and animal husbandry	8.2	27.1	6.5	6.0	6.0
Mining and quarrying	(14.2)	(7.3)	(5.0)	2.0	4.0
Manufacturing	(2.1)	(0.0)	7.0	8.5	7.0
Electricity, gas, and water supply	0.6	(1.5)	4.1	6.0	5.0
Construction	(9.0)	(2.2)	(2.0)	2.0	2.5
Trade	(3.0)	9.7	6.5	6.5	5.0
Accommodation and eating-drinking places	(10.6)	5.0	(1.0)	2.0	4.0
Transport, storage, and communication	31.5	9.6	4.0	5.0	4.5
Finance and insurance	4.7	2.4	(8.0)	(5.0)	3.0
Real estate, rental, and leasing	(14.0)	(5.1)	(5.5)	(3.3)	1.0
Services	(8.6)	1.0	1.5	4.0	3.7
Government agencies	(10.5)	(0.0)	4.0	(2.0)	(5.5)
Social security insurance, pension fund, and non-profit institutions	49.5	9.8	10.0	5.0	5.0
Individuals	0.4	10.6	8.5	9.0	8.0
Total loans	(2.1)	5.1	5.7	5.8	5.0

Source: CBC

Loan-to-deposit ratio now rising

All year long we have been pounding the table on the critical loan-to-deposit ratio (LDR) as a leading indicator for profitability, and in October we went on record as saying that Taiwan's long LDR slide (from a peak of 83.3% to a low of 64.3%) had turned around. The data now show that Taiwan did indeed lift off the bottom, with gross loans growing from June 2003 onwards and LDR rising from September onwards.

Our estimates call for an acceleration in the rise in LDR from 2H04 onwards as still-rising deposits begin to run off in favour of investments in property, equities, and other risk assets – such makes a reflationary market.

Fig 163 Taiwan LDR: 1961-2003

Source: CBC

Fig 164 Taiwan LDR: 2000-03

Source: CBC

Economic integration – questionable in the near term

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 re-election of the DPP government has very much limited the potential for swift integration, we still believe that there is the potential for positive changes given the need to placate business interests.

We no longer believe that cross-straits relations will improve much in the near-term, and we are indeed worried about friction with mainland China stemming from the result of the Taiwanese elections, but it does not seem that anything will halt the progress of manufacturing operations—and hence economic weight—from Taiwan to the mainland.

What potentially could a climate of closer economic integration mean for Taiwan and the Taiwanese banks?

A second CEPA

Firstly, improved cross-strait 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 renminbi business licence approval

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

Normally, the minimum waiting time for an Rmb licence (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 renminbi 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 is already 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.

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 acquisition of 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.

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 legitimisation 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 a securities finance company, one by a 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. 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 165 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

Trend towards 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 the 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 licences in the early 1990s. 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 2002-03 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.

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 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 licences, this would be a strong argument for Taiwanese institutions to buy up the smaller Hong Kong banks.

Renminbi 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 to 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 that 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

Earnings accretion is driving our perception of value in Taiwanese financials, with the average PER of significant companies dropping from 18.9x in FY03 (skewed by some large write-offs) to 15.1x in FY04. Our favourites such as Chinatrust and Taishin are trading even more cheaply at 11-12x forward EPS.

Fig 166 Taiwan bank valuation summary

Company	ING rating	Target (NT$)	Price (NT$) 4/22/04	BVPS (NT$) FY04F	P/BV (x)	EPS (NT$) FY03E	EPS (NT$) FY04F	PER (x) FY03E	PER (x) FY04F	Trailing DPS (NT$)	Yield (%)	ECB issued in FY03 (US$m)	Capital (NT$m)	Dilution (%)
Chinatrust FHC	**BUY**	50.00	38.00	19.55	1.9	2.15	3.16	17.6	12.0	0.90	2.4	-	54,962	-
Taishin FHC	**BUY**	29.65	32.20	16.32	2.0	2.02	2.71	15.9	11.9	1.00	3.1	220	36,685	9.7
First FHC	**SELL**	18.28	27.00	15.96	1.7	-1.45	1.38	N.M.	19.6	0.00	0.0	-	55,515	-
SinoPac Holdings	**HOLD**	19.36	19.00	13.28	1.4	1.27	1.42	15.0	13.4	0.65	3.4	-	37,481	-
E.Sun FHC	**BUY**	24.64	22.70	11.01	2.1	1.75	1.53	12.9	14.8	0.00	0.0	180	25,054	12.4
Cosmos Bank	**BUY**	27.10	23.00	12.89	1.8	0.82	2.09	28.0	11.0	0.00	0.0	-	17,710	-
Cathay Financial	**NR**	-	64.50	19.29	3.3	2.68	2.91	24.1	22.2	1.50	2.3	-	83,075	-
Fubon Financial	**NR**	-	34.10	20.69	1.6	2.11	2.30	16.2	14.8	1.20	3.5	245	82,541	2.4
Chang Hwa Bank	**NR**	-	21.60	17.79	1.2	0.79	1.11	27.3	19.5	0.00	0.0	-	34,595	-
Mega FHC	**NR**	-	22.90	16.99	1.3	1.60	1.90	14.3	12.1	0.38	1.7	690	114,272	9.7
Hua Nan FHC	**NR**	-	30.80	16.75	1.8	1.72	2.02	17.9	15.2	0.00	0.0	-	47,285	-
Average					1.8		2.05	18.9	15.1		1.5			

Note: Estimates for non-covered companies are consensus forecasts per I/B/E/S.
Source: Company data, Bloomberg, I/B/E/S, ING estimates

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Chinatrust FHC

Still on top

Rating: BUY

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%). 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.

Return to shareholders at Chinatrust FHC improved steadily from 1998-2002 due to continued improvement in underlying profitability, and especially the interest spread book. 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. 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, which is known for expensive marketing and servicing costs.

Compared to most of its local peers, Chinatrust is in a better position in terms of profitability because of its robust interest margin, resulting mainly from the credit card business. 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. While management foresees little spread compression on credit cards given that they betray no intention of cutting card rates, we project that the balances of both credit card and cash card loans will lose 125-150bps of gross yield over the next 24 months.

Chinatrust's asset quality is better than that of its large competitors, and is among the best in Taiwan overall. The bank's reported NPL ratio was 1.65% as of December 2003, or 2.45% if including loans under surveillance. 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. The coverage ratio has improved from 52% at YE2001 to 79.4% as of YE2003; this suggests lower provisioning expense in the years ahead.

The merger with GCB will help enhance Chinatrust's distribution power, given GCB's complementary branches and its tie-up with affiliate President Chain Store, which has the 7-11 franchise for Taiwan and is the country's largest retailer. The merger will also strengthen Chinatrust's fee-generating corporate banking given GCB's leading position in the FX transactions. On the wealth management front, the merger will reinforce Chinatrust's cross-selling capabilities in a wide range of financial products and services.

Given its mid- to long-term goal of capturing a 10% market share, management does not rule out the possibility of continued acquisitions. SinoPac Holdings (2890 TT, BUY, Target: NT$19.4) is one of the potential targets, given its foreign bank background and well-established overseas operations. The media also reports that merger discussions are underway with a commercial bank that has more than 100 branches. Chang Hwa Bank (2801 TT, NR) is believed to be the potential candidate, as it is still a standalone bank with the fourth largest distribution network on the island and a 5.4% loan market share. However, taking over Chang Hwa Bank would inevitably incur additional provisioning/write-off cost, given its mediocre balance sheet.

Chinatrust FHC

Taiwan

Share Price:	38.00	**Reuters Code:**	2891 TW	**Shares Outstanding**	5,496
52 Week Price Range:	23.96 - 41.90	**Bloomberg Code:**	2891 TT	**Market Cap (US$m)**	6,308

INCOME STATEMENT	01	02	03	04	05
Interest income	61,581	44,830	41,795	43,092	50,486
Interest expense	37,873	14,658	11,383	11,728	16,134
Net interest income	**23,708**	**30,173**	**30,412**	**31,364**	**34,352**
Non-interest income	17,333	12,751	18,482	24,959	30,875
Total operating income	**41,040**	**42,923**	**48,895**	**56,323**	**65,227**
Non-interest expense	17,959	18,795	22,375	26,614	29,018
Pre provision profit	**23,081**	**24,129**	**26,519**	**29,709**	**36,210**
Loan loss provisions	14,089	9,177	12,934	7,336	7,991
Non-operating income	138	159	-4,097	-1,520	-1,520
Pre tax profit	**9,130**	**15,111**	**9,489**	**20,852**	**26,699**
Tax	1,467	3,079	3,486	4,170	5,340
Net profit	**7,663**	**12,032**	**10,100**	**16,682**	**21,359**

BALANCE SHEET	01	02	03	04	05
Gross loans	515,632	559,901	734,602	797,149	875,926
Loan loss reserves	*7,334*	*8,619*	*8,618*	*5,882*	*6,357*
Net loans	504,651	547,990	721,763	786,701	864,546
Total earning assets	635,789	681,784	879,055	937,401	1,030,337
Other assets	181,136	167,472	170,914	171,386	169,440
Total Assets	**816,926**	**849,255**	**1,044,970**	**1,108,787**	**1,199,777**
Deposits	695,806	716,919	889,783	934,311	1,004,309
Other paying liabilities	21,241	21,920	37,590	29,778	30,436
Other liabilities	25,419	30,522	38,134	41,495	45,476
Total Liabilities	743,000	769,361	965,508	1,005,585	1,080,221
Total Equity	**73,925**	**79,894**	**84,462**	**103,202**	**119,556**

ASSET QUALITY	01	02	03	04	05
Nonperforming assets	16,629	15,700	16,067	12,666	12,950
NPAs/total loans	3.2%	2.8%	2.2%	1.6%	1.5%
Reserve coverage of NPAs	44.1%	54.9%	53.6%	46.4%	49.1%

PER SHARE DATA (NT$)	01	02	03	04	05
EPS	1.66	2.61	1.14	3.16	4.05
DPS	0.87	0.95	0.34	0.95	1.21
Effective payout ratio (%)	52.2	36.5	30.0	30.0	30.0
BVPS	16.05	17.35	16.00	19.55	22.64

BALANCE SHEET RATIOS	01	02	03	04	05
Loan-to-deposit	73.6%	77.6%	82.1%	84.8%	86.7%
Equity to assets	9.0%	9.4%	8.0%	9.3%	10.0%
Tier 1 CAR	8.7%	9.8%	8.0%	8.1%	8.5%
Total CAR	11.2%	12.6%	9.5%	9.6%	10.0%

VALUATION	01	02	03	04	05
Price to book value	2.4x	2.2x	2.4x	1.9x	1.7x
Price to earnings	22.9x	14.6x	33.3x	12.0x	9.4x
Price to underlying profit	9.0x	8.7x	7.9x	7.0x	5.8x
Yield at current price (%)	2.3	2.5	0.9	2.5	3.2

LOAN MIX	01	02	03	04	05
Consumer (%)	19.5	19.0	18.0	18.5	19.0
Mortgage (%)	33.2	33.0	33.0	32.0	31.0
Corporate (%)	47.3	48.0	49.0	49.5	50.0
Other (%)					

PROFITABILITY RATIOS (%)	01	02	03	04	05
Net interest margin	3.9	4.6	3.9	3.5	3.5
Yield on assets	9.7	6.6	4.8	4.6	4.9
Cost of liabilities	5.6	2.0	1.4	1.2	1.6
Non-int. inc (% Op income)	42.2	29.7	37.8	44.3	47.3
Cost to income	43.8	43.8	45.8	47.3	44.5
Overhead	2.9	2.9	2.9	2.9	2.9
ROA	1.0	1.4	0.6	1.5	1.9
ROE	10.8	15.6	7.3	17.8	19.2

GROWTH RATES (%,YoY)	01	02	03	04	05
Pre-provision earnings	51.1	4.5	9.9	12.0	21.9
Net profit	6.1	57.0	-50.1	177.9	28.0
EPS	6.1	57.0	-50.1	177.9	28.0
DPS	-2.2	9.2	-64.2	179.4	27.4
Net Loans	4.2	8.7	31.2	8.5	9.9
Assets	13.2	4.0	23.6	5.6	8.2
Deposits	12.3	3.0	24.1	5.0	7.5

Taishin FHC

Striving for No. 1

Rating: BUY

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. 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.

Given Taishin Bank's exposure to the financially stressed Hung Kuo Group in the years before 2001, returns at Taishin FHC have not been very impressive despite the company's high-margin focus. Nevertheless, both ROA and ROE improved dramatically starting in 2002 on the back of strong growth in the credit card business. Taishin has also increased its overall exposure to the high-yield consumer segment.

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. Compared to Chinatrust, Taishin is less vulnerable to margin compression resulting from slowing growth in credit card 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%. Low cost of funds, due to a better deposit mix, is the other factor driving up profitability.

We now have little concern over Taishin's asset quality given the limited NPL influx and consistent charge-offs. Taishin Bank's non-performing loans decreased 24.2% YoY in 2003, resulting in a reported NPL ratio of 1.59%, or 1.78% in broad definition. This ranks Taishin Bank as the second best domestic bank (after E.Sun Bank) in terms of asset quality. In 2003, Taishin Bank charged off NT$9.1bn in bad debt while booking NT$7.2bn in provisions (up 14.7% YoY). The provisioning increase is understandable given the 17.5% YoY expansion in overall loan book.

Management expects Taishin FHC's 2004 bottom line to grow 33% YoY. At the bank level, management is guiding for 30% YoY earnings growth given margin improvement, increased fee income from both wealth management and wholesale banking, and an expected further loan growth of 21% YoY. We do not quite agree with management guidance on margin improvement. Average NIM was 5.17% in 2003 and is targeted to reach 5.3% in 2004 due to continued growth in high-margin segments as a percentage of total loans. We foresee continued growth in high-margin loans given outperforming growth in both revolving credit card and cash card receivables in 2003. However, we believe the loan growth momentum will be somewhat offset by rising funding costs and undermined pricing power as a result of competition.

Taishin FHC's banking platform is small compared to other major FHCs, eg Chinatrust, Fubon, and Cathay. This makes further acquisition increasingly important. As a Taipei-based SME bank with 76 out of its 83 domestic offices located in Taipei, International Bank of Taipei (IBT, 2808 TT, NR) is one potential take-over target. First FHC would also be a favourable target given its immense distribution network and corporate client base. On the other hand, realistically it may take longer for this merger to proceed, due to political and cost concerns.

Taishin FHC

Taiwan

Share Price:	32.20	**Reuters Code:**	2887 TW	**Shares Outstanding**	3,756
52 Week Price Range:	15.80 - 33.10	**Bloomberg Code:**	2887 TT	**Market Cap (US$m)**	3,653

INCOME STATEMENT	**01**	**02**	**03**	**04**	**05**
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**
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**

BALANCE SHEET	**01**	**02**	**03**	**04**	**05**
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
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
Total Equity	**28,010**	**35,339**	**55,099**	**59,526**	**64,979**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	10,932	10,302	10,188	10,193	10,190
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%

PER SHARE DATA (NT$)	**01**	**02**	**03**	**04**	**05**
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

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
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%
Tier 1 CAR	11.0%	7.5%	8.1%	8.7%	9.0%
Total CAR	11.3%	10.3%	10.6%	10.8%	11.7%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	2.1x	2.1x	2.1x	2.0x	1.8x
Price to earnings	55.5x	18.2x	15.9x	11.9x	10.7x
Price to underlying profit	16.9x	10.0x	7.5x	6.7x	6.2x
Yield at current price (%)	1.0	4.7	4.7	4.7	4.7

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	13.6	15.0	16.3	17.4	19.5
Mortgage (%)	38.1	34.8	34.0	32.0	30.0
Corporate (%)	36.7	38.5	35.5	35.0	34.5
Other (%)					

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	4.5	6.0	5.0	4.6	4.6
Yield on assets	8.7	7.8	6.1	6.0	6.5
Cost of liabilities	6.1	4.3	1.8	1.8	2.5
Non-int. inc (% 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	2.8	3.2	3.2	2.7	2.7
ROA	0.4	1.0	1.3	1.5	1.3
ROE	3.7	12.9	16.3	17.3	17.5

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	30.3	69.8	33.3	12.3	6.6
Net profit	-46.0	293.8	80.9	34.2	10.4
EPS	-46.0	293.8	80.9	34.2	10.4
DPS	-	375.0	-1.3	0.0	0.0
Net Loans	1.0	75.8	8.7	10.5	10.0
Assets	11.1	62.3	24.5	20.0	25.6
Deposits	7.3	62.5	6.8	8.2	8.2

First FHC

Just not good enough

Rating: SELL

Through its 190 domestic units, 18 overseas offices, and 654 ATMs, First FHC provides a wide range of banking services and financial service products to its more than 4.1m retail and corporate customers.

Like most of its local peers, First Bank has experienced slowing loan growth since 1999. Total loans remained flat in 2003. 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 most of 2003. Although consumer loans grew year over year throughout 1999-2003, growth in this segment came mainly from residential mortgages and it has been pacing down. Meanwhile, other consumer loans, such as unsecured personal loans, have been declining since 1999. In all, consumer loan growth has been insignificant in helping First Bank's credit expansion, since corporate loans account for more than 70% of First Bank's total loan book.

First Bank's 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.

Return to shareholders at First Bank has been consistently poor in the past, with its best performance a 13.8% ROE in 1997. The driving factor has been huge charges in 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 600bps on average assets over the past three years, versus net income of -132bps.

First Bank's net interest margin rose in FY01-FY02, due mainly to continued interest rate cuts starting in late 2000. However, this trend has reversed since 1Q03. 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. The other key factor that drove down First Bank's profitability is lack of diversification – the bank relies too much on interest income. Over the last five years, interest income on average contributed to 70% of First Bank's total operating revenue, while fees accounted for less than 10%.

First Bank'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 have material P&L impact over the next three years.

First FHC

Taiwan

Share Price:	27.00	**Reuters Code:**	2892 TW	**Shares Outstanding**	5,549
52 Week Price Range:	18.30 - 29.50	**Bloomberg Code:**	2892 TT	**Market Cap (US$m)**	4,525

INCOME STATEMENT	**01**	**02**	**03**	**04**	**05**
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**
Non-interest income	10,097	3,741	10,174	11,194	11,945
Total operating income	**32,576**	**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**

BALANCE SHEET	**01**	**02**	**03**	**04**	**05**
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
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
Total Equity	**84,143**	**57,285**	**80,963**	**88,596**	**98,453**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	131,436	70,891	30,581	31,520	32,207
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%

PER SHARE DATA (NT$)	**01**	**02**	**03**	**04**	**05**
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

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
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%
Tier 1 CAR	8.9%	5.6%	7.9%	8.4%	9.0%
Total CAR	9.6%	9.0%	11.5%	12.1%	12.5%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	1.2x	1.8x	1.9x	1.7x	1.5x
Price to earnings	32.5x	-4.2x	-18.6x	19.6x	15.2x
Price to underlying profit	7.9x	9.9x	8.2x	8.1x	7.4x
Yield at current price (%)	1.9	0.0	0.0	2.2	3.7

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	3.5	3.5	4.3	5.4	7.9
Mortgage (%)	22.2	24.5	25.5	25.8	24.7
Corporate (%)	74.4	72.0	70.2	68.9	67.5
Other (%)					

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	2.2	2.2	1.8	1.6	1.6
Yield on assets	5.9	4.2	3.1	2.7	3.0
Cost of liabilities	3.7	2.1	1.4	1.2	1.6
Non-int. inc (% 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	1.3	1.2	1.1	1.0	1.0
ROA	0.3	-1.9	-0.6	0.5	0.6
ROE	3.8	-35.0	-11.7	9.0	10.5

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	-8.4	-20.3	20.3	1.1	10.4
Net profit	-24.3	-884.7	-67.4	-	29.1
EPS	-24.3	-884.7	-67.4	-	29.1
DPS	4.2	-100.0	-	-	66.7
Net Loans	0.6	0.6	7.8	6.7	7.6
Assets	3.7	2.6	7.4	5.2	8.0
Deposits	4.6	3.7	5.0	5.3	7.5

SinoPac Holdings

Waiting for love

Rating: HOLD

As opposed to other privately run banks that have been making efforts to increase their exposure to high-yield consumer products like credit cards and cash cards, SinoPac is quite conservative in terms of product offerings. 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. Going forward, we expect mortgages to remain the key contributor to SinoPac's total loan growth. On the other hand, corporate banking, especially cash management for SME clients, should become more significant as its growth momentum continues on the improved domestic economy and increasing communications/transactions throughout the Greater China area.

Return to shareholders at SinoPac Holdings 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 despite the bank's mortgage-centric loan portfolio. A possible reason is that Bank SinoPac launched the fully-integrated "Money Management Account" (MMA) in 2000. This was costly in its initial stages from both a hardware and software installation perspective.

Bank SinoPac reported an MoF-defined NPL ratio of 1.76%, or 2.15% including loans under surveillance, as of December 2003. This is far below the industry average of 4.33% (or 6.08% 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 Taiwan banks with the lowest NPL ratios. Management attributes this to its strict credit approval policy and, more importantly, limited exposure to high-yield products that are seen as risky.

Like most other Taiwan 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. Going forward, we nevertheless expect the downward trend in profitability to slow down and actually reverse in 2005, due to (1) the relatively high refinancing ratio, (2) management's intention to better utilise assets by placing excess funds into fixed-income instruments that generate higher returns than ordinary lending, and (3) the expected interest rate reversal beginning in 2H04.

Compared with most other small-sized, privately-run financial institutions, SinoPac Holdings is well positioned for China operations, for three 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 that has received the Chinese government's approval to engage in Rmb business. Additionally, SinoPac Securities has set up a representative office in Shanghai.

As for M&A, management seems to have changed its mentality dramatically subsequent to the failure of merger talks with CDIBH and Grand Commercial Bank, 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? Currently, Chinatrust and Fubon are potential acquirers at the table.

SinoPac Holdings

Taiwan

Share Price:	19.00	**Reuters Code:**	2890 TW	**Shares Outstanding**	3,748
52 Week Price Range:	10.85 - 21.00	**Bloomberg Code:**	2890 TT	**Market Cap (US$m)**	2,151

INCOME STATEMENT	**01**	**02**	**03**	**04**	**05**
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**
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**

BALANCE SHEET	**01**	**02**	**03**	**04**	**05**
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
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
Total Equity	**23,321**	**44,797**	**47,131**	**50,744**	**54,662**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	5,880	4,503	5,173	5,318	5,739
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%

PER SHARE DATA (NT$)	**01**	**02**	**03**	**04**	**05**
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 (%)	*59.0%*	*36.0%*	*36.0%*	*35.0%*	*35.0%*
BVPS	11.99	11.95	12.33	13.28	14.30

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
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%
Tier 1 CAR	14.7%	13.6%	12.5%	12.8%	13.1%
Total CAR	14.4%	12.9%	13.1%	13.5%	13.9%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	1.6x	1.6x	1.5x	1.4x	1.3x
Price to earnings	23.8x	20.4x	15.0x	13.6x	12.5x
Price to underlying profit	25.0x	11.6x	9.5x	8.8x	8.1x
Yield at current price (%)	2.5	1.8	2.4	2.6	2.8

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	11.8	10.3	8.0	8.5	10.0
Mortgage (%)	62.2	61.5	64.0	63.0	61.5
Corporate (%)	26.0	28.2	28.0	28.5	28.5
Other (%)					

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	2.4	2.6	1.6	1.4	1.5
Yield on assets	6.9	4.5	2.9	2.4	2.9
Cost of liabilities	4.2	2.8	1.4	1.1	1.5
Non-int. inc (% Op income)	30.2	52.9	64.1	68.1	65.5
Cost to income	58.2	59.6	56.5	56.1	55.1
Overhead	2.0	3.3	2.6	2.5	2.4
ROA	0.6	1.0	1.1	1.1	1.1
ROE	6.8	10.3	10.5	10.9	11.0

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	5.0	115.0	22.0	8.0	9.0
Net profit	-9.0	126.0	38.0	10.0	9.0
EPS	-9.0	126.0	38.0	10.0	9.0
DPS	-	-27.7	32.4	8.9	8.2
Net Loans	20.0	14.0	12.0	8.0	10.0
Assets	18.0	52.0	14.0	5.0	6.0
Deposits	18.0	34.0	12.0	5.0	6.0

E.Sun FHC

Prodigal sun

Rating: BUY

E.Sun has thus been gaining market share in lending, and the bank now accounts for 1.2% of the sector. Within the consumer sector, E.Sun places emphasis on mortgages as a key product despite its diminishing spreads. Mortgages are seen as a core part of the client relationship due to their long-term nature and high information content. Currently, E.Sun Bank ranks No.14 in mortgages, and mortgages account for approximately 38.5% of its total loan portfolio.

E.Sun currently ranks as the No. 6 credit card issuer in Taiwan. The bank's credit card business has been growing rapidly, with cards issued, cards in force, and charge volume all running well ahead of the industry average (20-25% YoY in the above categories), and contributes around 15-20% of its after-provisioning pre-tax profit. 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.

E.Sun FHC's return to shareholders has improved incrementally subsequent to the formation of the holding company umbrella. E.Sun's ROA 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 1.00-1.25% ROA on its current book, even after including 25-50bp in continuing long-run credit costs. This translates into a 14-16% ROE. We also believe that an ongoing shift to higher-margin businesses, combined with the recovery of corporate lending in Taiwan, will boost E.Sun's ROE above this baseline level.

Asset quality has continued improving in 2003, with the reported NPL ratio down to 1.18% (or 1.59% including loans under surveillance) at the year-end. NPL coverage was more than 75%. Taking a provisioning policy stricter than that of most other local peers for its ordinary loan portfolio, 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.

Compared with its peers, E.Sun Bank's interest spread and net interest margin started off in a poor position. This is attributable to the bank's corporate-centred loan portfolio. E.Sun switched its business focus to consumer lending in 1998, but 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). Nevertheless, there is limited further downside from mortgage refinancing, given a refinancing ratio of more than 70%.

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 it is a buyer – as management would prefer to be – one of our concerns is how management will handle 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 – which we see as the key factor for successful in-market consolidation.

E.Sun FHC

Taiwan

Share Price:	22.70	**Reuters Code:**	2884 TW	**Shares Outstanding**	2,505
52 Week Price Range:	14.55 - 24.10	**Bloomberg Code:**	2884 TT	**Market Cap (US$m)**	1,718

INCOME STATEMENT	**01**	**02**	**03**	**04**	**05**
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**
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**	**-4,171**	**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**

BALANCE SHEET	**01**	**02**	**03**	**04**	**05**
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
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
Total Equity	**22,804**	**22,121**	**27,965**	**30,636**	**37,294**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	5,472	2,319	2,325	2,462	2,626
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%

PER SHARE DATA (NT$)	**01**	**02**	**03**	**04**	**05**
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

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
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%
Tier 1 CAR	12.3%	9.4%	10.0%	10.6%	11.8%
Total CAR	11.0%	10.4%	12.9%	13.1%	14.1%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	1.8x	2.5x	2.3x	2.1x	1.7x
Price to earnings	21.4x	-18.2x	13.0x	13.0x	9.5x
Price to underlying profit	12.2x	10.1x	9.0x	8.5x	6.4x
Yield at current price (%)	3.1	0.0	3.5	3.5	5.3

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	6.0	9.0	15.0	23.0	29.0
Mortgage (%)	38.0	35.0	40.0	40.0	38.0
Corporate (%)	56.0	56.0	45.0	37.0	33.0
Other (%)					

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	2.4	2.9	2.8	2.6	3.3
Yield on assets	6.2	5.3	4.4	4.2	5.5
Cost of liabilities	4.2	2.4	1.7	1.7	2.4
Non-int. inc (% 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	1.4	1.7	1.8	1.7	1.9
ROA	0.8	-1.1	1.6	1.5	1.8
ROE	8.8	-13.8	19.5	16.5	19.6

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	32.5	20.4	12.5	5.2	33.8
Net profit	35.8	-260.3	-257.9	-0.7	37.4
EPS	35.8	-260.3	-257.9	-0.7	37.4
DPS	-	-100.0	-	1.3	50.0
Net Loans	7.8	-5.9	8.7	10.2	9.5
Assets	12.5	7.0	11.5	8.3	10.1
Deposits	11.4	3.6	10.9	8.8	9.0

Cosmos Bank

A universe of consumers

Rating: BUY

Cosmos Bank was founded in 1991 by Tainan-based Prince Automobile Group (unlisted), and other four conventional manufacturers in different fields such as shipping and paper-making together hold approximately 20% stake. The bank grows its branch platform mainly by acquiring community-level financial institutions located in middle and southern Taiwan. Cosmos Bank currently has 63 domestic branches.

Cosmos Bank started with its main business focus on corporate banking, but has since 1995 switched to the consumer segment where it targets cash cards as a key growth driver. As of December 2003, Cosmos Bank had over 1.3m cash card accounts and receivables of more than NT$71bn, representing a domestic market share of around 50%. Management expects its cash card receivables to reach NT$90bn by YE2004. We are somewhat more conservative, projecting a YE2004 balance of NT$82bn and 2004 growth of 18%.

Return to shareholders at Cosmos has ranged from poor to abysmal in the past, with ROE never breaking into the double digits due to the corporate-centred loan book and resulting charge-offs. However, net interest margin (NIM) has been trending upward, from less than 2% in FY98 to 7% in 4Q03, while the cost-to-income ratio dropped from 59.9% to below 40% 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. Cash card loans currently account for more than 40% of total loans and we expect this ratio to exceed 45% in FY04.

Cosmos's asset quality has been improving subsequent to several incremental write-offs. In 2003, Cosmos Bank charged off a total of NT$6.5bn, of which NT$3.4bn was wiped out by provisioning while the remainder sold to AMC. Management expects the additional provisions and charge-offs to reduce the company's reported NPL ratio to 2.87% (or 5.08% including loans under surveillance) as at December 2003, down more than 100bps from the September 2003 level.

Cosmos'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.

Cash card margins have risen in the last two years as funding costs have fallen due to consistently declining benchmark interest rates and excess deposit liquidity. Given its limited exposure to residential mortgages, Cosmos is able to uphold its overall profitability despite the increased prevalence of the index-oriented rate structure. We expect the cash card rate to fall by 150bps in the following eighteen months, and Cosmos to 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 two to three 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.

Cosmos Bank — Taiwan

Share Price:	23.00	**Reuters Code:**	2837 TW	**Shares Outstanding**	1,771
52 Week Price Range:	12.45 - 24.70	**Bloomberg Code:**	2837 TT	**Market Cap (US$m)**	1,230

INCOME STATEMENT	**01**	**02**	**03**	**04**	**05**
Interest income	12,989	13,489	15,920	16,667	18,991
Interest expense	7,887	5,251	3,633	2,743	4,095
Net interest income	**5,101**	**8,237**	**12,286**	**13,924**	**14,896**
Non-interest income	1,023	1,440	1,937	3,143	3,293
Total operating income	**6,125**	**9,677**	**14,223**	**17,067**	**18,188**
Non-interest expense	3,619	4,628	5,840	6,594	7,210
Pre provision profit	**2,506**	**5,048**	**8,383**	**10,473**	**10,978**
Loan loss provisions	895	3,061	4,575	2,631	1,816
Non-operating income	-275	-361	-1,930	-3,236	-3,236
Pre tax profit	**1,337**	**1,626**	**1,877**	**4,607**	**5,927**
Tax	297	435	432	921	1,185
Net profit	**1,040**	**1,192**	**1,445**	**3,685**	**4,741**

BALANCE SHEET	**01**	**02**	**03**	**04**	**05**
Gross loans	149,510	149,207	157,350	179,989	201,473
Loan loss reserves	*1,781*	*1,137*	*1,309*	*1,237*	*1,413*
Net loans	145,888	145,641	153,778	176,177	197,175
Total earning assets	171,001	180,952	187,676	212,760	237,298
Other assets	25,043	37,401	50,972	45,292	46,703
Total Assets	**196,044**	**218,353**	**238,648**	**258,053**	**284,002**
Deposits	176,651	194,490	213,510	229,523	251,328
Other paying liabilities	2,269	2,673	3,470	3,731	4,085
Other liabilities	5,353	5,286	5,116	5,707	6,350
Total Liabilities	182,004	199,776	218,626	235,231	257,678
Total Equity	**14,040**	**18,577**	**20,022**	**22,822**	**26,323**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	38,031	16,766	12,515	10,305	8,071
NPAs/total loans	25.8%	11.4%	8.1%	5.8%	4.1%
Reserve coverage of NPAs	4.7%	6.8%	10.5%	12.0%	17.5%

PER SHARE DATA (NT$)	**01**	**02**	**03**	**04**	**05**
EPS	0.74	0.67	0.82	2.08	2.68
DPS	0.00	0.00	0.00	0.50	0.70
Effective payout ratio (%)	*0%*	*0%*	*0%*	*24%*	*26%*
BVPS	10.02	10.49	11.31	12.89	14.86

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	83.6%	75.5%	72.6%	77.3%	79.0%
Equity to assets	7.2%	8.5%	8.4%	8.8%	9.3%
Tier 1 CAR	9.1%	10.1%	10.0%	10.3%	10.8%
Total CAR	8.25%	10.13%	10.21%	10.50%	11.00%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	2.3x	2.2x	2.0x	1.8x	1.5x
Price to earnings	31.0x	34.2x	28.2x	11.1x	8.6x
Price to underlying profit	16.3x	8.1x	4.9x	3.9x	3.7x
Yield at current price (%)	0.0	0.0	0.0	2.2	3.0

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	27.0	42.0	43.4	48.0	51.5
Mortgage (%)	11.0	8.0	8.6	7.5	7.0
Corporate (%)	62.0	50.0	48.0	44.5	41.5
Other (%)					

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	3.12	4.68	6.67	6.95	6.62
Yield on assets	7.60	7.45	8.48	7.83	8.00
Cost of liabilities	4.66	2.83	1.79	1.24	1.71
Non-int. inc (% Op income)	16.71	14.88	13.62	18.41	18.10
Cost to income	59.09	47.83	41.06	38.64	39.64
Overhead	2.22	2.63	3.17	3.29	3.20
ROA	0.55	0.58	0.63	1.48	1.75
ROE	7.69	7.31	7.49	17.20	19.29

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	65.3	101.5	66.0	24.9	4.8
Net profit	-132.5	14.6	21.3	155.1	28.6
EPS	-132.5	14.6	21.3	155.1	28.6
DPS	-	-	-	-	40.0
Net Loans	4.4	-0.6	5.7	14.4	11.9
Assets	8.9	11.4	9.3	8.1	10.1
Deposits	9.3	10.1	9.8	7.5	9.5

Thailand

Upcycle underway

Rating: Overweight

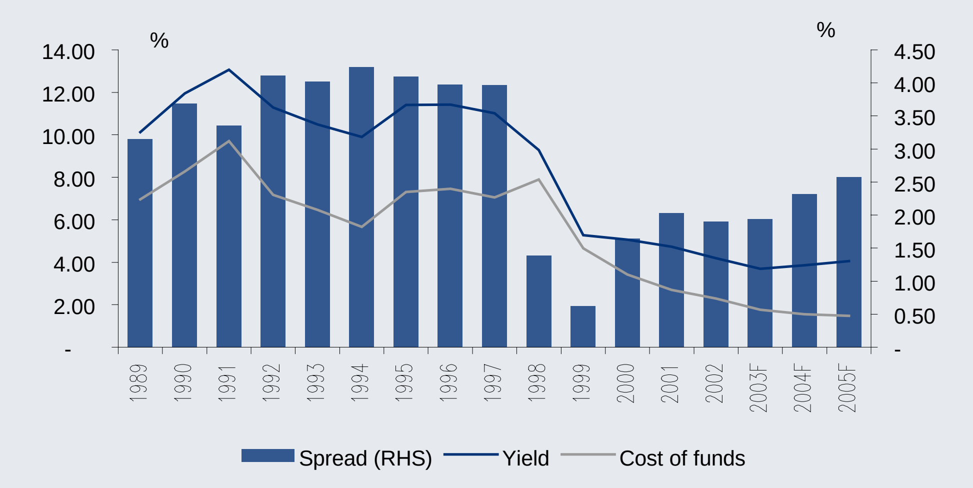
Falling cost of funds is the first driver of spread improvement in 2004

Falling cost of funds drives first stage

We see a steady spread recovery for Thai banks, mainly driven by falling cost of funds due to expensive hybrid redemptions in 2004 and by a rise in overall asset yield.

Despite these two drivers (falling cost of funds and rising yields), we remain conservative, forecasting the spread recovery to move to 2.25% in 2004 and 2.50% in 2005, far below the pre-crisis period of nearly 4% spreads.

Fig 167 Spread, yield and cost of funds trends



Source: Company data, ING estimates

The cost of funds decrease will come first from a continued shifting into low cost deposits, though we are reaching the end of what the banks can achieve from this move as most have already moved quite aggressively over the last few years. BBL has moved from 31.4% of low cost deposits in 4Q00 to 41.6% in 2Q03 (the last period for which data has been released by all the banks). KBANK has pushed this area of deposit cost reduction harder than any other bank, moving from 35.1% in 4Q00 to 2Q03's 50.9%. As a result, we can see that BBL, SCB and KTB all still have more room to go get closer to where KBANK is.

Fig 168 Deposit breakdown

	BBL		KBANK		SCB		KTB	
%	**4Q00**	**2Q03**	**4Q00**	**2Q03**	**4Q00**	**2Q03**	**4Q00**	**2Q03**
Current	2.7	3.9	2.8	4.6	2.4	3.7	2.3	3.3
Savings	28.7	37.7	32.2	46.3	25.8	39.9	28.6	34.5
Low cost deposits	**31.4**	**41.6**	**35.1**	**50.9**	**28.1**	**43.7**	**30.8**	**37.7**
Fixed - within 6 mths	52.6	41.4	56.4	38.0	51.2	38.0	44.2	24.3
Fixed - 6-12 mths	4.6	3.3	1.3	0.8	5.0	3.5	0.0	0.0
Fixed - > 1 year/CDs	11.4	13.7	7.2	10.2	15.7	14.8	25.0	38.0
Total deposits	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Company data, ING estimates

With regards to hybrids, the two banks in our coverage that should benefit from hybrid redemption are BBL and BAY (outside of our coverage would be TMB). In the case of BBL, they have stated their intention to replace the issue with a similar issue, but at a much more favourable rate. We expect that the bank will try to replace the issue with a similar issue that has a convertibility feature, which would allow the bank to offer a lower interest rate (possibly 2-4%). We expect that such a new issue would apply as tier 1 capital. In January 2004 KBANK replaced its hybrid instrument with a Bt12bn 10-year sub debt issue at 3.75% for the first five years and 4.25% for the second five years. However, this issue can only count as tier 2 capital.

Fig 169 Banks with high hybrid costs

	BBL		KBANK	
	2003	**% of TTL**	**2003**	**% of TTL**
Deposits	1,089.2	90.8	685.2	91.1
Borrowing	76.1	6.3	47.1	6.3
Hybrids	34.5	2.9	20.0	2.7
Total deposits/borrowings	**1,199.8**	**100.0**	**752.3**	**100.0**

Source: Company data, ING estimates

Next comes a yield enhancement spread recovery in 2004-05

The asset yield improvement is likely to be more long term and this improvement is not based on asset growth. There are three reasons why we expect yields to improve over the next few years even if overall asset (and/or loan) growth is very low. The first reason is that we expect the banks to continue to shift their excess liquidity out of short term and low yielding investments into loans. The next reason is that we expect that the business of companies with restructured loans to steadily improve and hence these companies will be able to handle interest rate step-ups as they arrive over this year and next. Finally, we expect NPLs to be slowly worked out and settled, and then repayments and recoveries are likely to be lent out in the form of new good loans.

Redeploying excess liquidity should raise yield

Over the last few years, the banks have virtually stopped lending as they have focused on raising capital and resolving NPLs. During that time, deposits continued to come into the banks and these deposits were not lent out. Instead, these deposits were put into short term interbank and money market lending and securities.

Fig 170 Deposit continue to flow into banks

Deposits Bt bn	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**Chg since 1997**	**% Chg since 1997**
BBL	946.5	969.8	957.2	1,033.5	1,071.9	1,062.7	1,089.2	142.7	15.1
KBANK	588.4	579.3	608.7	647.3	664.8	652.0	685.2	96.8	16.5
SCB	559.0	591.1	562.6	593.1	601.0	568.6	594.2	35.2	6.3
KTB	580.0	803.7*	802.1	844.1	867.0	958.7	1,025.8	445.8	76.9
BANKS	2,674.0	2,944.0	2,930.6	3,118.0	3,204.7	3,242.0	3,394.5	720.5	26.9

*Increase due to amalgamation companies taken over by KTB
Source: Company data, ING estimates

The table below shows the composition of the main interest bearing assets on the balance sheets of the banks and the respective yield for each category. The first category is interbank and money market lending, which accounts for about 9-17% of total interest earning assets. KBANK has the most exposure to this category. This portion of interest earning assets is currently yielding 1.3-2.0%; hence any shift into normal loans would cause a significant yield enhancement for each bank's overall loan asset yield.

The second category of interest earning assets is net securities where the banks have 5-25% of total assets. In the case of this category, the banks are earning 2.00-3.75%; most of this category are government bonds, and hence risk free. BBL has the highest exposure to this category, but the yield pick-up that each bank will get from shifting this into loans is relatively small as they are already getting a reasonably good yield relative to lending rates.

Finally, the last category is loans, where the banks are currently earning 3.54-3.94%. Of course, loans include both NPLs and restructured loans; hence the overall yield on loans is still below the quoted prime lending rate of 5.75%. We expect this yield to continue to rise over the next few years as the banks settle NPLs and restructured loans and replace them with good loans.

Fig 171 Breakdown of balance sheets (2003 estimates)

%	BBL	KBANK	SCB	KTB
IB and MM lending*	13.35	16.63	10.12	8.98
Net securities	24.66	17.17	21.80	4.78
Loans	59.81	64.87	66.58	84.81
Total interest-earning assets	**100.00**	**100.00**	**100.00**	**100.00**
Others	(3.57)	1.48	(4.06)	(0.22)
Total assets	**96.43**	**101.48**	**95.94**	**99.78**

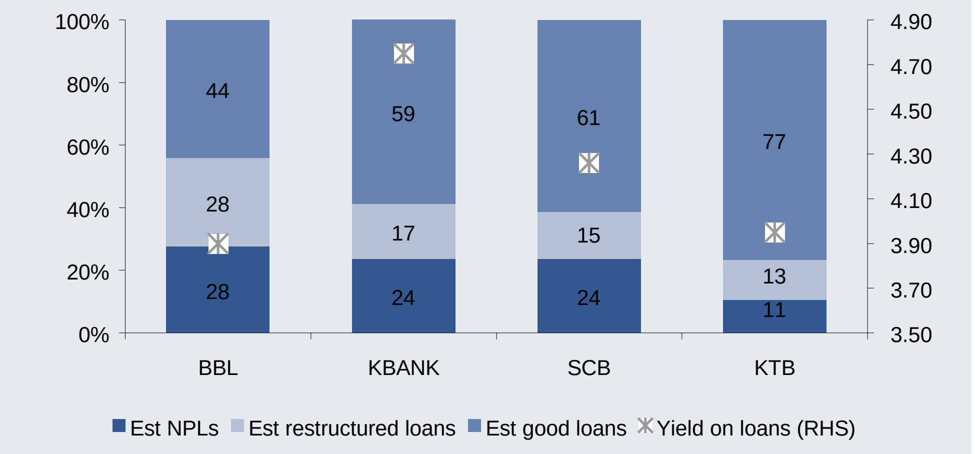
Yield on assets (2003E)

%	BBL	KBANK	SCB	KTB
Yield on IB & MM	2.00	1.80	1.45	1.30
Yield on securities	3.75	2.86	3.45	2.00
Yield on loans/others	3.90	4.75	4.26	3.95
Total yield	**3.62**	**3.94**	**3.81**	**3.54**

*IB and MM lending = Interbank and money market lending
Source: Company data, ING estimates

Falling NPLs and improving yield on restructured loans should drive overall loan yield

Fig 172 Estimated loan portfolio breakdown



Source: Company data, ING estimates

And profits rise as banks book lower provisions in 2004-05

Good NPL coverage means less need for large provisions

20% NPL ratio is manageable

The NPL ratio for the banks in our coverage has fallen from a peak of nearly 50% in 1998/99 to the current 20%. We expect this trend to continue, albeit slowly, unless the government introduces more measures to help the private banks clear these loans.

Banks have 12% provision to total loan coverage

Some are concerned about investing in banks with such high levels of NPLs. However, we would argue that the real question is how much provisions there are to cover losses on these NPLs. The chart below shows that the banks in our coverage currently have balance sheet provisions of about 12% relative to total loans. Again, the numbers are distorted by the 2000 write-off and subsequent 2002 write-backs of NPLs as mandated by the BOT.

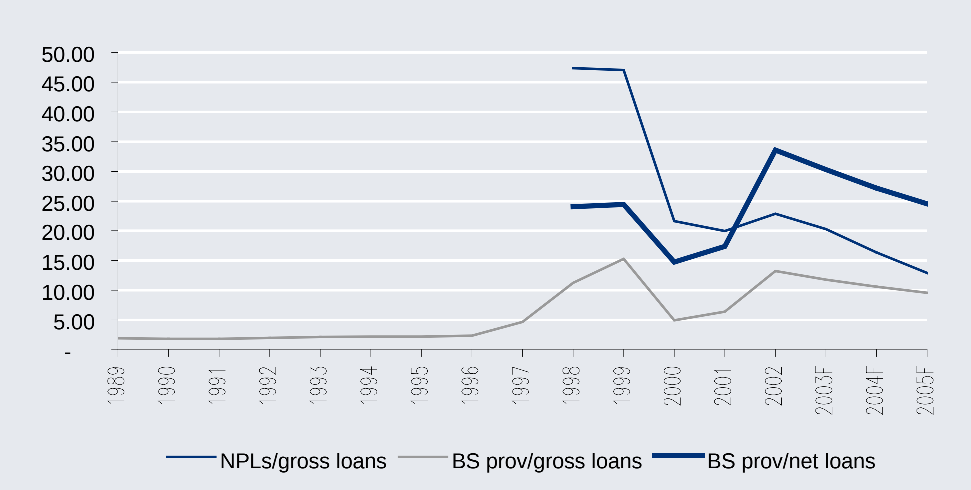
This rises to 35% once collateral is considered

Some may still argue that the 12% of provision to loan coverage is low, but we would counter that such a measure does not take into account collateral held by the banks, which is an important issue in a developing market such as Thailand. In the chart below we include the balance sheet provisions in relation to net loans (loans after deducting collateral value) to see that the coverage for this more appropriate measure is 35%.

But this is an overly conservative measure because it is applied to all loans

This means that if all loans of the banks went bad the banks would first try to get possession of the collateral and then sell it and then would have to suffer the loss of the uncollateralised portion of loans. For that loss they would have provisions to cover 35%. The advantage of this measure is that it considers all loans including good, NPLs and restructured loans. The disadvantage of this measure is that it is really considering highly unlikely event, ie, all loans going bad.

Fig 173 Provision-to-loan trends



Source: Company data, ING estimates

More realistic to relate provisions to NPLs, not total loans

We believe the chart below shows a more realistic picture. In this chart we only consider NPLs (any loan which is past due three months or more) as these are the highest risk loans of the banks.

65% provision coverage for gross NPLs

The first measure we consider is balance sheet provision related to gross NPLs, which is currently about 65%, meaning that the banks have provisions to cover a 65% haircut on the NPLs currently in their books without having to book more provisions through the P&L.

But more realistic to consider collateral as a secondary source

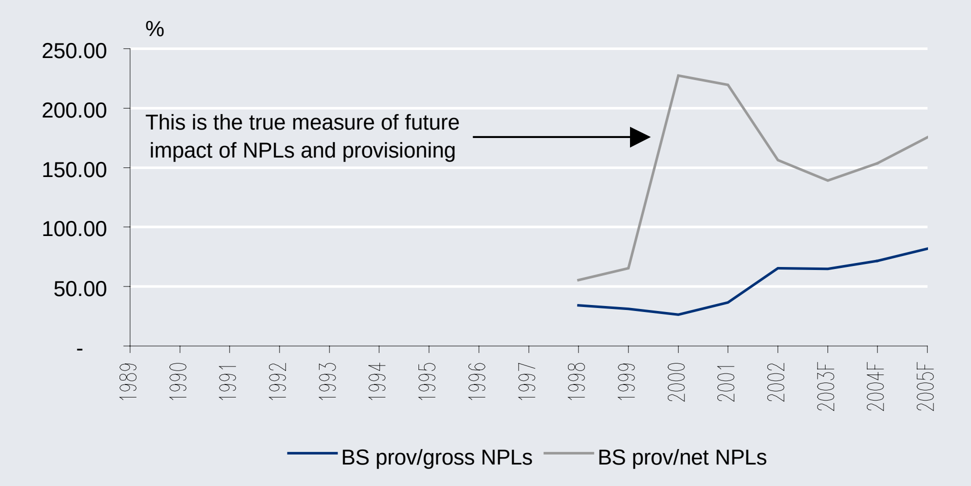
But again this is a bit unrealistic because the banks do not have to give such a haircut if they have a secondary source of repayment in the form of collateral, and in most cases the banks are holding collateral for their NPLs. In fact we calculate the current (as of 3Q03) collateral coverage for NPLs at 54%. So a more realistic measure would be to consider provisions for the uncollateralised portion of NPLs as this is the area where the banks run the highest risk of having to suffer a loss.

These banks have provisions to cover 150% of uncollateralised portion of NPLs

The chart below shows that as of 2003 the banks in our coverage had balance sheet provision relative to the uncollateralised portion of NPLs of about 150%. This means that they could easily cover a full hair cut on the uncollateralised portion of NPLs and still have balance sheet provisions to cover a fall in collateral values on these NPLs as well as losses related to restructured loans, while still maintaining a level of general provisions for good loans.

As a result, we are not concerned about the high 20% NPL ratio because after one factors in collateral and provision levels it can be seen that provision coverage is probably more than adequate. In fact, the subject may soon turn to provision write-backs in the near future.

Fig 174 Provision-to-NPL trends



Source: Company data, ING estimates

BOT's latest moves on reducing NPLs should help banks, not increase provisions

Three latest actions to reduce NPLs

The Bank of Thailand is continuing its push to reduce NPLs. The latest actions under consideration are: 1) to provide a new government buyer of NPAs from the banks; 2) to speed up the foreclosure process; and 3) to encourage the banks to put remaining cases into court. We remain buyers of banks – our top pick is BBL.

Outstanding NPLs of Bt315bn are the next target

The BOT continues its push to reduce NPLs. The BOT focused on reducing NPLs in the system starting with the CDRAC process soon after the 1997 baht crisis. This was followed last year with the set-up of an out-of-court process. According to the BOT, most of the large cases have now either been restructured or put into court. About Bt315bn of NPLs that have yet to be put into the court process remained as of September 2003, and this is its next target. The following three ways to deal with them are under consideration (there may be more or fewer, and these may or may not be fully implemented).

A new government buyer

Step 1: Provide a new government buyer of NPAs from banks. Step one is to amend the Asset Management Company (AMC) Law to allow the AMC to buy NPAs from the banks (right now, the AMC Law says it can only buy the nearly-gone assets of the 56 finance companies that were closed during the crisis – the FRA assets). This is likely to be in the form of an executive decree; it would take much longer if it had to go through Parliament. We think this would be positive for the banks.

Speed up the auction process

Step 2: Speed up the foreclosure process, specifically the auction process, by amending the Civil Court Law to expedite the auction process at the Legal Execution Department (the place where debtors' assets are sold after a judgement is made in the courts). Currently, the debtor has considerable rights to petition over the prices offered and force a new auction. We think this would be positive for the banks.

Restructuring remaining NPLs

Step 3: Encourage the banks to either restructure the remaining NPLs or put them in the court process. The NPLs that remain in the system are mainly to SMEs, as most large corporate restructuring has taken place over the last few years. Rather than try to micromanage these NPLs or implement a framework, the BOT appears to be more focused on giving deadlines, after which the banks would have to apply higher provisioning requirements to any NPLs that they refuse to put into the court process.

More provisions after one year

Our understanding at this point is that the BOT would phase in such measures. Currently, the banks are allowed to use 90% of the value of collateral to offset provisions. So if a bank had an NPL of 100 and collateral of 100, then it would be able to use 90 to offset provisions and would only have to provision for 10. However, we expect that the BOT will require the banks to use only half of that amount after one year if they haven't put the customer into the court process; hence, it would cause provisioning needs to rise to 55 (the original 10 plus half of the 90). Then we expect that after the second year, the bank would not be able to use any of the value of the collateral, implying a full provision of 100% for such loans.

Neutral for banks

The details of this measure have yet to be finalised. Thai bank bears may think this means more provisions; hence, the profit recovery that we having been talking about would be muted by provisions. We think this will be neutral for the banks, as they already have excess provisions that can be used if necessary. In addition, we expect the banks to follow the letter of the law and do what they need to do to keep from being penalised by the BOT.

Impact falls mainly on the banks with highest NPLs: BBL and SCB

The impact from such measures would fall mainly on BBL and SCB, both of which have the highest level of NPLs. We don't have full disclosure on how much of these NPLs are not yet in the court process; however, we expect these banks to start moving aggressively to put these customers into the court process or settle the NPLs. If either method were followed, then this new BOT regulation would not apply.

Fig 175 NPLs/gross loans

%	1999	2000	2001	2002	2003	2004F	2005F	2006F
BBL	48.4	23.6	21.8	25.9	27.9	23.6	18.8	14.7
KBANK	24.7	18.3	16.1	18.5	12.9	10.1	8.3	6.8
SCB	28.9	22.3	23.5	24.4	22.7	18.5	14.8	11.7
KTB	65.4	21.0	17.2	20.8	15.0	11.3	8.6	6.7
IND	**47.0**	**21.6**	**20.0**	**22.9**	**20.3**	**16.4**	**12.9**	**10.1**

Source: Company data, ING estimates

We remain positive on the banks' profits and share price recovery, with our top recommendation being BBL.

High and rising loan growth to drive growth in 2005-06 and beyond

Loan growth capped by NPL resolutions in 2004-05

Loan growth continues to be far below pre-crisis levels

At under 10%, loan growth is nowhere near pre-crisis levels of about 20%. Before we consider loan growth numbers it should be considered that the large drop in loan growth in 2000 came after banks were required by the BOT to write off the uncollateralised portion of loans that were more than 12 months overdue. This was followed by a spike in 2002 as the BOT reversed this policy and required the banks to write back the previously written-off loans.

Expect less than 10% through 2005

If adjusted for these events, industry loan growth would average about 3-4% for the past five years. We expect that growth to notch up to just under 10% this year and next but we don't expect loan growth of above 10% until after 2005.

A natural cap will prevent faster loan growth over the next couple of years

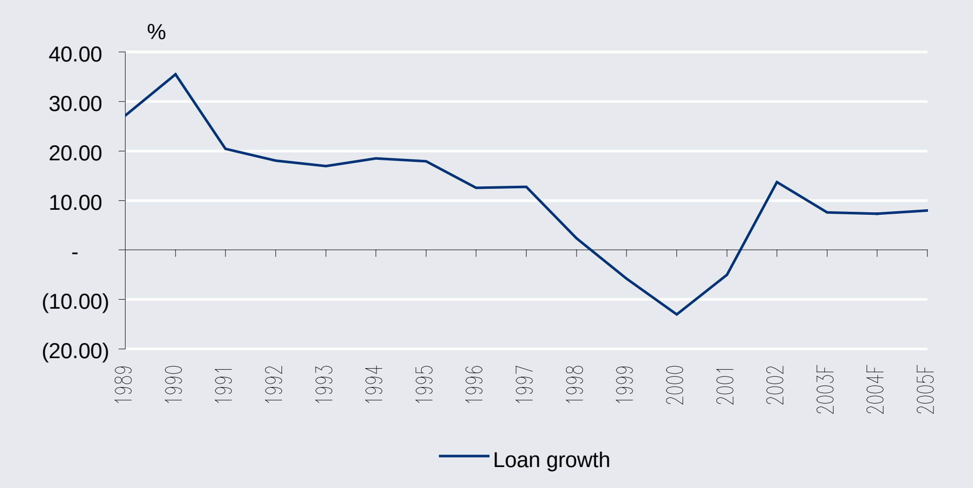
We believe there is a natural cap on loan growth because as banks start feeling positive about renewed loan growth we expect them to become more willing to allow hair cuts and settlements on NPLs. Such progress on NPLs would be good. However, write-offs and loan repayments would cause a large portion of the bank's loan book (30-50% if we include restructured loans) to fall.

Fig 176 Loan forecasts

BANKS	1998	1999	2000	2001	2002	2003F	2004F	2005F
Good loans	1,099.1	1,571.3	1,676.6	1,647.1	1,824.6	2,047.3	2,323.2	2,633.5
NPLs	989.5	1,394.2	463.1	410.9	540.5	520.9	454.5	389.8
Total loans	**2,088.6**	**2,965.5**	**2,139.7**	**2,058.0**	**2,365.1**	**2,568.2**	**2,777.7**	**3,023.3**
% chg	**1998**	**1999**	**2000**	**2001**	**2002**	**2003F**	**2004F**	**2005F**
Good loans		43.0	6.7	(1.8)	10.8	12.2	13.5	13.4
NPLs		40.9	(66.8)	(11.3)	31.5	(3.6)	(12.7)	(14.2)
Total loans		**42.0**	**(27.8)**	**(3.8)**	**14.9**	**8.6**	**8.2**	**8.8**

Source: Company data, ING estimates

Fig 177 Loan growth trend



Source: Company data, ING estimates

Loan growth coming from shifting excess liquidity to loans

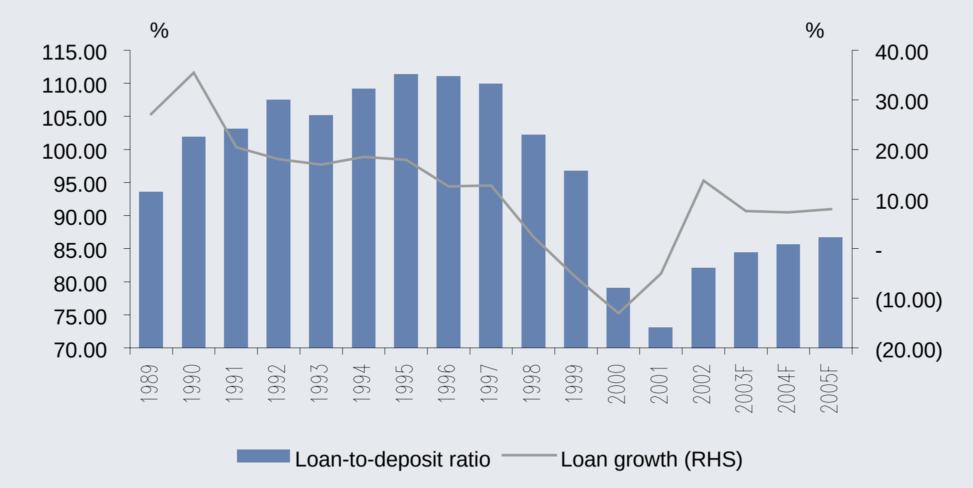
The loan-to-deposit ratio, though rising, still remains low, implying the banks are still holding a lot of excess liquidity.

The time to buy banks is when they still have a low loan-to-deposit ratio

We expect this liquidity to be slowly shifted into loans over the next few years as demand for loans in the economy continues to rise. The result should be a steadily rising yield as excess liquidity is now earning about 1.0-1.5% vs 4% for the loan portfolio including NPLs (implying about a 5-6% yield on the good portion of the loan portfolio).

We would rather be buying banks while loan-to-deposit ratios are low as we are nearly assured future loan growth as shown in the chart below where high loan growth was associated with high loan-to-deposit ratios and falling loan-to-deposit ratios meant falling loan growth.

Fig 178 Loan-to-deposit ratio relative to loan growth



Source: Company data, ING estimates

Once NPL resolution is complete, expect a strong recovery in loan growth

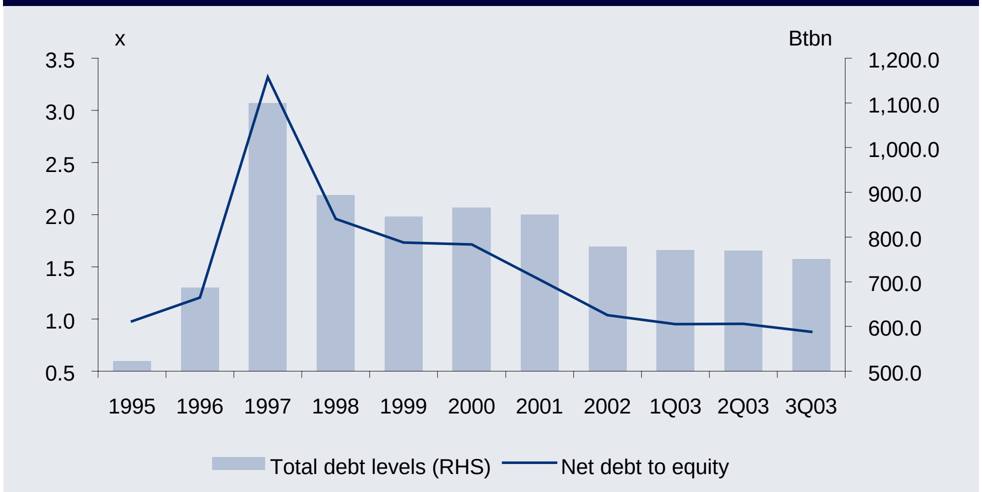
TOP90 corporates in the SET have been deleveraging aggressively

The loan-to-deposit ratio is one measure we look to assess the future loan growth, another measure is the debt levels of large corporates. We use our database of the top 90 listed companies by market cap (TOP90) to determine the ability of the large corporates in Thailand to borrow. The chart below shows that the TOP90 companies in the SET have been deleveraging for six years. We expect this deleveraging to reverse in 2004 or 2005, particularly as we notice that the revenue growth for these companies has been about 12% over the last few years, implying that they are steadily filling capacity.

Invest in banks when corporates are at the end of their deleveraging

We would rather be investing in banks at a time when this corporate deleveraging is reaching its bottom, as future loan growth is nearly assured as long as economic growth remains strong.

Fig 179 TOP90 SET companies' debt levels and net debt to equity



Source: Company data, ING estimates

Credit quality of TOP90 corporates improving dramatically…

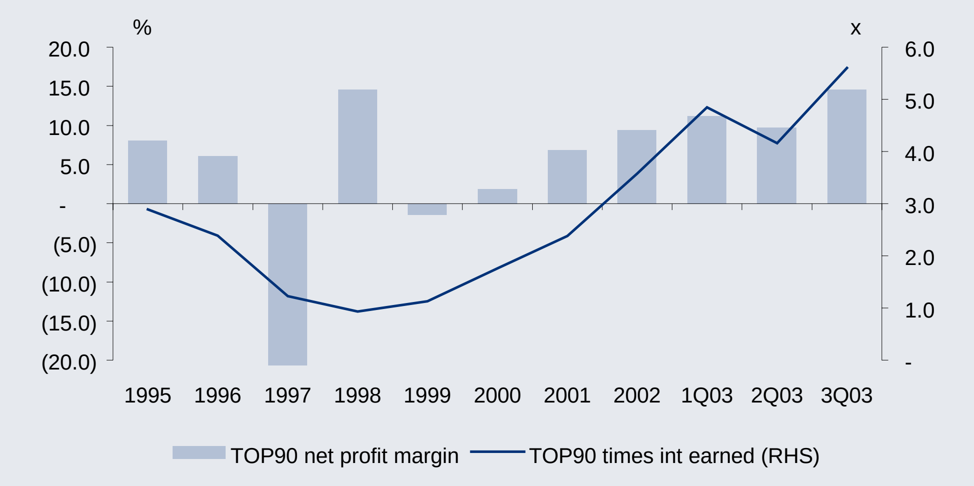
The chart below uses our TOP90 data further to assess the ability to pay interest and principal at the Thai corporates. We see from the data that the net profit margin for the TOP90 has been steadily rising for these companies. As well, the times interest earned has risen from as low as 1x just post crisis in 1998/99 to nearly 6x in 3Q03, the most recent quarter for which we have data.

...so once they get the appetite to borrow, we expect banks to lend aggressively

From this we can infer that when these corporates get the appetite for growth (currently the assets of this group of companies are only growing at 3-5% compared to 12% revenue growth) their credit ratings will be strong and the banks will be very willing to lend.

Our conclusion from all this data leads us to believe that we have a long cycle of accelerating loan growth at Thai banks, which could last three to five years. This, combined with steadily improving spreads, strengthens our assumption of strong EPS growth for Thai banks over the next three to five years.

Fig 180 Top 90 SET companies' net profit margin and times interest earned



Source: Company data, ING estimates

All this leads to a sustainable and long profit upcycle

Profits driven by lower cost of funds, higher yield and, eventually, loan growth

We believe that the Thai banks are out of trouble related to the 1997 economic crisis and we see a strong profit upcycle. We believe this will be driven first by a cost of funds-related spread recovery and second by yield improvement from better asset quality and a shift of excess liquidity into loans. As well, we expect that P&L provisions will be much lower over the next few years. The final driver of the recovery in profit will be loan growth, which we expect to pick up in about two years. We believe these three stages assure continued improvements in returns for Thai banks over the next three to five years, which gives us a positive view on the sector.

Income recovery is in place and improving

Gross income recovery strong but still off peak

Income recovery is strong, but still far from the peak. The table below shows gross income (both fee income and net interest income) rising slowly from the bottom of 2.2% in 1999; we expect this ratio to rise steadily over the next few years, but to remain far from the 1994 peak of 5.4%.

Fig 181 Gross income/avg assets

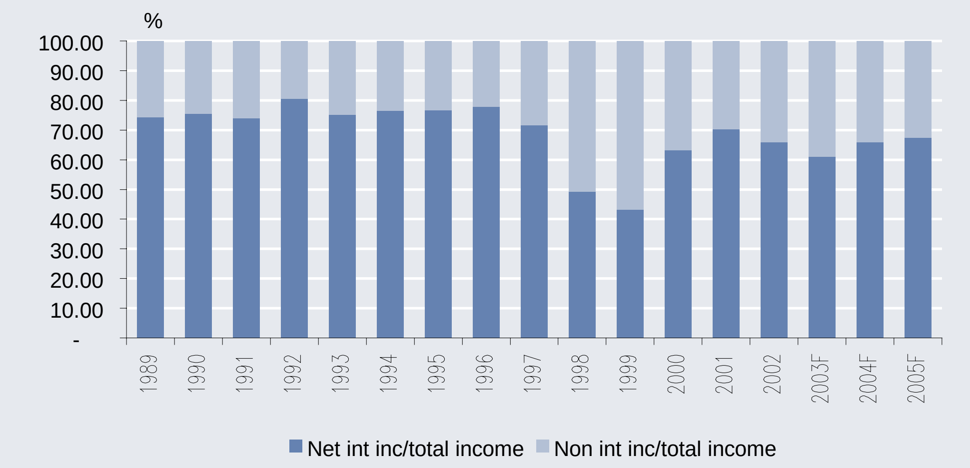
%	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004F	2005F	2006F
BBL	4.0	4.9	4.6	5.3	5.6	5.7	5.4	5.3	5.6	2.2	2.7	3.4	2.9	3.0	3.5	4.0	4.4	4.5
KBANK	4.2	4.7	4.2	5.0	5.3	5.5	5.7	5.4	5.2	3.1	1.9	2.9	3.0	3.1	4.0	3.8	4.1	4.2
SCB	4.5	5.0	4.2	4.6	4.6	5.2	5.2	5.0	5.1	3.2	2.8	3.4	3.2	3.8	4.2	4.2	4.2	4.3
KTB	2.8	3.3	2.9	3.9	4.7	4.8	4.7	4.6	4.5	2.4	1.2	1.9	2.6	2.7	2.6	3.1	3.3	3.6
IND	**3.8**	**4.5**	**4.1**	**4.8**	**5.1**	**5.4**	**5.3**	**5.1**	**5.2**	**2.6**	**2.2**	**2.9**	**2.9**	**3.1**	**3.5**	**3.7**	**4.0**	**4.2**

Source: Company data, ING estimates

Net interest income will be the driver of growth and returns

One element that we expect to drive returns in the next few years is the continued improvement in net interest income. The chart below shows that during the crisis and post-crisis period the banks had to rely on non-interest income as their spreads were being squeezed by high costs of funds and low yields. This trend has been reversing and hence we expect to see net interest income rather than fee income lead this recovery.

Fig 182 Net interest income and non-interest income ratio trends



Source: Company data, ING estimates

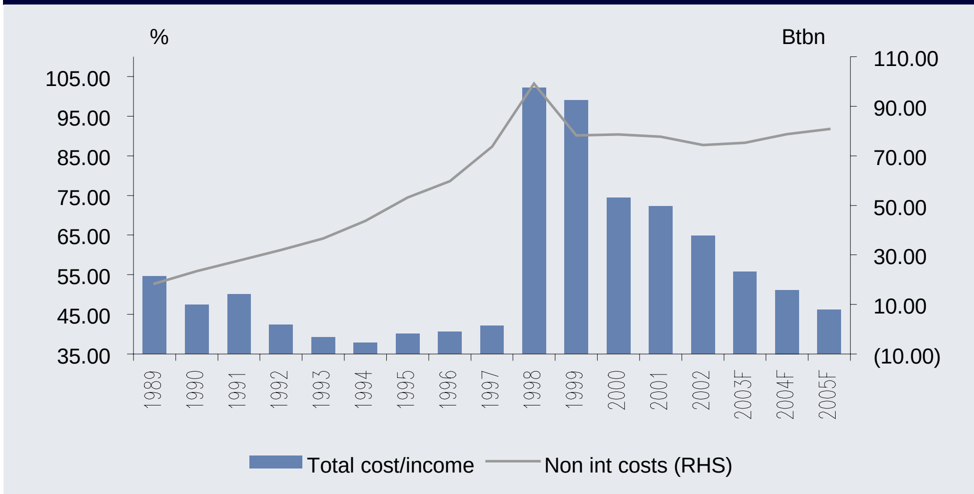
Cost control still a focus after many years of crisis

Cost-to-income ratio likely to continue its fall

Cost control has been a key feature of the last five years or so. The chart below shows that the cost-to-income ratio exploded post crisis as net interest income (a part of the denominator of the calculation) shrivelled. In addition, the numerator in the calculation exploded as the banks booked exceptional losses on the fall in value of assets and for charges related to premise and staff reductions and other restructuring charges.

However, the cost-to-income ratio has improved dramatically and now stands at about 55%. Since this ratio is still way above the boom time average of 37%, we expect a steady decline from 55% back down to 37% or lower. This should be driven by increasing income together with only slow increases in costs. From this data we feel confident that Thai banks can produce strong returns as net interest income continues to recover and costs remain in control.

Fig 183 Cost-to-income ratio trends

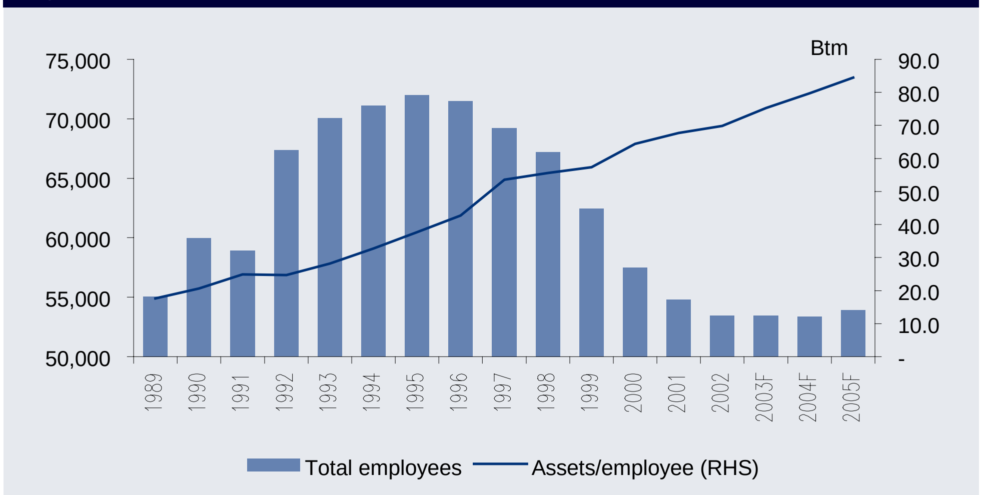


Source: Company data, ING estimates

Significant staff efficiency gains

The chart below shows that the banks have cut staff aggressively during the post crisis period, down from a high of 73,000 to a most recent 53,000, a 27% drop. As a result the amount of assets per employee has risen from Bt20m to Bt70m, implying that the banks are considerably more efficient. From this evidence of efficiency we believe that profits can rise over the next few years without a substantial rise in staff costs.

Fig 184 Staff headcount and assets-per-employee



Source: Company data, ING estimates

Core profits improving

Pre-provision profit driven by income recovery & cost control

We expect core profitability to continue to rise, as shown by the ratio of pre-provision profits to assets, which bottomed at a negative 0.06% and has been steadily rising. We expect a further rise in 2004 to 2.14%, which is still far from the high of 3.35% in 1994.

Fig 185 Pre-provision profit/avg assets

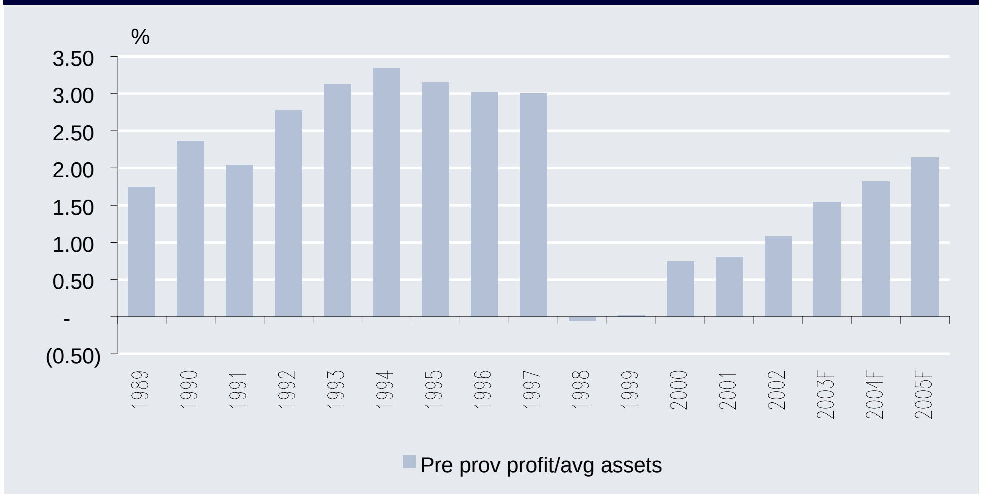
%	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004F	2005F	2006F
BBL	2.05	2.86	2.62	3.42	3.70	3.71	3.43	3.36	3.71	(0.11)	0.82	1.35	0.96	0.84	1.29	1.90	2.43	2.68
KBANK	1.91	2.43	1.95	2.61	3.19	3.38	3.29	3.16	2.48	(0.41)	(0.91)	0.28	0.38	0.96	2.00	1.81	2.10	2.28
SCB	1.88	2.48	2.08	2.53	2.46	2.97	2.85	2.68	2.67	(0.16)	0.68	1.41	1.35	1.79	2.21	2.29	2.34	2.52
KTB	0.91	1.26	1.02	1.94	2.53	2.97	2.78	2.61	2.56	0.39	(0.73)	(0.12)	0.54	0.99	1.10	1.45	1.74	2.07
IND	**1.74**	**2.36**	**2.04**	**2.77**	**3.13**	**3.35**	**3.15**	**3.02**	**3.00**	**(0.06)**	**0.02**	**0.74**	**0.80**	**1.08**	**1.54**	**1.82**	**2.14**	**2.39**

Source: Company data, ING estimates

Core profit improving significantly

The improvement in core profitability at the Thai banks can be better seen by considering pre-provision profits relative to assets. The chart below shows that this measure has been rising steadily, but still has a long way to go to get back to near pre-crisis levels.

Fig 186 Pre-provision profit relative to assets



Source: Company data, ING estimates

Reduced provisions to bring core profits to ROA and ROE as well as EPS

With much less provisions, profits will feed through to ROA

We expect ROA to rise over the next few years from 1.24% in 2003 to 1.51% in 2004 and 1.59% in 2005. This should be driven by improvement in core earnings and a reduction in provisions over the next few years. We have yet to factor in any exceptional gains from debt restructuring and/or provision write-backs. We think these ROA assumptions are reasonable, as they remain below the peak ROAs of 1.70-1.95% during 1993-95.

Fig 187 ROAA

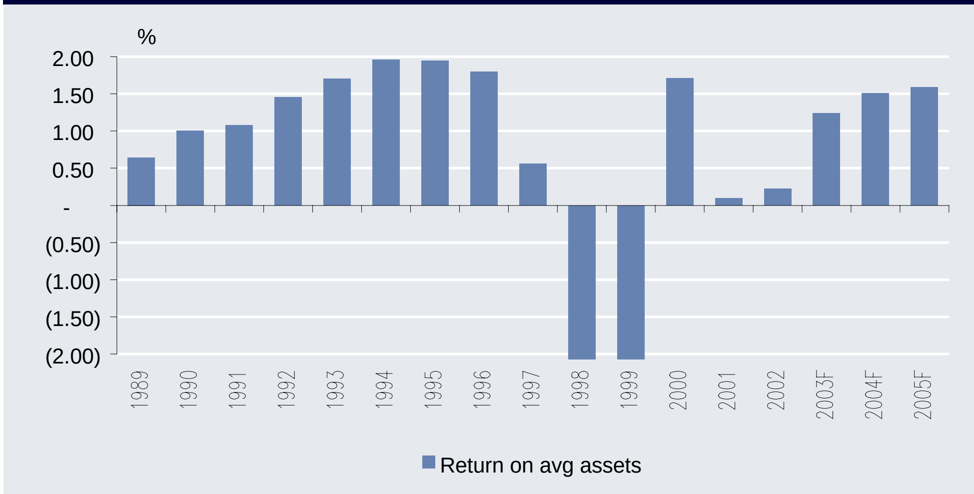
%	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004F	2005F	2006F
BBL	0.65	1.00	1.30	1.67	1.92	2.07	2.04	1.89	1.15	(3.70)	(4.70)	(1.54)	0.52	0.50	0.93	1.55	1.80	1.70
KBANK	0.85	1.35	1.19	1.55	1.97	2.19	2.12	1.93	0.11	(5.32)	(7.90)	0.17	0.13	0.87	1.83	1.58	1.64	1.52
SCB	0.93	1.34	1.30	1.66	1.62	1.79	1.89	1.81	0.51	(2.19)	(5.13)	0.51	0.06	(1.81)	1.86	1.96	1.74	1.70
KTB	0.26	0.43	0.40	0.81	1.10	1.66	1.70	1.52	0.03	(6.63)	(8.93)	7.69	(0.45)	0.79	0.78	1.15	1.25	1.27
IND	**0.64**	**1.00**	**1.08**	**1.45**	**1.70**	**1.96**	**1.95**	**1.80**	**0.56**	**(4.47)**	**(6.59)**	**1.71**	**0.09**	**0.23**	**1.24**	**1.51**	**1.59**	**1.54**

Source: Company data, ING estimates

Expect ROAs to continue to improve

From all of the above observations and assumptions we believe that ROAs will continue to improve for Thai banks, moving from the current 0.25% (mainly due to high provisions at SCB) up to 1.5% in 2003 and 2004.

Fig 188 ROA trend



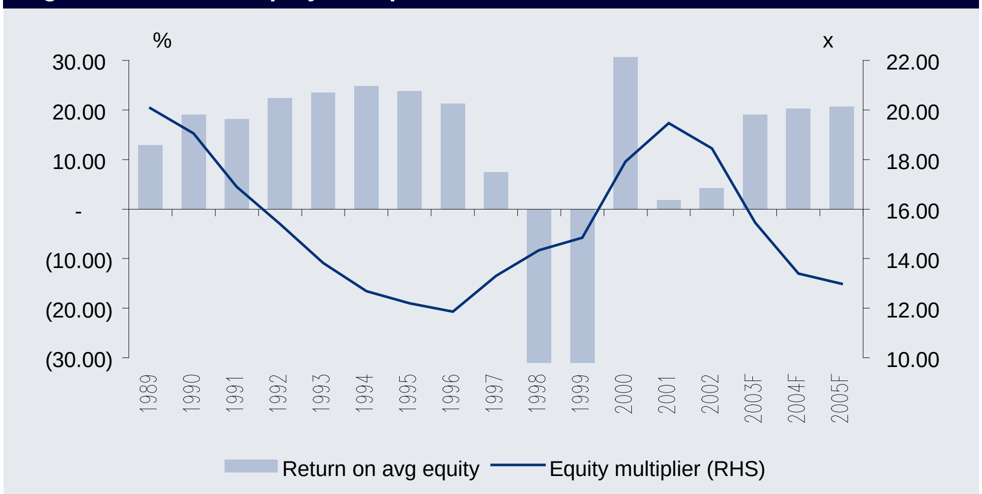
Source: Company data, ING estimates

ROE rising, even with declining leverage

Next we consider ROE and leverage to assess future performance. The chart below shows that ROE is improving during a time when leverage (the equity multiplier) is falling. This implies that the improvements in return are being driven by core operations rather than just leveraging up the balance sheet.

In fact, to keep ROE constant or rising during a period of deleveraging, the core operations must improve even more substantially.

Fig 189 ROE and equity multiplier trends



Source: Company data, ING estimates

Stronger profits and reduced provisions will reduce pressure on capital

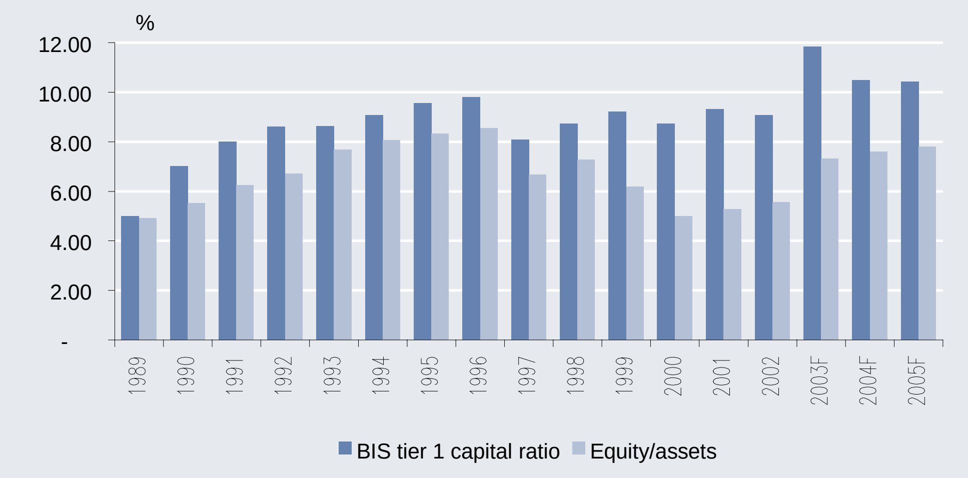
Both BIS tier 1 ratio and equity to assets ratio improving

Lastly, we illustrate the deleveraging that has been taking place as the banks have been raising capital and replacing hybrids with straight equity. As the chart shows, the BIS tier 1 ratio rose substantially in 2003 after the recent BBL share offering. In addition, this has caused the equity to asset ratio to improve.

We expect the BIS tier 1 ratio to fall in 2004 as the banks redeem hybrids and in the case of KBANK, do not replace them with equity.

Our conclusion related to capital is that the banks are not under pressure to raise capital and are only likely to do so if loan growth begins to require it and/or if the market is very favourable.

Fig 190 BIS tier 1 and equity-to-asset ratio trends



Source: Company data, ING estimates

Sector consolidation a positive driver: fewer competitors should mean increased profitability for survivors

Government intent on consolidation

The government has made it clear that they want to see an improved financial sector, which, as well as making it easier to regulate, we expect to happen in stages. The first stage is to get rid of finance companies, Bangkok International Banking Facilities (BIBFs) and credit fonciers. The second stage is to reduce the number of banks. Pre-crisis, there were more than 120 financial institutions, a number that came down considerably after the authorities closed 56 finance companies.

Currently about 48 institutions after our core bank assumptions

The table below highlights how we see the industry both currently and in the future. First, we came up with 15 core banks, based on our assumption of which banks would buy other banks and which finance companies would combine to upgrade to banks. This would leave 16 foreign banks, five Bangkok International Banking Facilities (BIBF – though these will have to upgrade to foreign bank status or be closed), three finance companies, four credit fonciers and five state banks. The three finance companies and the four credit fonciers will all lose their licences due to the implementation of the new financial institutions development plan; however, we do not yet have a strong picture of which other banks they would combine with.

Fig 191 Financial industry structure as of Nov 03 and possibly beyond

Number	Type	Assets (Bt bn)
15	Core banks	6,685.9
16	Foreign banks	642.2
5	BIBFs	19.8
3	Finance companies	16.2
4	Credit fonciers	1.4
5	State banks	1,486.5
48	**Financial system**	**8,851.9**

Source: Company data, ING estimates

There are currently five unlisted government banks, all of which have grown aggressively over the last five years, during which time the private banks were not lending, as they were working out their NPL problems.

SFIs are unlikely to merge in the near term

As these are specialised finance institutions (SFIs), we think the government is unlikely to aggressively merge them and therefore we believe they will continue to exist in the financial system. Our most recent talks with the president of the Government Housing Bank support the idea that these banks are facing stiff competition from each other and from the private banks. He mentioned in particular that the Government Housing Bank was facing strong housing loan competition from the Government Savings Bank and that competition from private banks in housing loans was heating up.

Fig 192 Government bank structure as of November 2003

Bt bn		Assets
1	Government Savings Bank	636.1
2	Bank for Agri and Agri Coops	411.5
3	Government Housing Bank	370.4
4	Export-Import Bank of Thailand	50.0
5	SME Development Bank of Thailand	18.5
	Govt banks	**1,486.5**

Source: Company data, ING estimates

Three foreign banks likely to focus on their branch networks

There are 18 foreign banks in Thailand, three of which have a foreign banking licence and hold a majority stake in a local Thai bank (ABN AMRO, Standard Chartered Bank and United Overseas Bank). Because of the one presence rule of the new Financial Institutions Development Plan, the three banks must decide which of the two banks they own they want to keep. At this point, we would conclude that all would want to maintain their stakes in their local banks as this gives the benefit of a local branch network, which most of the foreign banks do not have. We also think they will make this choice because they know that given the recovery in the banking system, they are unlikely to get another opportunity to own such a large stake in a full Thai bank.

Fig 193 Financial industry structure as of November 2003

Bt bn			Related or rumoured		
1	Citibank, N.A.	128.9	Citicorp Finance	4.7	133.6
2	Sumitomo Mitsui Banking Corp	102.8			102.8
3	The Bank of Tokyo-Mitsubishi	88.0	BTM Finance (Thailand) Ltd	4.0	92.0
4	HSBC	81.9			81.9
5	The Mizuho Corporate Bank	79.2			79.2
6	Deutsche Bank AG.	51.3			51.3
7	JP Morganchase	30.6			30.6
8	Credit Agricole Indosuez Bank	20.2			20.2
9	BNP Paribas	11.7			11.7
10	Bank of America	9.5			9.5
11	The Bank of China	7.6			7.6
12	The Bank of Nova Scotia	7.6			7.6
13	The Inter'l Commercial Bank of China	6.1			6.1
14	RHB Bank Berhad	3.1			3.1
15	Bharat Overseas Bank	3.0			3.0
16	Oversea Chinese Banking Corp	2.2			2.2
	Foreign banks	**633.5**		**8.7**	**642.2**

Source: Company data, ING estimates

We expect about 15 core banks

The banks that remain are those that we believe will form the core of the industry. Currently, we see 15 such banks emerging, which we list in the following table. Next to each bank is its related bank/finco, or one we believe may end up merging with the core institution. Of course, the first thing this shows is that the number of banks is likely to increase before decreasing, mainly as a result of the finance companies upgrading to banks. Outside of the following list, there are a few remaining finance companies, BIBFs and credit fonciers that are likely to have to either stop taking deposits or be bought out by another core institution.

Fig 194 Thai commercial banks

Bt bn	Core banks	Assets	Related or Rumoured	Assets	Related or Rumoured	Assets	Related or Rumoured	Assets	Assets
1	Bangkok Bank	1,298.0	Asia Credit	22.8	Bualuang Finance	3.4	Asia Credit Foncier	0.9	1,325.1
2	Krung Thai Bank (FIDF)	1,132.0							1,132.0
3	Kasikorn Bank	813.4							813.4
4	Siam Commercial Bank (MOF)	717.8	Siam Industrial Credit	29.5	Book Club Finance	5.2			752.5
5	Siam City Bank (FIDF)	530.2							530.2
6	Bank of Ayudhya	516.2	Ayudhya Investment And Trust	7.6					523.8
7	Thai Military Bank (MOF)	375.4	DBS Thai Danu Bank	99.6	IFCT	201.8			676.8
8	BankThai (FIDF)	277.5							277.5
9	Bank of Asia	163.7	ABN Amro Bank N.V.	28.5					192.3
10	National Finance	114.8	Thanachart Bank	58.1					172.9
11	Standard Chartered Nakornthon Bank (FIDF)	63.2	Standard Chartered Bank	57.0					120.2
12	UOB Ratanasin (FIDF)	62.5	United Overseas Bank	0.4					62.9
13	Tisco Finance	52.5	Thai Permsub Finance	0.1					52.6
14	Kiatnakin Finance	41.4	Radhantun Finance	0.6					42.0
15	Finansa Credit	4.5	Bangkok First Inv and Trust	7.3					11.8
	Core Thai banks	**6,163.2**		**311.3**		**210.5**		**0.9**	**6,685.9**

Source: Company data, ING estimates

Second stage is to reduce the number of banks

The next step in the process is to reduce the number of banks, which we believe will prove more difficult than it sounds. This is because we believe the private banks are not interested in merging as they are only just coming out of deep NPL problems; they are more interested in focusing on making their existing operations profitable.

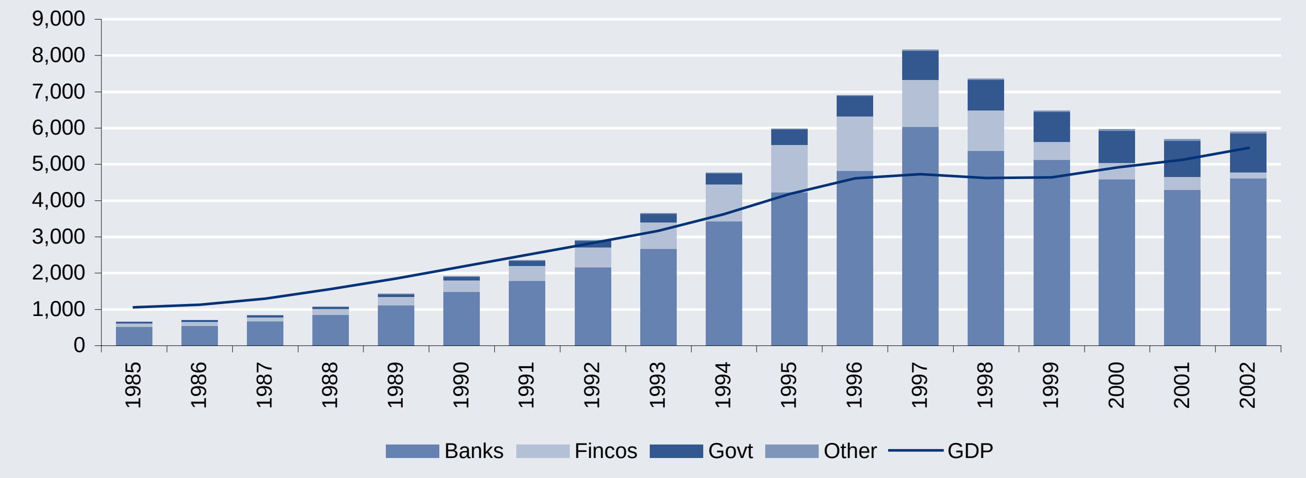
Private banks seem uninterested in mergers

We find it hard to believe that the private banks, after years of fierce rivalries, would join each other – so the only other way to grow would be for the banks to acquire government banks. But the unlikelihood that they could act to aggressively cut staff and reduce branches would prove to be a major stopping point. Thus, we see mergers amongst private banks as unlikely in the near term.

The following chart highlights some of the four reasons we are positive on Thai banks, as listed below:

- Outstanding credit is back to where it was in 1995, meaning essentially no growth over the last seven years. We think this leaves room for strong growth in the next couple of years.
- Nearly 90 finance companies are gone, with the three to five that will remain upgrading to banks.
- All credit fonciers and BIBFs will soon be gone.
- Our conclusion is that once loan growth resumes, it will be spread across only a small number of banks, giving more growth to the banks that survive.

Fig 195 Credit extended vs GDP



Source: Company data, ING estimates

How to play the consolidation theme

Our idea about how to play the financial sector consolidation theme in Thailand is:

First – beneficiaries are large private banks: BBL, KBANK and BAY

First, to focus on the big privately owned banks: BBL, Kasikornbank (KBANK/F TB, Bt56.5, Buy, Target: Bt76.0) and Bank of Ayudhya (BAY TB, Bt12.9, Buy, Target: Bt19.0). Our view is that, in the end, these banks will manage for value far better than government banks can. In addition, we believe that none of these banks will be forced into mergers on possibly unfavourable terms.

Second – good quality and large fincos: TISCO and KK

Our second way to play the consolidation theme is to focus on good quality and large finance companies that are planning on upgrading to banks: Tisco Finance (TISCO TB, Bt31.8, Hold, Target: Bt35.0) and Kiatnakin Finance (KK TB, Bt42.25, NR) – as National Finance (NFS TB, Bt16.8, Buy, Target: Bt21.0) already has its banking licence.

Third – small banks with bargaining power: BOA

For those who dare to venture down in size, our third way to play it is to stick to small banks that have some bargaining power, a strong franchise or expertise, and have a reputable shareholder (so that hopefully one could feel more confident about state financial data). The banks that we think fall into this category are Bank of Asia (BOA TB, Bt5.25, NR), whose major foreign shareholder is ABN Amro, and DBS Thai Danu Bank (DTDB TB, Bt3.46, NR), whose major foreign shareholder is DBS.

In our December 2003 Thailand Country Strategy, we highlighted that we liked the story on DTDB and thought that it would be a good laggard play; unfortunately, this call has gone wrong up to this point. The reason we liked the story on DTDB up until now is:

- We believed that we could be more confident in the financial statements of DTDB than those of Thai Military Bank (TMB TB, Bt4.12, NR) or Industrial Finance (IFCT TB, Bt4.40, NR), thus preventing any nasty collapses in BVPS.
- We believed that the provision that DTDB was recently forced to book due to a recent qualitative review by the BOT caused the BVPS to be understated, meaning that the P/BV ratio was actually less than the current 2.0x.

- We believed that DBS, which already holds a majority stake in DTDB and could increase that up to 75%, was looking to expand its platform in Thailand, and would not be satisfied with a minority stake in a larger bank.
- We believed that the MOF was interested in selling its stake as soon as it could.
- And we also had less confidence in the BVPS of TMB than that of DTDB; hence the probability of further provisions at TMB (causing BVPS to collapse) could potentially be higher, making a purchase of TMB on merger talks a less attractive proposition.

But the end result appears to be bad for DTDB shareholders, as they are getting paid in TMB shares, which could have a more questionable announced BVPS. In addition, DBS appears to be willing to accept a much lower stake in a larger bank. Hence, the share price is getting sold down and our ideas as outlined above are under question.

If the deal falls through, DTDB could bounce and the deal could go to SCB

A little lateral thinking: What if the deal falls through? We would propose one other scenario which is that there is a possibility (a high one given past experience) that the purchase of DTDB shares by TMB doesn't go through, particularly given DBS' insistence that most of the details aren't worked out. If that were the case, we think it is possible that SCB would end up being encouraged by its major shareholder (the MOF) to buy both TMB and IFCT, riding in as the white knight. If this scenario happened, we would play it by buying Siam Commercial Bank, which would then become one of the largest banks in Thailand, and it is likely that DTDB's share price could bounce back.

Bank valuations and recommendations

Bank valuation methodology

In valuing Thai banks we use the following methodology. First, we forecast performance over the next 10 years. Then we calculate the average performance over this period to arrive at our major assumptions (ROA, ROE and DPR), which are the inputs to determine target PER and P/BV multiples. Once we do this, we apply these multiples to our forecasted EPS and BVPS to determine target prices. After this, we use the dividend discount model, applying the dividends we have forecasted and the discount rates we have calculated in our PER and P/BV multiple calculation. We arrive at our final target price by using the average of these three methodologies. This is outlined in the table below.

Fig 196 P/BV and PER calculation inputs (%)

%	BBL	KBANK	SCB	KTB	BAY	NFS	TISCO
Market return							
Risk-free rate	5.00	5.00	5.00	5.00	5.00	5.00	5.00
Market premium	8.00	8.00	8.00	8.00	8.00	8.00	8.00
Market return	13.00	13.00	13.00	13.00	13.00	13.00	13.00
Bank cost of equity							
1992-2001 beta (x)	0.96	1.13	1.33	1.43	1.27	1.84	1.43
2002 beta (x)	1.89	1.69	1.83	1.18	1.04	1.80	1.64
2003 beta (x)	1.36	1.39	1.24	1.47	0.88	0.87	1.19
2004 YTD beta (x)	1.15	1.22	1.20	1.18	1.34	0.98	1.34
Est forward bank beta (x)	**1.03**	**1.18**	**1.10**	**1.10**	**1.25**	**1.20**	**1.10**
Market premium	8.00	8.00	8.00	8.00	8.00	8.00	8.00
Bank cost of equity (k)	**13.26**	**14.44**	**13.76**	**13.78**	**15.00**	**14.60**	**13.80**
Bank LT growth rate							
Est LT ROA 1989-96	1.57	1.64	1.54	0.99	1.38	2.11	0.56
Est LT assets/equity 1989-96 (x)	15.02	13.62	14.17	19.12	13.22	6.14	1.86
Est LT ROE 1989-96	21.76	21.40	21.31	17.23	18.20	22.06	4.19
Est LT DPR 1989-96	32.74	38.61	37.45	26.24	47.46	16.77	4.85
Est LT growth rate 1989-96 (g)	14.64	13.14	13.33	12.71	9.56	18.36	3.99
Est LT ROA 05-12	1.61	1.54	1.67	1.30	1.32	1.51	2.11
Est LT assets/equity 05-12 (x)	10.56	12.30	10.63	13.49	13.01	9.70	8.22
Est LT ROE 05-12	17.01	18.88	17.72	17.45	17.06	14.59	17.30
Est LT DPR 05-12	38.75	38.75	40.00	40.00	38.75	38.13	40.00
Est LT growth rate 05-12 (g)	10.42	11.57	10.63	10.47	10.45	9.03	10.38
Calculate implied target multiples							
Numerator (ROE - g)	6.59	7.32	7.09	6.98	6.61	5.56	6.92
Denominator (k - g)	2.85	2.87	3.13	3.31	4.55	5.57	3.42
Target P/BV [(ROE- g)/(k - g)] (x)	**2.32**	**2.55**	**2.27**	**2.11**	**1.45**	**1.00**	**2.02**
Target PE [(DPR/(k - g)] (x)	**13.62**	**13.48**	**12.79**	**12.10**	**8.51**	**6.84**	**11.69**

Source: Company data, ING estimates

Fig 197 Valuation outputs

Price (Bt)	BBL	KBANK	SCB	KTB	BAY	NFS	TISCO
Local	98.00	54.50	48.25	11.30	12.90	16.20	30.00
Foreign	102.00	56.50	48.25	11.40	13.00	16.20	30.00
Premium (%)	4.08	3.67	-	0.88	0.78	-	-
BVPS (Bt)							
02	37.84	14.91	16.64	5.82	9.14	13.57	10.44
03	53.56	20.58	23.88	6.70	10.02	14.44	14.44
04F	60.44	24.99	24.87	7.38	11.30	16.08	15.92
05F	65.44	28.74	26.12	8.03	12.75	17.78	17.82
EPS (Bt)							
02	4.28	2.84	(3.99)	0.72	1.15	1.29	1.64
03	6.73	6.29	3.96	0.78	1.30	2.00	2.67
04F	9.32	6.19	5.35	1.46	1.57	2.09	2.55
05F	10.82	5.35	4.46	1.25	2.07	2.33	2.60
DPS (Bt)							
02	-	-	-	-	-	-	-
03F	-	-	-	0.26	-	0.50	-
04F	1.86	1.24	1.61	0.58	0.31	0.60	0.91
05F	3.25	1.61	1.79	0.50	0.62	0.63	0.76
Target multiples (x)							
BVPS	2.32	2.55	2.27	2.11	1.45	1.00	2.02
PER	13.62	13.48	12.79	12.10	8.51	6.84	11.69
Price target (Bt)							
BVPS	151.56	73.16	59.20	16.95	18.51	17.75	36.02
PER	147.36	72.18	57.08	15.13	17.61	15.95	30.36
DDM	120.90	56.95	49.58	15.08	21.97	29.11	38.33
Weight applied (%)							
BVPS	33.33	33.33	33.33	33.33	33.33	33.33	33.33
PER	33.33	33.33	33.33	33.33	33.33	33.33	33.33
DDM	33.33	33.33	33.33	33.33	33.33	33.33	33.33
Total	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**
Weighted price target (Bt)							
BVPS	50.52	24.39	19.73	5.65	6.17	5.92	12.01
PER	49.12	24.06	19.03	5.04	5.87	5.32	10.12
DDM	40.30	18.98	16.53	5.03	7.32	9.70	12.78
Local price target (Bt)	**140.00**	**67.00**	**55.00**	**16.00**	**19.00**	**21.00**	**35.00**
Est foreign premium (%)	-	-	-	-	-	-	-
Foreign price target (Bt)	**140.00**	**67.00**	**55.00**	**16.00**	**19.00**	**21.00**	**35.00**
Up/down (%)	37.25	18.58	13.99	40.35	46.15	29.63	16.67

Source: Company data, ING estimates

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Bangkok Bank

Benefits to the biggest

Rating: BUY

Net interest income should jump at BBL in 2004 and 2005 driven by lower cost of funds as hybrids were redeemed in April 2004 (so the drop in funds for the whole year won't be felt until 2005). BBL was able to refinance 40% of its hybrid issues at a floating rate of about 3%, providing very large cost savings while maintaining tier 1 capital.

We expect non-interest expenses to be flat as the bank has booked a large amount of other expense charges in the last few years, which we expect to be reduced. BBL has one of the highest levels of general provisions in the sector at 17.5% of total loans. After its recent capital raising, the bank has a sector high BIS tier 1 capital ratio of about 13%.

Provisions should remain flat, as we expect a resolution of the TPI and TPIPL cases in 2004, which will allow the bank to move the large specific provision that we believe it holds to cover these loans to general provisions. If this occurs, then the balance sheet provision should be far in excess of the BOT minimum; we don't expect any reversal of provisions through the P&L to be allowed or to occur over the next few years.

We have downgraded our target price from Bt155 to Bt140, based on the same 2.3x P/BV and 13.6x PER that we previously used; however, we now apply them to a slightly lower EPS and BVPS. We maintain our BUY recommendation.

Bangkok Bank Thailand

Share Price (Bt):	102.00	**Reuters Code:**	BBL/F.BK	**Shares Outstanding** 1,909
52 Week Price Range (Bt):	58.00 - 120.00	**Bloomberg Code:**	BBL/F.TB	**Market Cap (US$m)** 4,909

INCOME STATEMENT	**01**	**02**	**03**	**04**	**05**
Interest income	60,411	52,189	48,073	47,108	50,908
Interest expense	(36,679)	(29,863)	(23,519)	(15,726)	(14,691)
Net interest income	**23,732**	**22,326**	**24,553**	**31,382**	**36,218**
Non-interest income	12,427	14,526	20,825	19,468	19,991
Total operating income	**36,159**	**36,852**	**45,378**	**50,850**	**56,209**
Non-interest expense	(24,220)	(26,350)	(29,291)	(28,740)	(29,166)
Pre provision profit	**11,939**	**10,502**	**16,087**	**22,110**	**27,043**
Loan loss provisions	(5,455)	(4,231)	(4,733)	(4,325)	(4,090)
Non-operating income	-	-	-	-	-
Pre tax profit	**6,484**	**6,271**	**11,355**	**17,785**	**22,953**
Tax	-	-	-	-	(2,295)
Net profit	**6,484**	**6,271**	**11,355**	**17,785**	**20,658**

BALANCE SHEET	**01**	**02**	**03**	**04**	**05**
Gross loans	718,142	830,622	848,859	883,870	952,927
Loan loss reserves	*(68,539)*	*(150,754)*	*(135,379)*	*(132,633)*	*(129,576)*
Net loans	649,602	679,868	713,480	751,237	823,351
Total earning assets	1,225,024	1,285,973	1,395,062	1,394,701	1,427,748
Other assets	23,724	(40,875)	(36,213)	(30,747)	(22,002)
Total Assets	**1,248,748**	**1,245,098**	**1,358,849**	**1,363,954**	**1,405,746**
	-	-	-	-	-
Deposits	1,071,931	1,062,665	1,114,910	1,148,357	1,182,808
Other paying liabilities	107,860	102,778	115,789	76,905	73,070
Other liabilities	25,760	24,154	25,921	23,329	24,962
Total Liabilities	**1,205,550**	**1,189,596**	**1,256,620**	**1,248,591**	**1,280,841**
	-	-	-	-	-
Total Equity	**43,197**	**55,502**	**102,229**	**115,363**	**124,905**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	157,327	215,681	210,773	182,780	155,363
NPAs/total loans	21.8%	25.9%	24.8%	20.7%	16.3%
Reserve coverage of NPAs	43.6%	69.9%	64.2%	72.6%	83.4%

PER SHARE DATA (HK$)	**01**	**02**	**03**	**04**	**05**
EPS	4.42	4.28	6.73	9.32	10.82
DPS	0.00	0.00	0.00	1.86	3.25
Effective payout ratio (%)	*0%*	*0%*	*0%*	*20%*	*30%*
BVPS	29.45	37.84	53.56	60.44	65.44

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	67.0	78.2	76.1	77.0	80.6
Equity to assets	3.5%	4.5%	7.5%	8.5%	8.9%
Tier 1 CAR	6.9%	6.9%	6.9%	6.9%	6.9%
Total CAR	11.7%	11.9%	16.7%	15.7%	16.1%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	3.463604	2.695712	1.904576	1.687729	1.558796
Price to earnings	23.07361	23.85873	15.16184	10.94776	9.425164
Price to underlying profit	22.36664	24.35979	22.88502	12.2696	9.980583
Yield at current price (%)	*0.0%*	*0.0%*	*0.0%*	*1.8%*	*3.2%*

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	N/A	N/A	N/A	N/A	N/A
Mortgage (%)	8.6	7.5	8.0	8.0	8.0
Corporate (%)	85.3	85.9	84.7	84.7	84.7
Other (%)	6.1	6.5	7.3	7.3	7.3

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	1.94	1.78	1.83	2.25	2.57
Yield on assets	4.94	4.16	3.59	3.38	3.61
Cost of liabilities	(3.11)	(2.55)	(1.96)	(1.28)	(1.18)
Non-int. inc (% Op income)	34.37%	39.42%	45.89%	38.28%	35.57%
Cost to income	66.98	71.50	64.55	56.52	51.89
Overhead	23.41	22.56	18.60	17.43	16.40
ROA	0.52	0.50	0.87	1.31	1.49
ROE	16.81	12.71	14.40	16.35	17.20

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	(26.78)	(12.03)	53.18	37.43	22.31
Net profit	n/m	(3.29)	81.07	56.63	16.15
EPS	n/m	(3.29)	57.36	38.49	16.15
DPS	-	-	-	-	74.23
Net Loans	-10.7%	4.7%	4.9%	5.3%	9.6%
Assets	1.02	(0.29)	9.14	0.38	3.06
Deposits	3.72	(0.86)	4.92	3.00	3.00

Kasikornbank

Growth-driven capital raising?

Rating: BUY

Net interest income should rise substantially in 2004 at KBANK as the cost of funds will fall after the January 2004 hybrid redemption. The bank's estimated BIS tier 1 capital ratio is also to fall as a result of the hybrids being replaced with long-term debt rather than equity. This will make the bank's equity-to-assets ratio lower than those of the other banks under our coverage, which could imply an eventual capital raising.

We expect a fall in non-interest income in 2004 because in 2003 non-interest income was supported by a gain from a reversal of an accounting policy as mandated by the BOT. This will be the main reason why the bank will see its net profit fall YoY in 2004.

We expect expenses to start to rise as the bank has stated that it may initiate some additional spending on staff and systems in 2004.

We expect a pickup in loan growth in 2004 to 8.4% and then 10.7% in 2005 driven by the bank's strong push into SME lending and smaller reduction in loans coming from debt settlements.

We have downgraded our target price from Bt76 to Bt67, based on a reduced P/BV multiple of 2.5x P/BV (prior was 3x) and a reduced PER multiple of 13.5x (prior was 15.3x), both because of our assumption of a slightly reduced ROE over the long term period of 2005-12 from 20.0% to 18.9%. We maintain our BUY recommendation.

Kasikorn Bank — Thailand

Share Price (Bt):	56.50	**Reuters Code:**	KBANK/F.BK	**Shares Outstanding**	2,354
52 Week Price Range (Bt):	33.00 - 70.00	**Bloomberg Code:**	KBANK/F.TB	**Market Cap (US$m)**	3,353

INCOME STATEMENT	**01**	**02**	**03**	**04**	**05**
Interest income	37,818	33,338	31,036	30,890	33,697
Interest expense	(21,427)	(17,286)	(13,191)	(7,867)	(8,166)
Net interest income	**16,391**	**16,052**	**17,845**	**23,023**	**25,531**
Non-interest income	7,003	7,989	14,187	9,889	12,033
Total operating income	**23,395**	**24,040**	**32,031**	**32,913**	**37,564**
Non-interest expense	(20,472)	(16,671)	(15,888)	(16,836)	(17,503)
Pre provision profit	**2,923**	**7,370**	**16,143**	**16,077**	**20,060**
Loan loss provisions	(1,290)	(800)	(1,387)	(1,500)	(2,000)
Non-operating income	-	-	-	-	-
Pre tax profit	**1,633**	**6,570**	**14,756**	**14,577**	**18,060**
Tax	(624)	115	58	29	(5,418)
Net profit	**1,008**	**6,684**	**14,814**	**14,606**	**12,642**

BALANCE SHEET	**01**	**02**	**03**	**04**	**05**
Gross loans	466,140	496,525	530,090	567,303	627,491
Loan loss reserves	*(28,700)*	*(58,367)*	*(49,317)*	*(42,740)*	*(39,649)*
Net loans	437,440	438,158	480,773	524,563	587,841
Total earning assets	749,276	767,821	807,209	815,686	845,932
Other assets	25,109	(7,119)	13,667	21,636	28,012
Total Assets	**774,385**	**760,702**	**820,876**	**837,322**	**873,944**
	-	-	-	-	-
Deposits	664,846	652,000	685,222	712,631	741,136
Other paying liabilities	62,579	54,249	66,737	47,265	45,243
Other liabilities	19,889	19,378	20,459	18,413	19,702
Total Liabilities	**747,314**	**725,627**	**772,418**	**778,309**	**806,081**
	-	-	-	-	-
Total Equity	**27,072**	**35,075**	**48,458**	**59,013**	**67,863**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	75,402	92,109	68,058	57,849	52,643
NPAs/total loans	16.1%	18.5%	12.8%	10.2%	8.4%
Reserve coverage of NPAs	38.1%	63.4%	72.5%	73.9%	75.3%

PER SHARE DATA (HK$)	**01**	**02**	**03**	**04**	**05**
EPS	0.43	2.84	6.29	6.19	5.35
DPS	0.00	0.00	0.00	1.24	1.61
Effective payout ratio (%)	*0%*	*0%*	*0%*	*20%*	*30%*
BVPS	11.50	14.91	20.58	24.99	28.74

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	70.1	76.2	77.4	79.6	84.7
Equity to assets	3.5%	4.6%	5.9%	7.0%	7.8%
Tier 1 CAR	7.6%	7.6%	7.6%	7.6%	7.6%
Total CAR	13.1%	14.9%	18.8%	14.4%	15.0%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	4.911056	3.790443	2.744767	2.260983	1.966141
Price to earnings	131.8358	19.88962	8.976495	9.120605	10.55411
Price to underlying profit	618.6597	22.69456	9.903529	9.921228	11.69943
Yield at current price (%)	*0.0%*	*0.0%*	*0.0%*	*2.2%*	*2.8%*

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	N/A	N/A	N/A	N/A	N/A
Mortgage (%)	9.7	7.6	10.4	10.4	10.4
Corporate (%)	81.8	79.9	77.7	77.7	77.7
Other (%)	8.5	12.5	11.9	11.9	11.9

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	2.20	2.12	2.27	2.84	3.07
Yield on assets	5.08	4.39	3.94	3.81	4.06
Cost of liabilities	(2.96)	(2.41)	(1.81)	(1.04)	(1.06)
Non-int. inc (% Op income)	29.94%	33.23%	44.29%	30.05%	32.03%
Cost to income	87.51	69.34	49.60	51.15	46.60
Overhead	30.66	21.48	15.89	16.70	15.51
ROA	0.13	0.87	1.87	1.76	1.48
ROE	3.83	21.51	35.47	27.18	19.93

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	40.88	152.17	119.05	(0.41)	24.78
Net profit	(20.26)	562.84	121.62	(1.40)	(13.45)
EPS	(20.26)	562.84	121.57	(1.58)	(13.58)
DPS	-	-	-	-	29.63
Net Loans	-4.0%	0.2%	9.7%	9.1%	12.1%
Assets	0.82	(1.77)	7.91	2.00	4.37
Deposits	2.71	(1.93)	5.10	4.00	4.00

Siam Cml Bank Value to come with growth

Rating: HOLD

Given that spreads are already high at SCB relative to the other banks and that there are no hybrids to redeem we expect net interest income to grow only based on loan growth, not from spread enhancement.

The bank's ROA and ROE are already strong at 1.9% and 21.2%, respectively, hence we see no major increases in profits in the near term. This makes SCB a play on loans as the next driver of growth, and unfortunately we don't see significant increases in loan growth until at least 2005. The bank is one of the most efficient on cost control; however, we expect costs to begin to rise a bit as the company spends to upgrade.

The bank's capital levels are above industry average and given the slow loan growth environment we don't expect demands on capital to rise substantially in the next two years, meaning a near-term capital raising is unlikely.

Target price raised from Bt52 to Bt55, HOLD maintained. Based on this higher profit (and the potential of higher dividends) we have upgraded our target price from Bt52 to Bt55, but continue to value the stock on a 2.3x P/BV multiple and an 12.4x PER, which combined with our DDM value gives a target price of Bt55, a 12% upside, hence we maintain our HOLD rating.

We continue to prefer BBL and BAY in the sector as both are facing a couple of years of strong core earnings growth due to hybrid redemption and improved yield, SCB has already been through this earnings upcycle and is dependent only on loan growth (and gains on securities for these gains).

Siam Commercial Bank

Thailand

Share Price (Bt):	48.00	**Reuters Code:**	SCB/f.BK	**Shares Outstanding**	3,163
52 Week Price Range (Bt):	33.00 - 56.50	**Bloomberg Code:**	SCB/f.TB	**Market Cap (US$m)**	3,828

INCOME STATEMENT	**01**	**02**	**03**	**04**	**05**
Interest income	32,875	30,051	27,439	25,072	28,286
Interest expense	(16,797)	(12,568)	(8,364)	(5,906)	(6,423)
Net interest income	**16,078**	**17,483**	**19,075**	**19,166**	**21,863**
Non-interest income	6,613	8,967	9,298	14,792	11,877
Total operating income	**22,691**	**26,449**	**28,372**	**33,958**	**33,741**
Non-interest expense	(13,079)	(14,112)	(13,512)	(14,522)	(15,083)
Pre provision profit	**9,612**	**12,338**	**14,860**	**19,437**	**18,657**
Loan loss provisions	(9,207)	(24,825)	(2,400)	(2,400)	(1,836)
Non-operating income	-	-	-	-	-
Pre tax profit	**405**	**(12,488)**	**12,460**	**17,037**	**16,821**
Tax	-	-	-	-	(2,523)
Net profit	**405**	**(12,488)**	**12,460**	**17,037**	**14,298**

BALANCE SHEET	**01**	**02**	**03**	**04**	**05**
Gross loans	456,267	485,111	506,293	561,053	627,850
Loan loss reserves	*(23,535)*	*(79,807)*	*(71,961)*	*(65,384)*	*(57,488)*
Net loans	432,732	405,304	434,332	495,669	570,361
Total earning assets	683,564	692,014	751,611	784,806	839,637
Other assets	28,334	(24,792)	(15,354)	(4,751)	7,291
Total Assets	**711,899**	**667,222**	**736,257**	**780,055**	**846,928**
	-	-	-	-	-
Deposits	600,990	568,602	607,132	649,631	708,098
Other paying liabilities	36,917	34,540	34,894	30,737	33,740
Other liabilities	12,050	11,962	18,707	20,017	21,418
Total Liabilities	**649,957**	**615,104**	**660,733**	**700,385**	**763,255**
	-	-	-	-	-
Total Equity	**61,941**	**52,118**	**75,524**	**79,670**	**83,673**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	107,546	119,206	90,138	73,913	62,826
NPAs/total loans	23.5%	24.4%	17.7%	13.1%	10.0%
Reserve coverage of NPAs	21.9%	66.9%	79.8%	88.5%	91.5%

PER SHARE DATA (HK$)	**01**	**02**	**03**	**04**	**05**
EPS	0.13	(3.99)	3.96	5.35	4.46
DPS	0.00	0.00	0.00	1.61	1.79
Effective payout ratio (%)	*0%*	*0%*	*0%*	*30%*	*40%*
BVPS	19.78	16.64	23.88	24.87	26.12

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	75.9	85.3	83.4	86.4	88.7
Equity to assets	8.7%	7.8%	10.3%	10.2%	9.9%
Tier 1 CAR	10.3%	10.3%	10.3%	10.3%	10.3%
Total CAR	16.7%	14.0%	15.3%	15.0%	14.5%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	2.426419	2.884391	2.010306	1.93001	1.837677
Price to earnings	371.3739	-12.037	12.12527	8.968715	10.75426
Price to underlying profit	248.7933	-11.5697	12.2668	11.07066	11.39896
Yield at current price (%)	*0.0%*	*0.0%*	*0.0%*	*3.3%*	*3.7%*

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	N/A	N/A	N/A	N/A	N/A
Mortgage (%)	21.2	22.3	18.9	18.9	18.9
Corporate (%)	77.3	76.2	79.3	79.3	79.3
Other (%)	1.5	1.5	1.8	1.8	1.8

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	2.35	2.54	2.64	2.49	2.69
Yield on assets	4.80	4.37	3.80	3.26	3.48
Cost of liabilities	(2.64)	(2.03)	(1.34)	(0.89)	(0.90)
Non-int. inc (% Op income)	29.14%	33.90%	32.77%	43.56%	35.20%
Cost to income	57.64	53.35	47.63	42.76	44.70
Overhead	17.91	15.63	15.39	14.79	15.33
ROA	0.06	(1.81)	1.78	2.25	1.76
ROE	0.66	(21.90)	19.52	21.96	17.51

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	(2.08)	28.36	20.44	30.80	(4.01)
Net profit	(88.63)	n/m	n/m	36.73	(16.07)
EPS	(88.65)	n/m	n/m	35.20	(16.60)
DPS	-	-	-	-	11.20
Net Loans	-6.5%	-6.3%	7.2%	14.1%	15.1%
Assets	(0.04)	(6.28)	10.35	5.95	8.57
Deposits	1.33	(5.39)	6.78	7.00	9.00

Krung Thai Bank

A growing giant

Rating: BUY

KTB should see strong growth in net interest income in 2004 due to its shift of about Bt70bn in short term and low yielding assets (excess liquidity) into loans. This combined with an additional Bt47bn in deposits allowed the bank to grow its loans outstanding by 17.3% in 2003. After recapitalisation the bank holds about 20% of its assets in risk free government bonds which keeps tier 1 capital strong. As well, NPL levels are some of the lowest in the industry at 15%.

This shift and increase in loans should raise yield and net interest income due to the increased volume of loans. In addition, the bank still has the smallest proportion of savings and current deposits (low cost deposits) among the top banks, giving scope for reducing the cost of funds.

The bank's level of non interest income has always been lower than the industry average. Consider foreign exchange, where the bank makes less than half the fees that BBL makes despite being of equal size. Fee income should be a key driver of growth, however, we question whether the bank can substantially increase fee income in this competitive environment.

Expenses should rise in 2004 as expenses in 2003 were kept down partially due to a reversal of a previously booked impairment charge. We don't expect any major cost cutting, a difficult move in a state-owned financial institution.

We value KTB on 2.1x P/BV and a 12x PER, which when averaged with our DDM value of Bt15 gives us our Bt16 price target. We remain BUYers.

Krung Thai Bank — Thailand

Share Price (Bt):	11.30	**Reuters Code:**	KTB.BK	**Shares Outstanding**	11,182
52 Week Price Range (Bt):	7.20 - 13.30	**Bloomberg Code:**	KTB.TB	**Market Cap (US$m)**	3,186

INCOME STATEMENT	**01**	**02**	**03**	**04**	**05**
Interest income	39,485	39,801	39,854	42,406	47,124
Interest expense	(20,001)	(20,066)	(17,220)	(13,058)	(13,964)
Net interest income	**19,484**	**19,735**	**22,634**	**29,348**	**33,160**
Non-interest income	5,775	7,520	7,796	11,575	9,545
Total operating income	**25,259**	**27,255**	**30,429**	**40,923**	**42,704**
Non-interest expense	(19,908)	(17,231)	(18,183)	(20,075)	(21,240)
Pre provision profit	**5,351**	**10,024**	**12,247**	**20,848**	**21,465**
Loan loss provisions	(9,766)	(2,015)	(3,542)	(4,500)	(3,540)
Non-operating income	-	-	-	-	-
Pre tax profit	**(4,416)**	**8,009**	**8,705**	**16,348**	**17,925**
Tax	-	-	-	-	(3,943)
Net profit	**(4,416)**	**8,009**	**8,705**	**16,348**	**13,981**

BALANCE SHEET	**01**	**02**	**03**	**04**	**05**
Gross loans	700,413	849,776	979,026	1,052,663	1,126,925
Loan loss reserves	*(29,133)*	*(63,924)*	*(59,454)*	*(60,344)*	*(62,612)*
Net loans	671,280	785,852	919,572	992,319	1,064,313
Total earning assets	946,744	1,057,845	1,113,319	1,176,256	1,257,412
Other assets	29,724	542	21,132	19,058	22,354
Total Assets	**976,468**	**1,058,388**	**1,134,451**	**1,195,315**	**1,279,766**
	-	-	-	-	-
Deposits	866,955	958,732	1,005,930	1,036,108	1,108,635
Other paying liabilities	34,221	20,665	34,973	56,780	60,033
Other liabilities	11,805	13,856	18,613	19,916	21,310
Total Liabilities	**912,982**	**993,253**	**1,059,516**	**1,112,803**	**1,189,978**
	-	-	-	-	-
Total Equity	**63,487**	**65,135**	**74,935**	**82,511**	**89,788**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	70,656	113,520	83,940	71,349	64,214
NPAs/total loans	17.2%	20.8%	11.5%	8.7%	7.0%
Reserve coverage of NPAs	41.2%	56.3%	70.8%	84.6%	97.5%

PER SHARE DATA (HK$)	**01**	**02**	**03**	**04**	**05**
EPS	(0.39)	0.72	0.78	1.46	1.25
DPS	0.00	0.00	0.26	0.58	0.50
Effective payout ratio (%)	*0%*	*0%*	*33%*	*40%*	*40%*
BVPS	5.68	5.82	6.70	7.38	8.03

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	80.8	88.6	97.3	101.6	101.6
Equity to assets	6.5%	6.2%	6.6%	6.9%	7.0%
Tier 1 CAR	15.2%	15.2%	15.2%	15.2%	15.2%
Total CAR	16.3%	13.3%	10.8%	10.4%	10.0%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	1.9908226	1.9399715	1.6862669	1.5314288	1.4073204
Price to earnings	-28.62391	15.77886	14.515978	7.7293559	9.0378597
Price to underlying profit	-35.5358	15.229773	14.774897	8.1474963	9.4637983
Yield at current price (%)	*0.0%*	*0.0%*	*2.3%*	*5.2%*	*4.4%*

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	N/A	N/A	N/A	N/A	N/A
Mortgage (%)	7.3	7.9	8.7	8.7	8.7
Corporate (%)	46.1	50.9	57.0	57.0	57.0
Other (%)	46.6	41.2	34.3	34.3	34.3

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	2.05	1.97	2.08	2.56	2.73
Yield on assets	4.16	3.97	3.67	3.70	3.87
Cost of liabilities	(2.22)	(2.13)	(1.70)	(1.22)	(1.23)
Non-int. inc (% Op income)	22.86%	27.59%	25.62%	28.28%	22.35%
Cost to income	78.82	63.22	59.75	49.06	49.74
Overhead	24.31	22.92	23.55	19.62	19.93
ROA	(0.45)	0.79	0.79	1.40	1.13
ROE	(6.84)	12.45	12.43	20.77	16.23

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	n/m	87.33	22.17	70.23	2.96
Net profit	n/m	n/m	8.69	87.80	(14.48)
EPS	n/m	n/m	8.70	87.80	(14.48)
DPS	-	-	-	124.80	(14.48)
Net Loans	-3.6%	17.1%	17.0%	7.9%	7.3%
Assets	(1.33)	8.39	7.19	5.37	7.07
Deposits	2.71	10.59	4.92	3.00	7.00

Bank of Ayudhya Better collateral

Rating: BUY

We do not expect large additional P&L provisions

The main issue about Bank of Ayudhya is whether the bank is under provisioned relative to the other Thai banks, which if true would cause BVPS to be overstated. This main difference is due the bank's long term higher than average collateral coverage ratio, which currently stands at about 76%. If this collateral coverage ratio is correct, which we believe it is, then the bank's provisions are unlikely to rise. But even if we are wrong, and this collateral coverage has been over stated for many years and we adjust this collateral to the industry average, the additional provision needed is about equal to the provisions we have forecasted the bank will make in its P&L during the years 2004 to 2006. As a result we believe that the BVPS of BAY should not be adjusted downward.

Warrant conversion assures capital for growth

BAY raised Bt10bn in new capital in Aug03 as well as issuing Bt14.9bn worth of 5-year warrants. The initial Bt10bn will be used to replace its expensive hybrid in Mar04, which accounts for about Bt13bn of tier 1 capital. We have factored in regular conversion of warrants until expiration as these warrants are now at or near the money. We forecast that this steady conversion will give the bank adequate capital to use for growth over the next few years.

Expect a fall in cost of funds

We expect that EPS growth over the next few years will be first driven by lower costs of funds in 2004 and 2005 due to a continued shift into low cost deposits, a recent redemption of an expensive 12% sub debt issue and the Mar04 redemption of its 11% hybrid debt issue. This fall in funds will be the main driver of wider spreads for the bank.

Expect asset yield to rise

We expect that a rising yield on overall assets will be the second factor which will drive up spreads over the next 2-3 years. We expect this increased yield to first come from a continued shift out of low-yielding short term money market lending into higher yielding commercial loans. The second factor driving up yield should be the continual step ups in interest rates on restructured loans which we expect the bank will be able to receive due to the improved economic environment. The last factor should be the continued work out of NPLs and the shifting of these funds into higher yielding good commercial loans.

Hurt less by an interest rate rise

We highlight that BAY has a small bond portfolio relative to its peers, which implies that if interest rates were to rise there would be substantially less unrealised losses on its bond portfolio dragging down BVPS. This makes BAY less hurt by an interest rate rise than most of the other Thai banks.

We value BAY on 1.5x P/BV and a 8.5x PER which when averaged with our DDM value of Bt21 gives us our Bt19 price target. BAY remains the only bank trading at book value and we are BUYers as we think it is a good play on the economic revival.

Bank of Ayudhya — Thailand

Share Price (Bt):	12.9	**Reuters Code:**	BAY.BK	**Shares Outstanding**	2,850
52 Week Price Range (Bt):	8.10 - 14.80	**Bloomberg Code:**	BAY.TB	**Market Cap (US$m)**	927

INCOME STATEMENT	**01**	**02**	**03**	**04**	**05**
Interest income	18,889	19,311	19,081	21,295	23,557
Interest expense	(13,973)	(12,450)	(10,619)	(10,179)	(10,215)
Net interest income	**4,916**	**6,861**	**8,461**	**11,116**	**13,342**
Non-interest income	2,563	3,776	6,385	5,236	5,708
Total operating income	**7,480**	**10,636**	**14,846**	**16,352**	**19,050**
Non-interest expense	(8,746)	(7,914)	(8,787)	(8,805)	(9,656)
Pre provision profit	**(1,267)**	**2,722**	**6,059**	**7,547**	**9,394**
Loan loss provisions	(1,397)	(600)	(3,000)	(3,000)	(3,000)
Non-operating income	-	-	-	-	-
Pre tax profit	**(2,663)**	**2,122**	**3,059**	**4,547**	**6,394**
Tax	(4)	(3)	(7)	-	-
Net profit	**(2,667)**	**2,119**	**3,053**	**4,547**	**6,394**

BALANCE SHEET	**01**	**02**	**03**	**04**	**05**
Gross loans	342,277	375,841	395,572	428,154	474,807
Loan loss reserves	*(10,852)*	*(21,317)*	*(21,441)*	*(21,254)*	*(22,735)*
Net loans	331,424	354,523	374,131	406,900	452,073
Total earning assets	407,479	436,739	487,614	523,800	575,925
Other assets	31,080	26,845	28,324	30,687	31,904
Total Assets	**438,560**	**463,584**	**515,938**	**554,487**	**607,830**
	-	-	-	-	-
Deposits	372,250	391,913	420,666	454,319	499,751
Other paying liabilities	43,709	47,547	57,797	57,310	56,696
Other liabilities	7,443	7,218	8,901	9,525	10,191
Total Liabilities	**423,402**	**446,678**	**487,365**	**521,154**	**566,638**
	-	-	-	-	-
Total Equity	**15,158**	**16,906**	**28,573**	**33,334**	**41,191**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	63,314	76,669	66,783	56,765	51,656
NPAs/total loans	18.3%	20.2%	16.8%	13.2%	10.8%
Reserve coverage of NPAs	17.1%	27.8%	32.1%	37.4%	44.0%

PER SHARE DATA (HK$)	**01**	**02**	**03**	**04**	**05**
EPS	(1.44)	1.15	1.30	1.57	2.07
DPS	0.00	0.00	0.00	0.31	0.62
Effective payout ratio (%)	*0%*	*0%*	*0%*	*20%*	*30%*
BVPS	8.19	9.14	10.02	11.30	12.75

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	91.9	95.9	94.0	94.2	95.0
Equity to assets	3.5%	3.6%	5.5%	6.0%	6.8%
Tier 1 CAR	6.1%	6.1%	6.1%	6.1%	6.1%
Total CAR	11.0%	11.1%	14.2%	11.6%	12.4%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	1.6x	1.4x	1.3x	1.1x	1.0x
Price to earnings	-8.9x	11.3x	9.9x	8.2x	6.2x
Price to underlying profit	-9.3x	15.1x	24.4x	10.5x	7.5x
Yield at current price (%)	*0.0%*	*0.0%*	*0.0%*	*2.4%*	*4.8%*

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	N/A	N/A	N/A	N/A	N/A
Mortgage (%)	7.4	7.5	8.7	8.7	8.7
Corporate (%)	85.9	87.2	85.9	85.9	85.9
Other (%)	6.7	5.2	5.3	5.3	5.3

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	1.21	1.63	1.83	2.20	2.43
Yield on assets	4.67	4.57	4.13	4.21	4.28
Cost of liabilities	(3.39)	(2.91)	(2.31)	(2.06)	(1.91)
Non-int. inc (% Op income)	34.27%	35.50%	43.01%	32.02%	29.96%
Cost to income	116.93	74.41	59.19	53.85	50.69
Overhead	40.66	23.38	19.74	19.00	17.61
ROA	(0.61)	0.47	0.62	0.85	1.10
ROE	(17.48)	13.22	13.42	14.69	17.16

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	n/m	n/m	122.60	24.54	24.48
Net profit	n/m	n/m	44.07	48.94	40.63
EPS	n/m	n/m	13.42	20.70	31.98
DPS	-	-	-	-	97.97
Net Loans	4.6%	7.0%	5.5%	8.8%	11.1%
Assets	1.79	5.71	11.29	7.47	9.62
Deposits	3.78	5.28	7.34	8.00	10.00

Thailand

Non-bank finance – a transition year

Rating: Neutral

FY04 will be a year of uncertainty

We remain NEUTRAL on Thailand's non-bank financials. Although selected stocks show great potential, there will be considerable upheaval in major parts of the industry going forward as the new Financial Sector Master Plan is implemented. This will lead to a period of uncertainty and volatility in share prices, in our opinion.

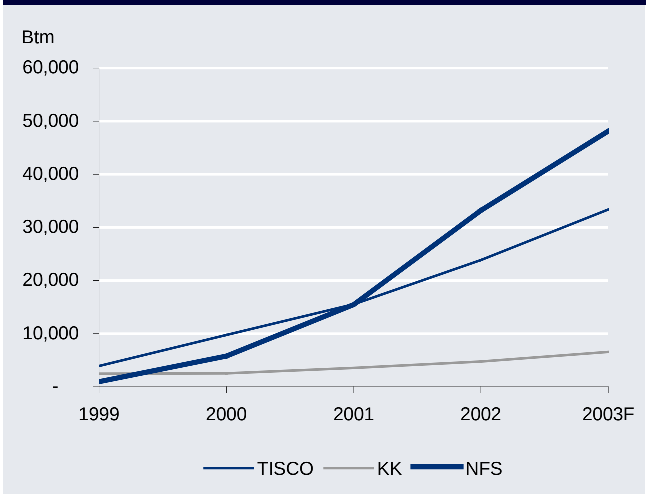
The business mix will be the key differentiating factor for the performance of finco shares prices in FY04 given widely differing business models, market segmentation and cost structures. Going forward, we prefer less capital market sensitive stocks and those companies least affect by regulatory changes.

Portfolio yields

Portfolio yields could come under pressure

Although competition among HP (auto) providers subsided in the later half of FY03, there is a strong possibility that HP loan yields will again come under pressure in FY04. Commercial banks and upgraded fincos, eager to enhance their yields (6% for HP loans versus average bank yields of just 4% for banks) and boost their net interest margins, are likely to take advantage of the new regulations allowing them to provide HP services. Given the low barriers to entry (many already operate HP/leasing subsidiaries) and their cost of funds advantage, these players could establish themselves very quickly.

Fig 198 Hire purchase loans



Source: Company data

Fig 199 Hire purchase loan yields

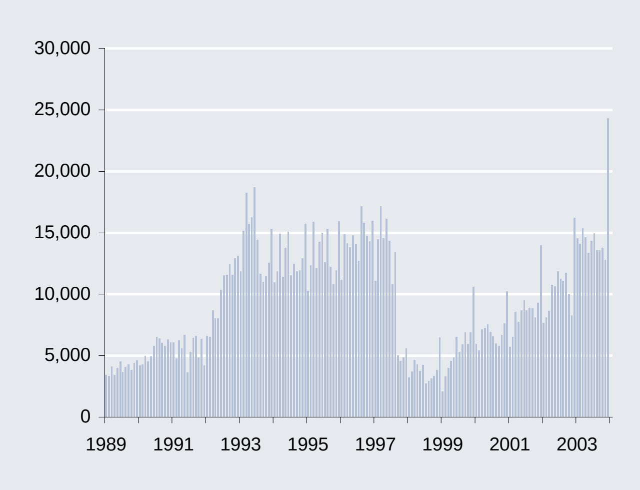
Source: Company data

Loan growth

Loan growth will slow off of a high base

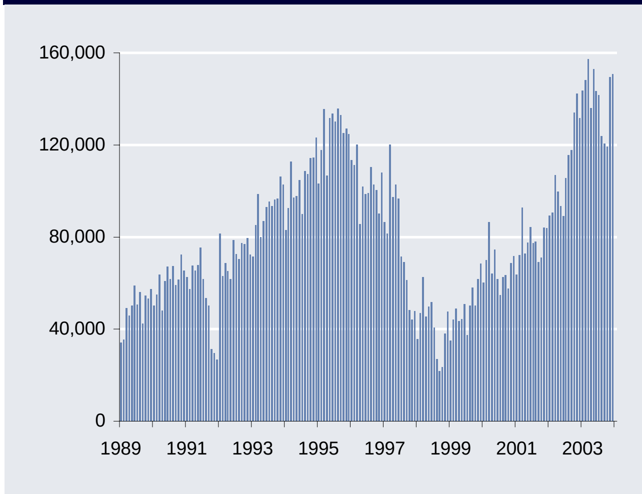
Another issue impacting fincos will be loan growth. Although we expect auto and motorcycle volume sales to remain high given low ownership levels, a favourable replacement cycle and low interest rates, growth momentum should slow in 2004 as a result of the high base effect. At the current rate, auto and motorcycle sales are back to levels achieved during Thailand's last peak in consumption.

Fig 200 Passenger car sales



Source: Bank of Thailand

Fig 201 Motorcycle sales



Source: Bank of Thailand

Speciality players will be more insulated

Companies such as Kiatnakin Finance (KK) should be less affected by the slowdown in auto sales owing to the firm's focus on distressed assets and property loans. Nevertheless, even this segment of the market will come under more pressure as state entities are allowed to compete for distressed assets and commercial banks begin to re-extend credit to higher quality developers.

Impact of Master Plan

Competition from banks will outweigh benefits in the mid-term

Fincos upgraded into commercial banks will be able to broaden their business activities more than banks. However, it will be easier for banks to compete on an equal footing with existing hire-purchase firms than for fincos (upgraded into commercial banks) to compete with banks. As such, competition from banks will, in the short-to-medium term, outweigh the benefits the fincos receive from adding new businesses, in our view.

Big players will busy themselves upgrading into banks

Moreover, traditional finance companies such as National Finance (NFS), Thai Investment & Securities (TISCO), and KK are likely to busy themselves throughout 2004 and 2005 upgrading into full-fledged commercial banks. This is likely to involve significant reorganisation of personal, systems and corporate structure. Consolidation will also be a major issue among key players as they vie for market share and try to build up distribution channels. Although we believe that the above mentioned companies should ultimately benefit from the new system, this year will be a transition year for all.

Peripheral players will face tougher hurdles

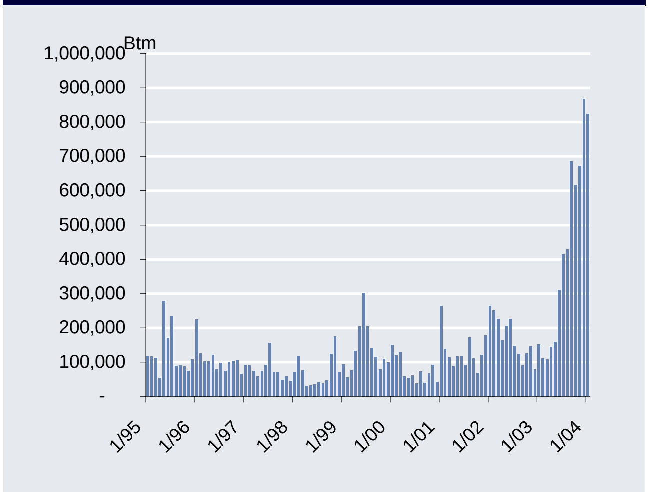
Peripheral players such as the leasing companies and credit fonciers, however, could face much tougher hurdles. Just as with the fincos, it is very likely that banks will chose to muscle in on these areas in a bid to enhance yields and improve NIM. This should prove relatively easy given the low barriers and cost of funds advantage. Another issue facing this segment is the fact that many are controlled or owned in part by banks. Under the new plan, it appears that subsidiaries and affiliates must either be amalgamated into the parent or cast free. This puts a big question mark on the future position of companies such Siam Panich Leasing (SPL) and Siam Industrial Credit (SICCO), both subsidiaries of Siam Commercial Bank (SCB).

Market sensitive revenues

The SET could have a big impact on earnings

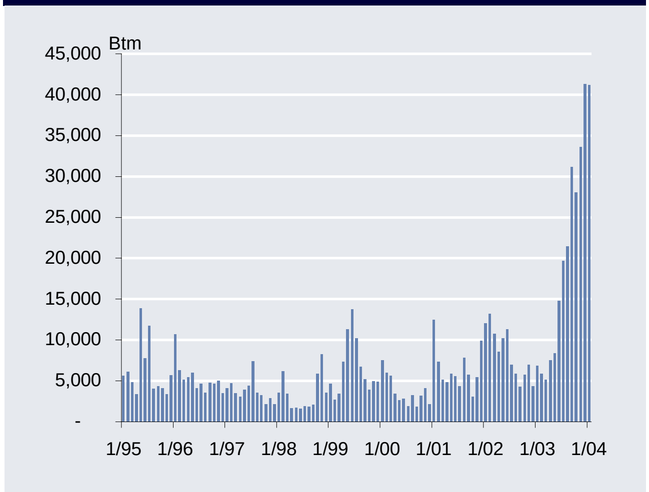
A major mitigating factor for many of the fincos will be trading volumes on the Stock Exchange of Thailand (SET), as this will be a key feature driving fincos' brokerage fees and proprietary trading income. The average daily trading volume in FY03 was Bt18,430m, versus just Bt8,101m in FY02 and Bt5,755m in FY01, owing mainly to diminishing risk factors and an improving macro outlook. Our base case assumption for daily trading volumes for FY04 will remain high at Bt15bn on the back of rising corporate profitability, prospects of higher MSCI weightings, and an active IPO market. We also note that FY04 is likely to be an election year in Thailand. Historically, general elections have been preceded by heavy trading volumes as candidates and parties build up election war chests.

Fig 202 Trading volumes



Source: Stock Exchange of Thailand

Fig 203 Average daily trading volumes



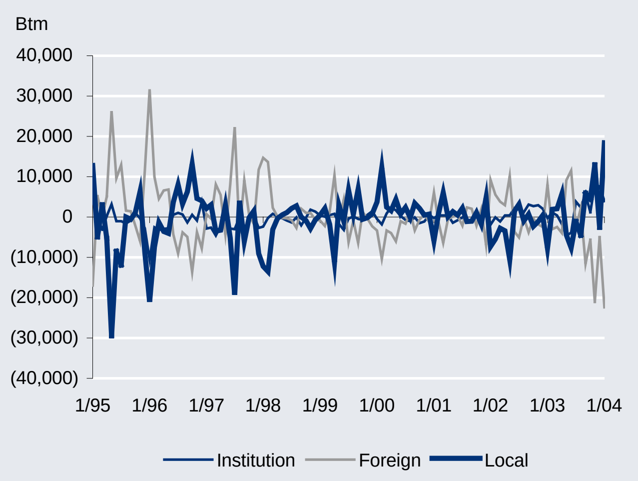
Source: Stock Exchange of Thailand

More consolidation likely among securities companies

Another factor driving brokerage revenues in FY04 will be market share and client composition. Until recently the market share of large brokers had been steadily declining as sub-brokers upgraded to full broker status. However, the prospect of commission liberalisation being implemented as early as 2005 has encouraged consolidation in the industry, most recently between Asset Plus and Asia Securities. We believe that this trend will continue in FY04 as large brokers attempt to capture market share ahead of full liberalisation. Consolidation is also likely to get a boost from the new financial master plan. Under the new plan, some banks may choose to let subsidiaries go or merge them with other players in order to meet single presence restrictions. Under this scenario, big brokers, particularly those with large retail market share such as the new Asset Plus/AST entity, Kim Eng (KEST), Seamico (ZMICO), KGI Securities (KGI) and Capital Nomura (CNS), should continue to garner the bulk of transaction volume. Securities companies with a good diversification of investor type will also benefit in FY04, particularly if foreign participation picks up. The players that would benefit the most in this category are TISCO and SCB Securities.

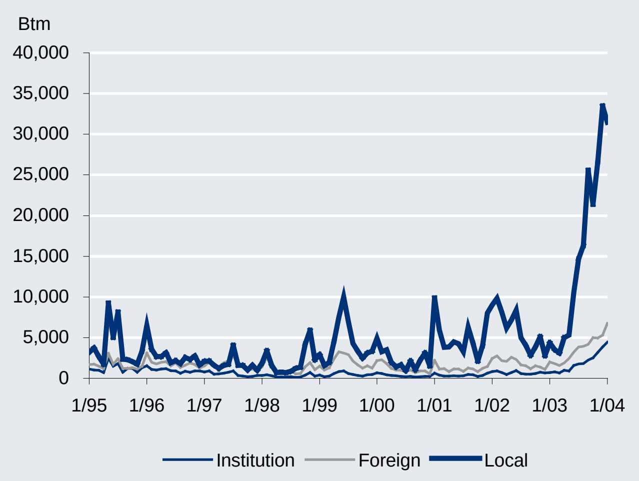
Those with more diversified investor base will benefit

Fig 204 Net position by investor type



Source: Stock Exchange of Thailand

Fig 205 Avg daily trading value by investor type



Source: Stock Exchange of Thailand

Fig 206 Broker market share (%)

	1998	1999	2000	2001	2002	2003
KIMENG	4.5	5.3	7.4	8.8	13.1	11.3
ZMICO	4.5	4.8	4.0	8.9	6.0	7.1
AST	10.2	10.1	9.5	10.0	8.1	7.1
KGI	10.5	9.4	6.7	5.7	7.8	5.3
CNS	5.2	5.9	4.7	5.2	5.1	3.9
BLS	-	-	-	-	2.2	3.5
TSC	4.3	4.6	3.8	3.2	4.1	3.3
DBSV	6.3	5.6	4.5	3.2	3.9	3.3
SCBS	1.0	2.1	2.2	2.0	2.4	3.2
PHATRA	6.7	5.5	6.8	4.1	4.0	3.1
UOBKHST	1.4	1.4	1.4	2.0	4.3	3.0
GLOBLEX	-	-	-	-	0.1	2.9
PHILIP	2.5	3.8	3.2	3.7	3.7	2.9
ASSET	-	-	-	-	0.9	2.8
AYS	1.6	1.8	2.3	3.2	2.0	2.6
NATSEC	3.4	3.8	3.7	4.3	3.5	2.5
TRINITY	-	-	-	-	1.5	2.4
ASL	3.4	4.7	4.6	5.3	3.5	2.4
KKS	4.0	6.3	5.0	4.3	2.8	2.3
UBS	3.7	2.8	3.9	2.0	3.1	2.3

Source: Stock Exchange of Thailand

Consumer finance companies

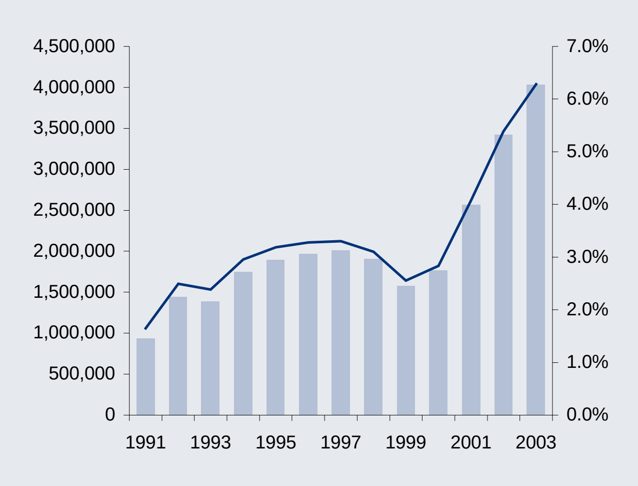
Consumer finance segment looks to be the most interesting

One sector unlikely to feel much impact from regulatory reform is the consumer finance sector. This also happens to be one of the most promising segments of the Thai financial sector, in our opinion, given the limited level of competition and huge potential for growth.

Low penetration rates suggest big opportunities

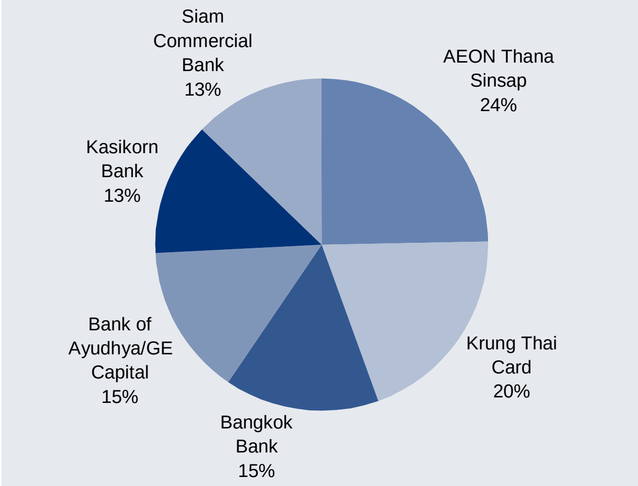
Penetration rates in Thailand for consumer finance products are among the lowest in the region at around 6%, while access to consumer credit is restricted largely to upper-end urban consumers. Although many commercial banks have retail affiliations via their credit card and ATM services, their consumer finance products are limited (mortgages and high-end personal loans) while banks tend to favour higher end consumers. Banks have traditionally overlooked the low end of the consumer segment due to the logistical constraints of managing millions of small accounts, and this is unlikely to change much going forward.

Fig 207 Credit cards & penetration rate



Source: Bank of Thailand

Fig 208 Credit card market share



Source: Company data & ING estimates

As a result, large swaths of Thailand's population, in particular rural consumers, have effectively no access to institutional credit. Consider the following charts; nearly 70% of Thailand's population or 42 million people live outside municipal areas while 82% of rural households have a monthly income of Bt10,000 or less. Virtually none of these people have access to institutional credit. Assuming that just half of these people meet minimum lending requirements suggests a potential customer base of at least 10 million people. This is over 20x the size of the combined customer base of MIDA Assets (MIDA), AEON Thana Sinsap (AEONTS), Singer Thailand (SINGER) and Krung Thai Card (KTC).

Fig 209 Household income demographics – Thailand

	Upper	Middle	Lower
Greater Bangkok	20%	33%	47%
Upcountry Urban	16%	41%	43%
Upcountry Rural	8%	23%	69%
Whole Kingdom	11%	26%	63%

Source: FCB Thailand

Fig 210 Household income – categories

	Upper	Middle	Lower
Greater Bangkok	< Bt40,000	Bt20-40,000	> Bt20,000
Upcountry Urban	< Bt25,000+	Bt10-25,000	> Bt10,000
Upcountry Rural	< Bt12,500+	Bt6-13,000	> Bt6,000

Source: FCB Thailand

Changes in regulatory environment would have little impact

Although there have been suggestions that the Bank of Thailand may try to regulate these operators and/or impose caps on lending rates, we believe that this is unlikely. First, penetration rates for institutional consumer credits are very low while credit quality has remained very high, even throughout the recent crisis. Second, Thai authorities are keen to institutionalise the consumer credit industry, which has long been dominated by black market operators. Finally, we believe it is very unlikely that any government, particularly one with such strong support from rural voters, would choose to disenfranchise a large proportion of the population in a period of economic recovery (and ahead of a general election). Even if such a measure were taken, it is unlikely that this would have a material impact on profitability, in our opinion. First, any cap on interest charges could quickly be offset by an increase in fees (as was done by AEONTS in FY02). Second, income and lending limits are unlikely to be strictly defined as long as asset quality remains high. Lastly, regulatory changes, if any, would most likely affect reporting standards, capital requirements and asset quality criterion – most of which are already well within Thai banking guidelines.

Valuations

Valuations vary widely

There is a wide variation in Thai finco valuations, reflective of the significant differences in revenue components and market segmentation of individual companies.

P/BV valuations appear high for some, but not relative to ROE

On a price-to-book basis, companies within the ING universe trade within a very large range, with only NFS and SPL currently below 2x. However, it is important to note that although P/BV valuations appear high for companies such as AEONTS and MIDA, both companies also generate unusually high ROE.

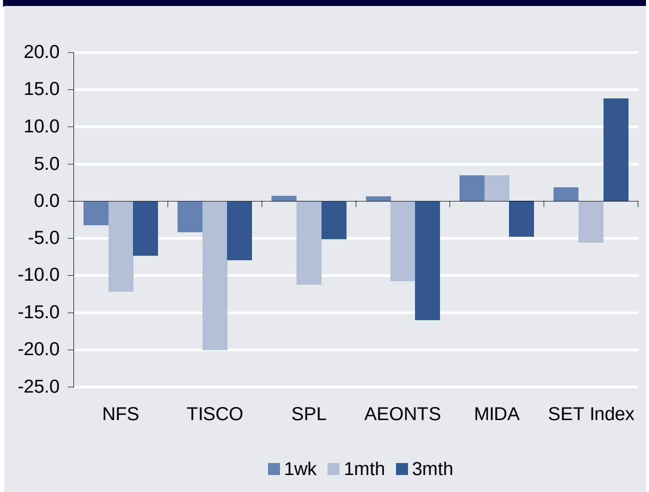
PER valuations look more compelling

Earnings valuations on the other hand look much more attractive, particularly when compared to earnings growth momentum and dividend yield. AEONTS and MIDA in particular look attractive given tremendous growth prospects, high margins and strong profitability.

Fig 211 Valuation matrix - ROE vs P/BV

Source: ING estimates

Fig 212 Share price changes (%)



Source: SET

Fig 213 Thailand fincos – valuation overview

	NFS	SPL	TISCO	AEONTS	MIDA
Price to book value	1.0x	1.5x	2.55	2.7x	9.2x
Price to earnings	7.8x	7.2x	0.77	7.6x	12.3x
Price to underlying profit	11.4x	7.2x	*30%*	5.3x	9.2x
Yield at current price (%)	*3.9%*	*7.0%*	15.92	*3.7%*	*3.1%*

Source: ING estimates

Although valuations for NFS and SPL appear undemanding, there are significant factors that could affect the profitability and loan growth of both companies in FY04. TISCO on the other hand already trades at a premium, commensurate with its more diversified revenue stream and stronger market position.

AEON Thana Sinsap

Credit the consumer

Rating: BUY

Pure consumer finance play

Thailand's largest pure consumer finance play

AEONTS is Thailand's biggest consumer finance company with a 22% market share of total credit cards issued and an estimated 55% share of the non-vehicle hire purchase market. The company's business consists of three main product lines – credit cards, personal loans and hire purchase. As there is little direct competition, the company boasts wide margins and strong asset growth.

Underdeveloped market offers huge growth

Huge growth potential

Credit card penetration rates in Thailand are among the lowest in the region at less than 5%, while access to consumer credit is restricted largely to upper-end consumers. By targeting low-end consumers and offering finance products to suit their needs, AEONTS's potential market encompasses at least 10m people.

Fears over government controls unfounded

Concerns not justified

Concerns that AEONTS may be negatively impacted by government regulation have weighed on the stock in recent weeks. However, we believe this is unlikely to occur given the government's populist stance and the high quality of consumer finance company portfolios. Should any measure be taken, AEONTS should easily be able to cope by shifting its revenue structure toward more fee-based products.

Revenue stream to surge

Earnings outlook remains favourable

As a result of a significant pick-up in consumer confidence and limited competition in the segment, we expect loan growth of 28% in FY04. This should be fuelled by the addition of new products and services, continued expansion of its distribution network and improving consumer spending. Although margins may contract somewhat, owing to increased competition in some segments, they will nevertheless remain in excess of 23%. This will help the company continue to post strong earnings growth.

Massive cost reductions to boost margins

Cost reductions will continue to show through in FY04

A major cost-cutting initiative, undertaken last year, aimed at consolidating reporting expenses and passing on transaction costs to end-users, resulted in a Bt230m reduction in operating expenses. This, combined with measures to boost fee income on credit cards, should lead to earnings gains in FY04.

Valuations are attractive

Valuation not demanding

We value AEONTS at Bt216 per share. We base our valuation on the assumption that a company such as AEONTS should trade on earnings given its tremendous growth prospects and huge leverage. Our target price of Bt194/sh is based on an FY04F target PER multiple of 10x.

AEON Thana Sinsap

Thailand

Share Price (Bt):	141.00	**Reuters Code:**	AEONTS.TK	**Shares Outstanding**	50
52 Week Price Range (Bt):	97.50 - 230.00	**Bloomberg Code:**	AEONTS.TB	**Market Cap (US$m)**	178

INCOME STATEMENT	**01**	**02**	**03**	**04**	**05**
Interest income	2,153	3,533	4,127	5,364	6,592
Interest expense	(316)	(470)	(479)	(563)	(810)
Net interest income	**1,837**	**3,062**	**3,649**	**4,801**	**5,782**
Non-interest income	44	64	93	113	141
Total operating income	**1,880**	**3,126**	**3,742**	**4,914**	**5,923**
Non-interest expense	(1,108)	(1,626)	(1,435)	(1,394)	(1,508)
Pre provision profit	**772**	**1,500**	**2,307**	**3,520**	**4,415**
Loan loss provisions	(332)	(833)	(1,420)	(2,195)	(2,888)
Non-operating income	-	-	54	-	-
Pre tax profit	**440**	**667**	**940**	**1,325**	**1,528**
Tax	(148)	(203)	(266)	(398)	(458)
Net profit	**292**	**464**	**674**	**928**	**1,069**

BALANCE SHEET	**01**	**02**	**03**	**04**	**05**
Gross loans	8,777	12,790	16,093	20,492	25,986
Loan loss reserves	*(164)*	*(320)*	*(453)*	*(599)*	*(787)*
Net loans	8,613	12,470	15,640	19,893	25,200
Total earning assets	9,207	13,337	14,425	19,358	25,225
Other assets	776	1,015	1,086	1,457	1,899
Total Assets	**9,983**	**14,353**	**15,511**	**20,815**	**27,124**
Deposits	-	-	-	-	-
Other paying liabilities	8,815	12,846	13,570	18,210	23,730
Other liabilities	-	-	-	-	-
Total Liabilities	**8,815**	**12,846**	**13,570**	**18,210**	**23,730**
Total Equity	**1,168**	**1,507**	**1,941**	**2,605**	**3,394**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	150	287	412	544	715
NPAs/total loans	1.7%	2.2%	2.5%	2.6%	2.7%
Reserve coverage of NPAs	109.3%	111.3%	110.0%	110.0%	110.0%

PER SHARE DATA (HK$)	**01**	**02**	**03**	**04**	**05**
EPS	5.84	9.28	13.48	18.55	21.39
DPS	0.00	2.50	4.80	5.28	5.60
Effective payout ratio (%)	*0%*	*27%*	*36%*	*28%*	*26%*
BVPS	23.36	30.14	38.82	52.09	67.88

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	N/A	N/A	N/A	N/A	N/A
Equity to assets	11.7%	10.5%	12.5%	12.5%	12.5%
Tier 1 CAR	N/A	N/A	N/A	N/A	N/A
Total CAR	N/A	N/A	N/A	N/A	N/A

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	6.0x	4.7x	3.6x	2.7x	2.1x
Price to earnings	24.1x	15.2x	10.5x	7.6x	6.6x
Price to underlying profit	16.0x	10.6x	8.0x	5.3x	4.6x
Yield at current price (%)	*0.0%*	*1.8%*	*3.4%*	*3.7%*	*4.0%*

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	100.0	100.0	100.0	100.0	100.0
Mortgage (%)	-	-	-	-	-
Corporate (%)	-	-	-	-	-
Other (%)	-	-	-	-	-

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	26.22	27.17	26.29	28.42	25.94
Yield on assets	23.39	26.49	28.61	27.71	26.13
Cost of liabilities	(4.94)	(4.56)	(3.80)	(3.73)	(4.07)
Non-int. inc (% Op income)	2.32	2.03	2.48	2.30	2.37
Cost to income	58.93	52.02	38.35	28.36	25.45
Overhead	15.82	14.43	10.34	8.25	6.76
ROA	3.84	3.81	4.51	5.11	4.46
ROE	25.00	30.78	34.72	35.62	31.51

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	87.97	94.18	53.82	52.59	25.44
Net profit	90.19	58.82	45.27	37.66	15.28
EPS	90.19	58.82	33.68	49.60	15.28
DPS	N/A	N/A	92.00	10.00	6.06
Net Loans	94.61	46.61	26.22	27.46	26.94
Assets	91.16	43.77	8.07	34.20	30.31
Deposits	N/A	N/A	N/A	N/A	N/A

Mida Assets

Charging ahead

Rating: BUY

Hybrid consumer finance play

Highly profitable hybrid

MIDA operates an unusual yet highly profitable business that combines door-to-door sales of home appliances and other white goods with hire purchase financing. As the company also targets low-end rural consumers, a segment devoid of competition, the company boasts huge margins and enviable levels of bad debt.

Underdeveloped market offers huge growth

Huge opportunity for growth

Penetration rates in Thailand for consumer finance products are among the lowest in the region at less than 5%, while access to consumer credit is restricted largely to upper-end consumers. This is also true of modern retail trade. By targeting low-end consumers and offering electrical appliances and finance products to suit their needs, MIDA's potential market encompasses at least 10m people.

Fears over government controls unfounded

Unlikely to be impacted by regulatory changes

In reaction to credit quality problems in other parts of the region, the Bank of Thailand imposed guidelines on consumer finance companies late last year and capped interest on credit cards at 18%. Although this put a dent in the profitability of other consumer finance companies, the move had no impact on MIDA. Given the government's overtly populist stance, it is unlikely that additional measures will be imposed that would restrict consumer credit to the masses. Even if this were to occur, MIDA could easily restructure its revenue stream allowing it to maintain its high degree of profitability.

Revenue stream to surge

Sharp increase in earnings expected

As a result of a massive consolidation of its distribution network over the last 12 months, a significant pick-up in consumer confidence and limited competition in the segment, we expect earnings growth of at least 100% in FY04 and 50% in FY05. This should be fuelled by continued expansion of its distribution network, improvements in sales team efficiency and improving consumer spending. The addition of new product lines could significantly boost bottom line earnings.

Valuations are attractive

Currently trading close to our target, but new developments could boost value

We currently value MIDA at Bt31.50 per share. We base our valuation on the assumption that the stock should trade on earnings multiples to better reflect the huge earnings growth and earnings potential. Given a projected FY04 EPS growth of Bt2.1 we believe that MIDA should trade at a multiple of no less than 15x. Addition of new product lines and distribution channels could significantly increase our estimates and target value.

Mida Assets Plc

Thailand

Share Price (Bt):	25.75	**Reuters Code:**	MIDA.TK	**Shares Outstanding**	500
52 Week Price Range (Bt):	10.00 - 35.50	**Bloomberg Code:**	MIDA.TB	**Market Cap (US$m)**	12,875

INCOME STATEMENT	**01**	**02**	**03**	**04**	**05**
Interest income	283	381	1,339	2,635	3,922
Interest expense	(5)	(9)	(45)	(97)	(179)
Net interest income	**278**	**372**	**1,294**	**2,539**	**3,743**
Non-interest income	235	1,135	2,061	3,533	5,045
Total operating income	**513**	**1,507**	**3,355**	**6,071**	**8,788**
Non-interest expense	(468)	(1,355)	(2,508)	(4,354)	(6,191)
Pre provision profit	**45**	**152**	**847**	**1,718**	**2,596**
Loan loss provisions	-	-	(144)	(320)	(499)
Non-operating income	-	-	-	-	-
Pre tax profit	**45**	**152**	**703**	**1,398**	**2,098**
Tax	(13)	(53)	(183)	(349)	(524)
Net profit	**31**	**98**	**520**	**1,048**	**1,573**

BALANCE SHEET	**01**	**02**	**03**	**04**	**05**
Gross loans	502	1,701	3,234	5,967	9,946
Loan loss reserves	*(10)*	*(34)*	*(144)*	*(320)*	*(499)*
Net loans	492	1,668	3,089	5,647	9,447
Total earning assets	505	1,690	3,378	6,287	10,444
Other assets	-47	(49)	(522)	(961)	(1,031)
Total Assets	**458**	**1,641**	**2,856**	**5,325**	**9,414**
Deposits	-	-	-	-	-
Other paying liabilities	175	1,060	2,106	3,928	6,943
Other liabilities	-	-	-	-	-
Total Liabilities	**175**	**1,060**	**2,106**	**3,928**	**6,943**
Total Equity	**283**	**582**	**750**	**1,398**	**2,471**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	21	45	144	320	499
NPAs/total loans	4.3%	2.6%	4.3%	5.1%	4.8%
Reserve coverage of NPAs	47.0%	75.6%	100.0%	100.0%	100.0%

PER SHARE DATA (HK$)	**01**	**02**	**03**	**04**	**05**
EPS	1.05	0.36	1.04	2.10	3.15
DPS	0.00	0.00	0.36	0.80	1.00
Effective payout ratio (%)	*0%*	*0%*	*35%*	*38%*	*32%*
BVPS	9.44	2.15	1.50	2.80	4.94

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	N/A	N/A	N/A	N/A	N/A
Equity to assets	61.8%	35.4%	26.2%	26.2%	26.2%
Tier 1 CAR	N/A	N/A	N/A	N/A	N/A
Total CAR	N/A	N/A	N/A	N/A	N/A

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	2.7x	12.0x	17.2x	9.2x	5.2x
Price to earnings	24.6x	70.6x	24.8x	12.3x	8.2x
Price to underlying profit	17.2x	45.8x	18.3x	9.2x	6.1x
Yield at current price (%)	*0.0%*	*0.0%*	*1.4%*	*3.1%*	*3.9%*

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	100.0	100.0	100.0	100.0	100.0
Mortgage (%)	-	-	-	-	-
Corporate (%)	-	-	-	-	-
Other (%)	-	-	-	-	-

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	53.25	33.91	51.08	52.54	44.75
Yield on assets	55.94	22.54	39.66	41.92	37.55
Cost of liabilities	(5.94)	(2.46)	(3.44)	(3.37)	(3.46)
Non-int. inc (% Op income)	45.90	75.30	61.43	58.19	57.40
Cost to income	91.25	89.92	74.75	71.71	70.45
Overhead	89.81	123.46	98.99	90.10	74.01
ROA	6.83	9.37	23.13	25.63	21.35
ROE	11.09	16.92	69.38	74.99	63.66

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	48.27	238.35	457.94	102.78	51.16
Net profit	57.01	213.51	428.45	101.55	50.07
EPS	1.69	-65.17	185.36	101.55	50.07
DPS	N/A	N/A	N/A	122.22	25.00
Net Loans	-6.64	239.10	98.52	86.11	66.14
Assets	-0.73	258.19	73.98	86.48	76.77
Deposits	N/A	N/A	N/A	N/A	N/A

National Finance

Fighting on all fronts

Rating: BUY

Flaws in growth strategy

Aggressive growth strategy not sustainable

NFS's aggressive growth in its HP portfolio in FY03 and ambitious targets for FY04 may not be without risk. First, growth targets may not be achievable if competition from banks and upgraded fincos picks up. Second, aggressive growth in the HP segment may result in credit issues later if processes are not monitored carefully – non performing problems in HP loan portfolio normally take between 18-24 months to feed through.

Asset/liability mismatch

Thin margins leave little room to manoeuvre

Due to its aggressive pricing strategy, in order to gain market share in the HP market, NFS has thin margins for its HP loans. This could result in a reluctance to issue bonds to match against the HP portfolio (which will squeeze margins) and leave NFS more susceptible to interest rate rises over the next two to three years. The thin margins also leave little room for error on the asset quality side. This could become an issue if competition in the segment increases.

Regulatory reform

Increased competition on all sides

The new financial master plan comes at a bad time for NFS. Competition will now come increasingly from other fincos seeking to upgrade to banks while reform will allow big banks to operate in NFS's core business segment (HP loans).

Investment portfolio woes

Rising rates could hurt investment portfolio

NFS's large securities investment portfolio, equivalent to 30% of its total assets, could have a big impact on the firm's bottom line, especially as 81% of its investments are in fixed income securities. This will become an increasingly important issue if interest rates begin to rise.

Low valuation reflects inherent risks

Too much risk

We have increased our FY04 forecast from Bt2,282m to Bt2,785m and increased our FY05 forecast from Bt2,593m to Bt3,106m. Current consensus forecasts for 2004 and 2005 are Bt2,694m and Bt2,882m, respectively.

We are concerned about the inherent risks related to NFS's policy of strong hire-purchase loan growth. First is the risk of rising interest rates, which NFS would not be able to pass on to fixed-rate HP loans. Second, the current low spread on HP loans doesn't leave much room for profit after loan loss provisions are considered. On the positive side, NFS has a strong blend of banking, securities, asset management and insurance businesses, which make it a strong diversified financial company.

Due to what we perceive to be higher risks and lower returns, we value the company on 1x P/BV and 6.8x PER. We are upgrading from a Sell to a BUY because we still see 25% upside using this punishing valuation. However, for investors who believe that interest rates will rise aggressively, NFS would not be a stock to hold.

National Finance — Thailand

Share Price (Bt):	15.40	**Reuters Code:**	NFS.BK	**Shares Outstanding**	1,333
52 Week Price Range (Bt):	11.60 - 19.20	**Bloomberg Code:**	NFS.TB	**Market Cap (US$m)**	521

INCOME STATEMENT	**01**	**02**	**03**	**04**	**05**
Interest income	5,245	5,733	7,131	8,811	11,733
Interest expense	(2,826)	(2,793)	(3,095)	(3,709)	(4,828)
Net interest income	**2,419**	**2,940**	**4,036**	**5,101**	**6,905**
Non-interest income	2,292	3,598	2,842	2,628	2,349
Total operating income	**4,711**	**6,538**	**6,878**	**7,729**	**9,254**
Non-interest expense	(2,110)	(2,925)	(3,073)	(3,272)	(2,902)
Pre provision profit	**2,601**	**3,613**	**3,806**	**4,457**	**6,353**
Loan loss provisions	(2,025)	(1,774)	(1,290)	(592)	(597)
Non-operating income	-	-	-	-	-
Pre tax profit	**576**	**1,839**	**2,515**	**3,865**	**5,756**
Tax	(26)	(116)	(120)	(870)	(1,829)
Net profit	**550**	**1,723**	**2,395**	**2,995**	**3,927**

BALANCE SHEET	**01**	**02**	**03**	**04**	**05**
Gross loans	55,161	74,954	108,902	136,099	152,397
Loan loss reserves	*(2,364)*	*(3,934)*	*(3,902)*	*(4,465)*	*(5,028)*
Net loans	52,796	71,020	105,000	131,634	147,370
Total earning assets	78,743	118,208	128,660	157,051	174,427
Other assets	19,980	7,278	25,053	26,248	28,313
Total Assets	**98,724**	**125,486**	**153,713**	**183,299**	**202,741**
Deposits	-	-	-	-	-
Other paying liabilities	80,517	104,343	116,586	130,558	145,174
Other liabilities	1,968	3,053	2,110	2,324	2,485
Total Liabilities	**82,485**	**107,396**	**118,696**	**132,882**	**147,659**
Total Equity	**16,238**	**18,090**	**35,017**	**50,417**	**55,082**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	7,823	7,723	7,443	7,403	8,501
NPAs/total loans	14.1%	10.3%	6.8%	5.4%	5.6%
Reserve coverage of NPAs	30.2%	50.9%	52.4%	60.3%	59.1%

PER SHARE DATA (HK$)	**01**	**02**	**03**	**04**	**05**
EPS	0.20	0.64	0.89	1.11	1.46
DPS	0.00	0.00	0.50	0.65	0.86
Effective payout ratio (%)	*0%*	*0%*	*56%*	*59%*	*59%*
BVPS	12.18	13.57	14.75	14.36	15.59

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	N/A	N/A	N/A	N/A	N/A
Equity to assets	16.4%	14.4%	22.8%	27.5%	27.2%
Tier 1 CAR	24.6%	22.4%	16.1%	17.5%	17.2%
Total CAR	25.7%	23.7%	22.8%	25.6%	24.6%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	1.3x	1.1x	1.0x	1.1x	1.0x
Price to earnings	75.3x	24.0x	17.3x	13.8x	10.5x
Price to underlying profit	75.3x	24.0x	17.3x	13.8x	10.5x
Yield at current price (%)	*0.0%*	*0.0%*	*3.2%*	*4.2%*	*5.6%*

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	28.7	40.0	47.0	53.0	55.0
Mortgage (%)	7.3	6.0	5.0	4.5	4.0
Corporate (%)	56.6	48.0	43.5	37.5	35.5
Other (%)	7.4	6.0	4.5	5.0	5.5

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	3.29	2.99	3.27	3.57	4.17
Yield on assets	7.13	5.82	5.78	6.17	7.08
Cost of liabilities	(3.80)	(3.02)	(2.80)	(3.00)	(3.50)
Non-int. inc (% Op income)	48.65%	55.04%	41.32%	34.00%	25.39%
Cost to income	44.78	44.74	44.67	42.33	31.35
Overhead	12.93	12.47	12.45	11.63	10.20
ROA	0.56	1.54	1.72	1.78	2.03
ROE	3.39	10.04	9.02	7.01	7.45

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	25.80	38.89	5.32	17.12	42.54
Net profit	(137.85)	213.34	38.99	25.06	31.11
EPS	(137.85)	213.34	38.99	(9.05)	31.11
DPS	N/A	N/A	N/A	30.72	31.11
Net Loans	28.6%	34.5%	47.8%	25.4%	12.0%
Assets	15.54	27.11	22.49	19.25	10.61
Deposits	N/A	N/A	N/A	N/A	N/A

Siam Panich Leasing

Uncertain times

Rating: SELL

Loan growth

Loan growth should remain strong, unless banks enter the fray

We expect growth to remain robust given the increasing proportion of credit-financed car acquisitions, the impetus behind SPL's strong loan growth thus far. High lending rates (effective rates of 12-13%) for second-hand car sales has also mitigated fierce competition in the new car financing market while SPL's long established reputation and dealer relationship will continue to provide SPL with an edge in the second hand car financing segment. However, the growth in new car sales will likely begin to slow later in FY04 while the new financial master plan raises the possibility of increased competition from banks and upgraded fincos.

Yields stable, but for how long?

Yields are stable, but increased competition from banks would hurt

Net interest margin has begun to stabilise as fierce competition in new car financing is waning while the rising proportion of second hand car financing is increasing. However, this too could be short-lived if banks, eager to increase yields, choose to go after this market segment.

Good funding mix

Least susceptible to margin squeeze

SPL's asset liability match is one of the best of any financial institution. If interest rates rise, SPL will have the least risk for margin squeeze. SPL has one of the highest proportion of assets matched to liabilities in the HP sector, which means that in the event rates start to rise, SPL will be best protected against any margin squeeze. On the other hand, SPL will not have as much upside as NFS if rates continue to fall.

Good asset quality

Low NPL levels

The asset quality of SPL's hire purchase portfolio is one of the highest among Thai financial institutions, with about 2.5% NPLs as at end-3Q03. This is due to strong controls, long-standing agents who are familiar with their customers as well as the management of all processes in house.

Regulatory changes

SPL could be merged into SCB

SPL is an associate company of Siam Commercial Bank (SCB). SCB also owns stakes in several other financial institutions, including SICCO. Under the new master plan, it appears that SCB will either be forced to amalgamate its subsidiaries or cast them free. Uncertainty over the future of SPL will therefore be an increasingly important issue going forward.

Valuation

Upside remains, but risks are growing

Our target price is Bt45/share based on a FY04 P/BV of 2.0x. We note however, that the new master plan may lead to increasing operating and structural risks for the company.

Siam Panich Leasing Plc

Thailand

Share Price (Bt):	38.50	**Reuters Code:**	SPL.BK	**Shares Outstanding**	199
52 Week Price Range (Bt):	30.00 - 43.30	**Bloomberg Code:**	SPL.TB	**Market Cap (US$m)**	193

INCOME STATEMENT	**01**	**02**	**03**	**04**	**05**
Interest income	1,614	1,967	2,367	2,957	3,614
Interest expense	(681)	(739)	(771)	(994)	(1,196)
Net interest income	**933**	**1,227**	**1,595**	**1,964**	**2,418**
Non-interest income	96	192	105	110	135
Total operating income	**1,029**	**1,420**	**1,700**	**2,074**	**2,553**
Non-interest expense	(314)	(367)	(412)	(452)	(494)
Pre provision profit	**715**	**1,053**	**1,288**	**1,622**	**2,059**
Loan loss provisions	(25)	(84)	(110)	(113)	(106)
Non-operating income	(4)	-	-	-	-
Pre tax profit	**687**	**969**	**1,178**	**1,509**	**1,953**
Tax	(13)	(194)	(338)	(438)	(571)
Net profit	**674**	**775**	**840**	**1,071**	**1,382**

BALANCE SHEET	**01**	**02**	**03**	**04**	**05**
Gross loans	15,394	21,164	27,352	34,085	40,878
Loan loss reserves	*(301)*	*(225)*	*(255)*	*(284)*	*(321)*
Net loans	15,093	20,939	27,097	33,801	40,557
Total earning assets	17,641	24,173	30,147	37,547	45,001
Other assets	(1,671)	(2,350)	(2,126)	(2,641)	(3,144)
Total Assets	**15,970**	**21,823**	**28,021**	**34,906**	**41,856**
Deposits	-	-	-	-	-
Other paying liabilities	11,713	16,683	22,607	28,889	32,850
Other liabilities	407	655	708	774	841
Total Liabilities	**12,121**	**17,338**	**23,314**	**29,664**	**33,691**
Total Equity	**3,850**	**4,485**	**4,707**	**5,242**	**8,166**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	521	581	518	628	725
NPAs/total loans	3.4%	2.8%	1.9%	1.9%	1.8%
Reserve coverage of NPAs	57.8%	38.7%	49.2%	45.3%	44.3%

PER SHARE DATA (HK$)	**01**	**02**	**03**	**04**	**05**
EPS	3.39	3.89	4.21	5.38	5.25
DPS	0.00	1.75	2.11	2.69	2.63
Effective payout ratio (%)	*0%*	*45%*	*50%*	*50%*	*50%*
BVPS	18.62	21.36	22.47	25.16	30.15

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	N/A	N/A	N/A	N/A	N/A
Equity to assets	24.1%	20.6%	16.8%	15.0%	19.5%
Tier 1 CAR	21.3%	18.2%	15.4%	13.7%	17.9%
Total CAR	21.3%	18.2%	15.4%	13.7%	17.9%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	2.1x	1.8x	1.7x	1.5x	1.3x
Price to earnings	11.4x	9.9x	9.1x	7.2x	7.3x
Price to underlying profit	11.3x	9.9x	9.1x	7.2x	7.3x
Yield at current price (%)	*0.0%*	*4.5%*	*5.5%*	*7.0%*	*6.8%*

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	91.7	92.8	93.2	93.3	93.3
Mortgage (%)	-	-	-	-	-
Corporate (%)	8.3	7.2	6.8	6.7	6.7
Other (%)	-	-	-	-	-

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	6.11	5.87	5.87	5.80	5.86
Yield on assets	10.56	9.41	8.71	8.74	8.76
Cost of liabilities	(6.99)	(5.21)	(3.93)	(3.86)	(3.87)
Non-int. inc (% Op income)	9.33%	13.54%	6.17%	5.32%	5.28%
Cost to income	30.50	25.82	24.26	21.81	19.34
Overhead	15.96	13.78	12.65	10.73	9.02
ROA	4.90	4.10	3.37	3.40	3.60
ROE	19.19	18.60	18.27	21.53	20.62

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	27.63	47.22	22.29	25.93	26.99
Net profit	10.16	15.02	8.33	27.54	29.07
EPS	10.16	14.87	8.33	27.54	(2.29)
DPS	N/A	N/A	20.43	27.54	(2.29)
Net Loans	40.3%	38.2%	29.1%	24.5%	19.9%
Assets	38.25	36.65	28.40	24.57	19.91
Deposits	N/A	N/A	N/A	N/A	N/A

Thai Investment & Sec Transition year

Rating: HOLD

Diversified revenue stream

Diversification revenue stream and good growth prospects

TISCO operates one of the most diversified businesses of any Thai finco. As a result, consumer lending, residential lending and stock market revenues provide investors with a good proxy for the economic recovery and strong growth in these sectors. HP loan growth continues to remain strong on the back of strong car sales, with forecast loan growth of 20% for FY04 while strong contributions from its securities business and fee based services will contribute solid growth.

Strong balance sheet

Ample room for expansion

TISCO has one of the cleanest balance sheets of any Thai financial institution in Thailand, with NPL coverage of 108%. The CAR ratio also provides ample room for expansion at 20.1% with tier 1 of 17.85%, well above regulatory requirements of 8% for finance companies.

Excess provisions

Excess provision mask market gains

TISCO has excess provision of almost Bt1.2bn (Bt1.6/sh) over BOT requirements, making its balance sheet one of the cleanest of any Thai financial institution. These tend to mask large market related gains and could be a source of eventual write backs.

Regulatory changes

Competition could outweigh gains in the short-term

As with other fincos, regulatory changes offer new opportunities for TISCO. Although we believe that the firm will ultimately benefit from the new financial model, increased competition from banks and upgraded fincos, particularly in the HP segment, is likely to outweigh any gains in short-to-medium term.

Valuations

Upside remains

We have upgraded our forecasts for TISCO to Bt1,819.6m in FY04 and Bt1,856.3m in FY05 from Bt1,706m and Bt1,691m in those respective years. The last consensus forecasts for TISCO were Bt1,696m and Bt1,781m for 2004 and 2005, respectively.

We like TISCO for its: 1) careful risk management policies: 2) management's ability to maintain its spread and strong profitability: 3) its diversified banking, securities and strong pension asset management businesses: and 4) its very low NPL level combined with its relatively high provisioning level. Together these factors lead us to value the company on a higher P/BV and PER multiple than NFS.

We base our valuation of TISCO on 2x P/BV and 11.7x PER, which when averaged with our Bt38 DDM valuation gives our target price of Bt35. Since this only provides a 10% upside, we downgrade our recommendation from a Buy to a HOLD.

Tisco Finance Thailand

Share Price (Bt):	29.00	**Reuters Code:**	TISCO.BK	**Shares Outstanding**	707
52 Week Price Range (Bt):	15.80 - 36.25	**Bloomberg Code:**	TISCO.TB	**Market Cap (US$m)**	520

INCOME STATEMENT	**01**	**02**	**03**	**04**	**05**
Interest income	3,112	3,369	3,651	4,330	5,194
Interest expense	(1,345)	(1,267)	(1,223)	(1,529)	(1,838)
Net interest income	**1,767**	**2,102**	**2,428**	**2,801**	**3,356**
Non-interest income	1,457	1,761	1,947	2,069	2,044
Total operating income	**3,224**	**3,863**	**4,376**	**4,869**	**5,400**
Non-interest expense	(2,078)	(1,964)	(2,173)	(2,275)	(2,378)
Pre provision profit	**1,146**	**1,900**	**2,202**	**2,595**	**3,023**
Loan loss provisions	(171)	(518)	(211)	(129)	(226)
Non-operating income	70	(38)	-	-	-
Pre tax profit	**1,045**	**1,344**	**1,991**	**2,465**	**2,797**
Tax	(206)	(190)	(235)	(444)	(824)
Net profit	**839**	**1,154**	**1,756**	**2,022**	**1,973**

BALANCE SHEET	**01**	**02**	**03**	**04**	**05**
Gross loans	32,553	40,637	50,586	60,625	69,639
Loan loss reserves	*(2,151)*	*(4,695)*	*(4,329)*	*(4,381)*	*(4,473)*
Net loans	30,402	35,943	46,257	56,244	65,167
Total earning assets	42,802	48,653	54,262	64,377	73,671
Other assets	4,257	559	4,964	5,504	6,185
Total Assets	**47,059**	**49,212**	**59,226**	**69,881**	**79,857**
Deposits	-	-	-	-	-
Other paying liabilities	38,966	40,251	48,099	56,708	65,078
Other liabilities	1,838	1,582	2,556	2,896	3,234
Total Liabilities	**40,804**	**41,833**	**50,655**	**59,604**	**68,312**
Total Equity	**6,255**	**7,379**	**8,570**	**10,277**	**11,544**

ASSET QUALITY	**01**	**02**	**03**	**04**	**05**
Nonperforming assets	1,800	3,484	2,966	2,700	2,766
NPAs/total loans	5.5%	8.6%	5.9%	4.4%	4.0%
Reserve coverage of NPAs	119.5%	134.8%	146.0%	162.2%	161.7%

PER SHARE DATA (HK$)	**01**	**02**	**03**	**04**	**05**
EPS	1.19	1.63	2.49	2.86	2.79
DPS	0.00	0.00	0.00	0.00	0.70
Effective payout ratio (%)	*0%*	*0%*	*0%*	*0%*	*25%*
BVPS	7.30	8.91	10.44	12.60	15.46

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04**	**05**
Loan-to-deposit	N/A	N/A	N/A	N/A	N/A
Equity to assets	13.3%	15.0%	14.5%	14.7%	14.5%
Tier 1 CAR	17.0%	18.4%	18.4%	17.3%	17.8%
Total CAR	18.4%	20.4%	20.4%	19.0%	19.4%

VALUATION	**01**	**02**	**03**	**04**	**05**
Price to book value	4.0x	3.3x	2.8x	2.3x	1.9x
Price to earnings	24.3x	17.8x	11.7x	10.1x	10.4x
Price to underlying profit	26.5x	17.2x	11.7x	10.1x	10.4x
Yield at current price (%)	*0.0%*	*0.0%*	*0.0%*	*0.0%*	*2.4%*

LOAN MIX	**01**	**02**	**03**	**04**	**05**
Consumer (%)	46.3	50.0	50.0	50.0	50.0
Mortgage (%)	8.8	8.8	8.8	8.8	8.8
Corporate (%)	30.9	30.9	30.9	30.9	30.9
Other (%)	14.0	10.3	10.3	10.3	10.3

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04**	**05**
Net interest margin	4.39	4.60	4.72	4.72	4.86
Yield on assets	7.73	7.37	7.10	7.30	7.53
Cost of liabilities	(3.69)	(3.20)	(2.77)	(2.92)	(3.02)
Non-int. inc (% Op income)	45.18%	45.59%	44.50%	42.48%	37.85%
Cost to income	64.46	50.83	49.67	46.71	44.03
Overhead	23.31	20.98	17.60	16.13	14.84
ROA	1.78	2.40	3.24	3.13	2.64
ROE	13.41	16.93	22.02	21.45	18.08

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04**	**05**
Pre-provision earnings	13.74	65.81	15.93	17.82	16.50
Net profit	(5.27)	37.62	52.14	15.13	(2.40)
EPS	(5.50)	36.71	52.14	15.13	(2.40)
DPS	N/A	N/A	N/A	N/A	N/A
Net Loans	18.3%	18.2%	28.7%	21.6%	15.9%
Assets	15.33	4.58	20.35	17.99	14.27
Deposits	N/A	N/A	N/A	N/A	N/A

Indonesia

Lower rates to continue

Rating: Overweight

Consumption-driven loan growth

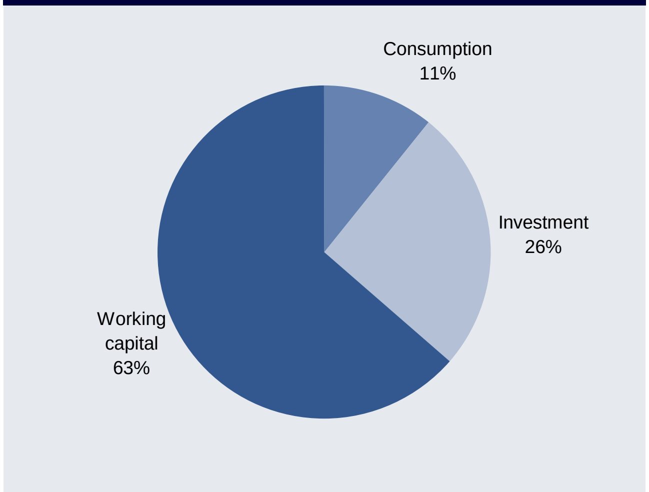
Fig 214 Banking sector loan growth

Source: Bank Indonesia

Loan growth a robust 20% YoY in 2003

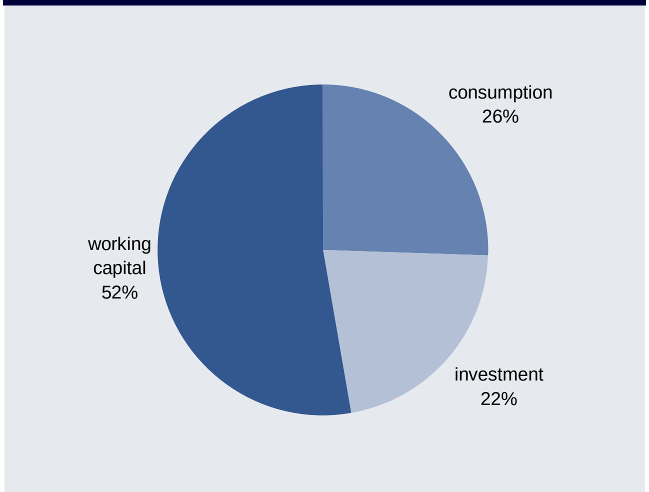
Against the backdrop of falling rates, loan growth accelerated to 20% YoY in 2003 from 19% in 2002. The strong loan growth was despite the slew of corporate bond issuance in 1H03 as corporates took advantage of low interest rates to lock in long-term financing. The 2002 loan growth was boosted by purchases of Indonesian Banking Restructuring Agency loans (IBRA); stripping those out, banking sector loans only grew 11% YoY in 2002. Despite the election coming up this year, the bankers that we talked to all expressed optimism that loan growth will remain strong in 2004, driven by lower rates. We project loan growth to remain at 20% YoY in 2004, before tapering off to 15% YoY in 2005-06F (due to the higher base).

Fig 215 Loan breakdown by type of loan 1999



Source: Bank Indonesia

Fig 216 Loan breakdown by type of loan 2003

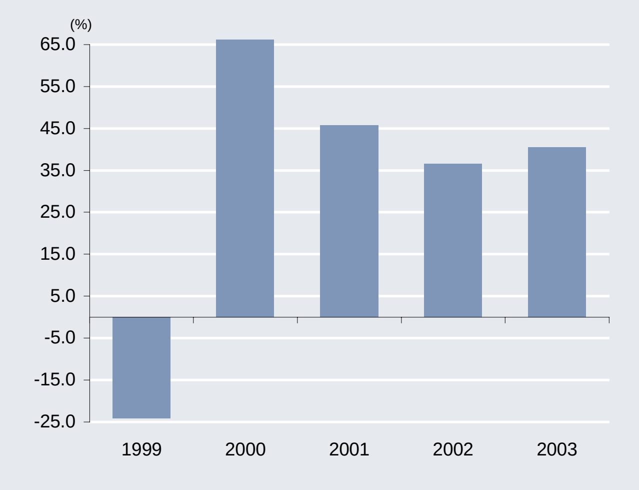


Source: Bank Indonesia

Consumption credits driving growth …

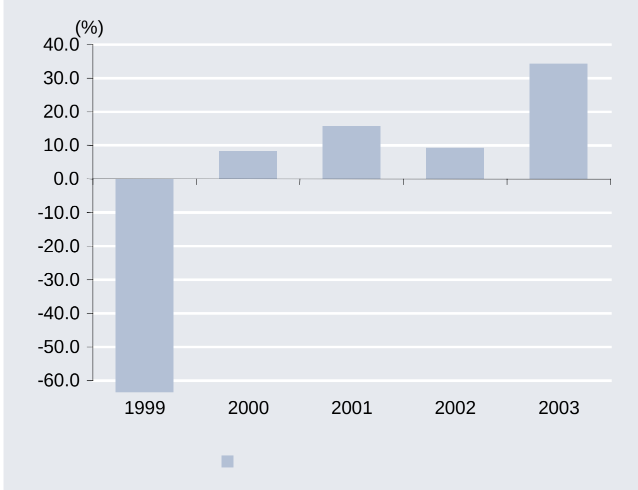
Looking at the sub-segments, consumption credits continued to drive new lending, growing 40% YoY in 2003, exceeding the investment credits and working capital credits, which both expanded by 14% YoY. A combination of low financing rates and the banks' focus on growing consumer loans led to the rapid growth of consumer loans over the past four years. Post-crisis, the banks are keen to lend to the consumer sector, having witnessed negligible non-performing consumer loans during the crisis. As a result, consumption credits accounted for 26% of total loans as of December 2003, up sharply from 11% in 1999.

Fig 217 Consumption credit growth



Source: Bank Indonesia

Fig 218 Property credit growth



Source: Bank Indonesia

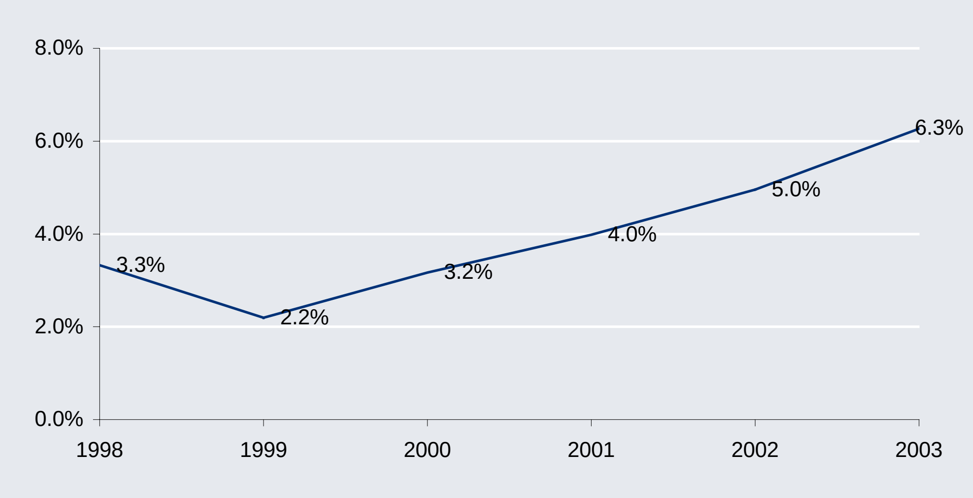
… as financing costs are at a historical low

With the low financing rates, currently 11-13% per annum for mortgage rates compared to pre-crisis rates of 23-24%, it is understandable that consumer loans have enjoyed strong growth in 2003. Property credits, which grew 9% YoY in 2002, picked up sharply in 2003 to grow a strong 34% YoY. Certain banks such as BCA indicated that they are tying up with reputable property developers to provide low financing rates of 9-10%. For other mortgages (not tie-ups with property developers), the interest rate charged is 12-13%.

Car and motorcycle sales grew strongly in 1Q04

While Bank Indonesia (BI) does not publish the car and motorcycle financing figures, we expect the new lending in this segment to be strong as well, led by the car market rising 12% YoY in 2003 and motorcycle volume up 23% YoY. The banks are charging car financing rates of 12-14% per annum, an historical low versus the 23-24% pre-crisis. The sharp decline in financing costs has rendered it more affordable for the general public to draw down financing. In addition to lower financing costs, we view that the introduction of cheaper models have also helped the car market to continue its robust growth of 25% YoY in 1Q04 while motorcycle sales were up 36% YoY, exceeding our expectation.

Fig 219 Consumption credits as % of GDP

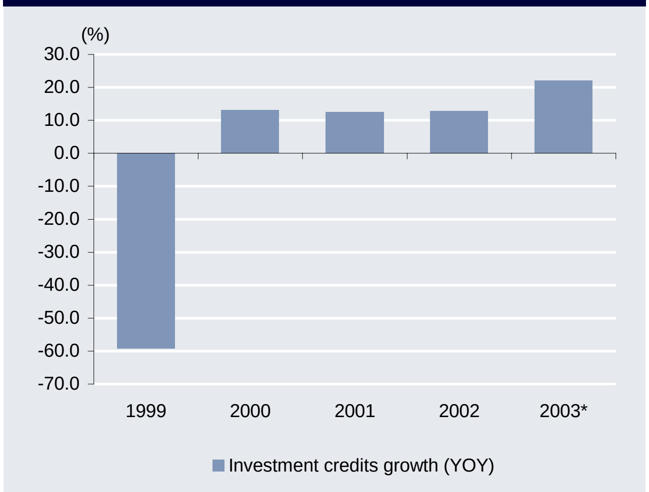


Source: Bank Indonesia

Despite rapid growth, consumption credits still only 6.7% of GDP

We believe the consumer financing business still has enormous potential. Despite the rapid growth over the past three years, consumption credits amounting to Rp112tr as of December 2003 represented only 6.4% of GDP. While competition is keen, the banks are still asking for 10-30% downpayments for car loans as well as mortgages (10% for popular new cars and 30% for used cars), a move that we view as prudent. The terms for vehicle financing are also reasonable at two to three years for cars and motorcycles, while the mortgages are longer at 10-15 years but mostly 10 years.

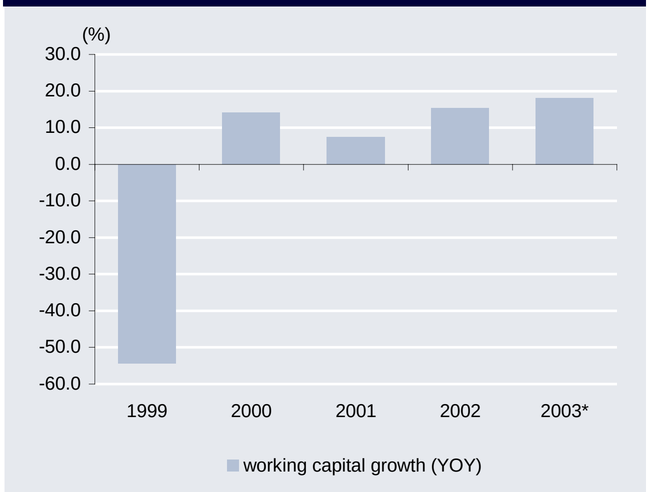
Fig 220 Investment credit growth



* October

Source: Bank Indonesia

Fig 221 Working capital credit growth



* October

Source: Bank Indonesia

The return of credit cycle for investments

Interestingly, we have seen the return of the credit cycle for expansion or capex purposes. The pace of growth of investment credits accelerated in 10M03 to 22% YoY from 12% YoY in 2002. This makes it the strongest growth over the past four years, indicating improving business confidence. With various business owners already having obtained the *debt and release discharge* from the IBRA, we expect these businessmen can start investing in new projects and do not have to be concerned that they still have outstanding obligations with the government. Working capital credits also expanded 18% YoY in 10M03, up from 15% YoY in 2002, again indicating improving business activities.

Regulatory challenges & opportunities

New banking regulation to result in consolidation

On the regulatory front, BI has just revealed the new *Indonesian Banking Landscape,* basically a blueprint for the sector reform over the next five to 10 years. The blueprint calls for banks to be categorised under four tiers:

- International banks, with minimum paid-up capital in excess of Rp50tr (US$6.0bn), are able to open branches overseas.
- National banks with minimum paid-up capital of Rp10-50tr (US$1.2-6.0bn) with a nationwide scope of operation.
- Specialised banks, with minimum paid-up capital of Rp100bn up to Rp10tr (US$11,900-US$1.2bn) focusing on particular business segments.
- Rural banks, with minimum paid-up capital in excess of Rp100bn (US$11,900) and a limited scope of operation.

Fig 222 Minimum capital requirements for Indonesian banks (Rp bn)

International	>50,000
National	>10,000-50,000
Specialised	>100-10,000
Rural	100

Source: *Indonesian Banking Landscape,* Bank Indonesia

55 out of a total of 138 banks do not comply with minimum capital requirements

The ruling is expected to bring about consolidation in the banking sector, whereby the central bank envisages two international banks, three to five national banks and 30-50 specialised banks. Currently, there are 138 banks operating in Indonesia. BI's governor Burhanuddin Abdullah indicated that out of these, 55 would have capital below the new minimum requirements. While not naming them, the BI governor indicated these 55 banks include one foreign bank, four joint-venture banks, 41 private banks and nine provincial banks. We expect the 41 smaller private banks are likely to be merged or acquired by the larger ones.

Expects consolidation in the medium term as banks are given until 2010 to comply

While BI expects the new ruling on minimum paid-up capital should reduce the number of banks to about 60, we think even then there would still be too many banks in the country. The pace of consolidation may be another issue. The press release indicated that banks are allowed five to 10 years to comply with the minimum capital requirements, but one of the banks indicated that the compliance deadline is sooner, or by 2010. We do not expect the banks to undertake rights issues in 2004 to increase their capital, but they may choose to do so in two or three years.

Fig 223 Capital of various banks per December 2003 (Rp bn)

Mandiri	27,202
BCA	11,172
BNI*	10,283
Danamon	6,198
BRI*	7,903
Panin*	4,900
BII*	3,329
Niaga*	1,675
Permata*	1,164
NISP **	1,035

*Based on Sep 03
** Based on Nov 03
Source: Company data

Only Mandiri and BCA have capital >Rp10tr, hence, national banks

Among the listed banks, only two, namely Mandiri and BCA, have capital in excess of Rp10tr; hence, are qualified to be in the national bank category. The other major banks, Danamon, BNI, BRI, BII, Lippo, Permata, Niaga, Panin and NISP, are likely to be merged or raise capital in order to become national banks.

From capital argument, ING expects BII to be merged with Danamon

From the capital point of view, we think it likely that Temasek, which has controlling stakes in both Danamon and BII, will merge the two banks, resulting in a bank with combined capital of over Rp9tr. This, together with the profit to be generated over the next few years, should bring the capital of the merged Danamon/BII to over Rp10tr. Hence, Temasek may not need to inject additional capital to qualify for national bank status. However, we do not think the merger is likely to take place in 2004.

Mandiri plans to become an international bank; hence, may need to raise capital

Bank Mandiri's president commissioner Binhadi told the press recently that the bank aimed to become an international bank. This implies that Mandiri had to raise its capital to Rp50tr from the current Rp27tr. Other banks such as BRI, BNI, Permata, Panin and Niaga (owned by Commerce Asset of Malaysia) also need to raise capital to become national banks.

NISP is awaiting details from BI to decide on national or specialised banks' status

We recently talked with NISP, which indicated it would await further details from the policymaker to determine if there are restrictions in being a specialised bank in terms of expansion strategy (branch openings and ATM additions, for example). If there are restrictions, NISP plans to increase its capital to become a national bank with minimum paid-up capital of Rp10-15tr (US$1.2-1.8bn). In this case, it may need to raise capital to increase its minimum paid-up capital. Leaving that aside, NISP does not plan to raise capital but to finance its rapid growth from existing capital. NISP's CAR stood at 13.8% in November 2003.

Removal of blanket guarantee scheme will be another challenge …

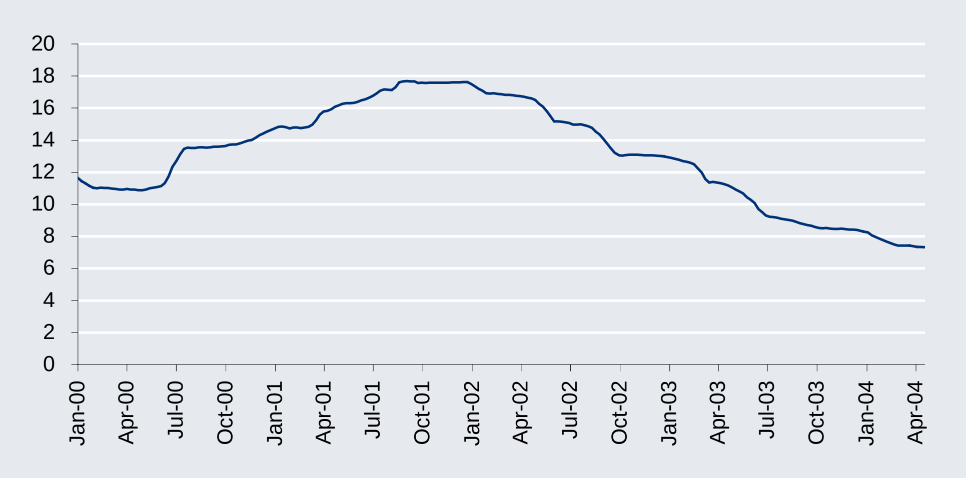
Another regulatory challenge will be the grafting of the "blanket guarantee scheme" (that guarantees the deposits in banks regardless of the size of the deposits or the health of the banks) onto something like a deposit guarantee scheme. The government will set up a new institution under the Ministry of Finance to take over IBRA's role in implementing the government's blanket guarantee scheme. The institution would operate on a temporary basis pending the establishment of a permanent unit called the deposit guarantee agency (or LPS, based on the Indonesian acronym) which requires a new law as its legal basis. The government is currently drafting the new law before submitting this to Parliament for approval.

… but to benefit quality banks

BI had previously planned to remove the blanket guarantee by mid-2004, but with the election coming up, the policymaker is likely to delay the move out of fear of deposit runs in the banking system similar to the late 1997 when BI closed several banks. We expect the earliest BI will eliminate the blanket guarantee will be in 2005 as a six-month transition period will be provided. Our view is that the elimination of the 'blanket guarantee scheme' will accelerate banking sector restructuring and reduce the moral hazard of protecting weak and badly managed banks. We expect there will be a 'flight to quality' towards major banks from smaller banks. BCA, Panin and Danamon will all benefit as they have foreign partners – Farallon Capital, ANZ and Temasek/Deutsche respectively. The state banks BRI and Mandiri should fare well also given their sovereign ownership.

Rates to go lower

Fig 224 SBI rates (1991 - Jan 2004)



Source: Bank Indonesia

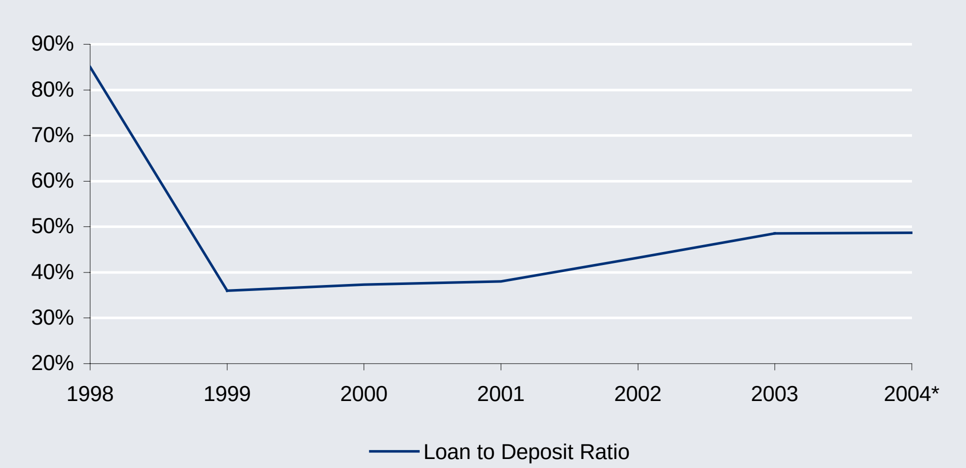
Expect interest rates to continue downward trend due to low CPI …

On the interest rate front, we are optimistic that rates will remain favourable for the banking sector. Inflation has been very much under control this year, coming in at 4-5% YoY, the lowest in Indonesian history. The benign inflation should thus present room for BI to continue its monetary easing. The latest SBI pricing (21 April 2004) saw its rates at 7.33% while ING is looking at SBI rates to decline to 7.0% over the next three months.

… which is positive for loan growth

We are, thus, positive on the outlook for the Indonesian banking sector as we expect banks to be more aggressive in lending, spurred by low interest rates and improvements in the business environment. While BCA saw its average lending rates at 14.4% per annum in 2003, we expect these to decline to around 12% in 2004. BCA is now pricing its lending rates at 11-12% for the corporate sector but for certain top tier corporate borrowers, BCA prices the loans as low as 10%. The bank is pricing its lending to small-to-medium enterprise (SME) borrowers at 12-13%. On the other hand, BCA is pricing its mortgage loans competitively at 10-12%, the lowest in history. However, for the mortgage rate of 10%, BCA did have rebates from the developers who subsidised 1.0-1.5% of rates – hence BCA's effective lending rate is 11.5%.

Fig 225 Indonesian banking sector loan-to-deposit ratio (%)



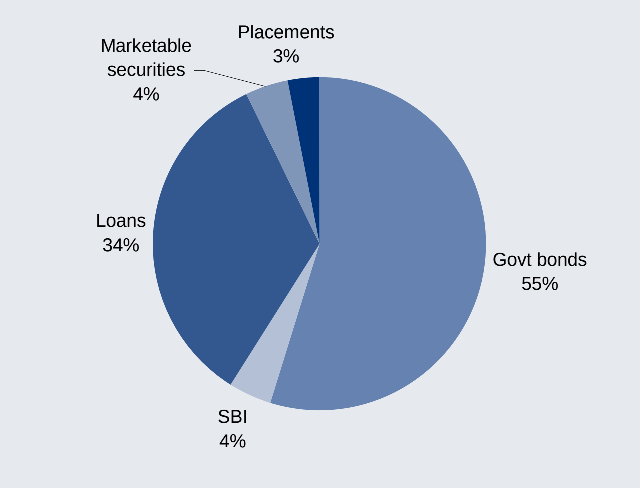
* Up to January 2004

Source: Bank Indonesia

Banks are flush with liquidity, thus will be aggressive in lowering their cost of funds

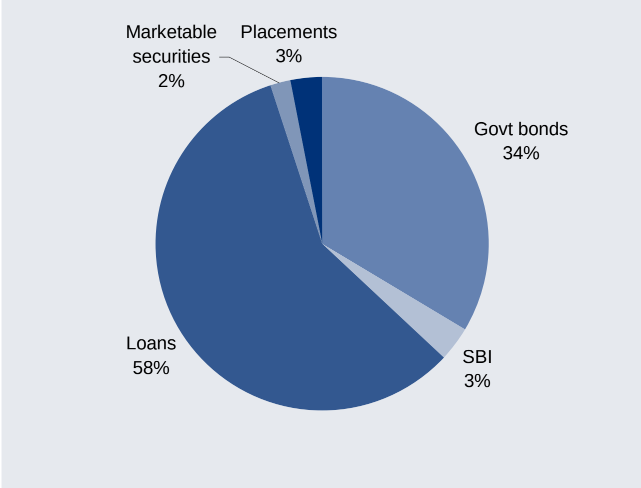
As banks are still flush with liquidity, we argue that they are likely to price their deposit rates low. While the loan-to-deposit ratio (LDR) for the sector had increased to 49% as of January 2004, from 43% in 2002, it is nevertheless still low. Banks are still holding lots of SBI. In the case of BCA, SBI accounted for 30% of earning assets in 1Q04 and 10% for Danamon. This does not include their marketable securities and placements.

Fig 226 Mandiri's earning assets mix Sept 03



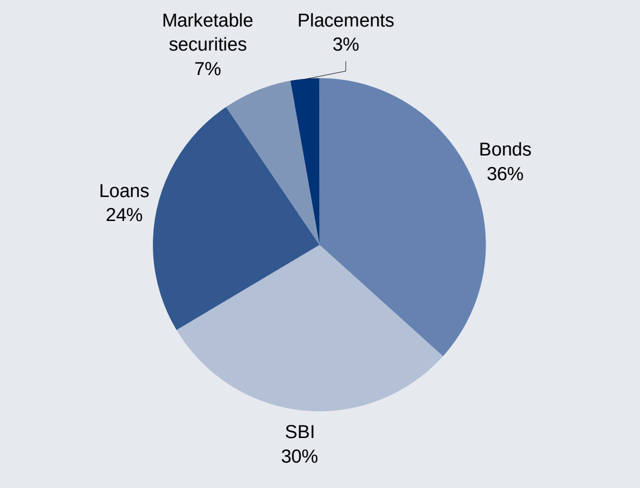
Source: Company data

Fig 227 BRI's earning assets mix (2003)



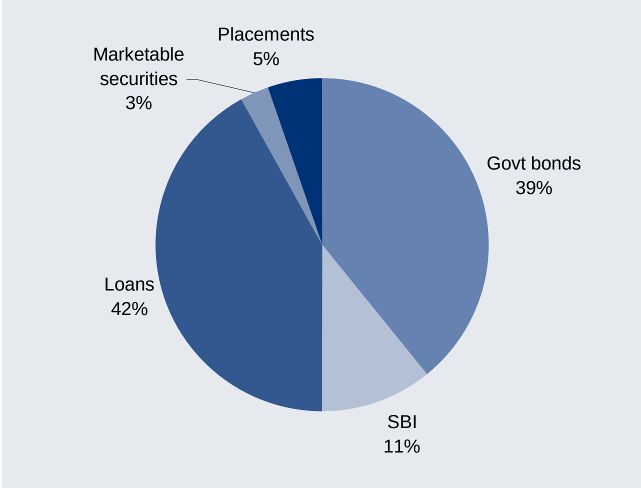
Source: Company data

Fig 228 BCA's earning assets mix 1Q04



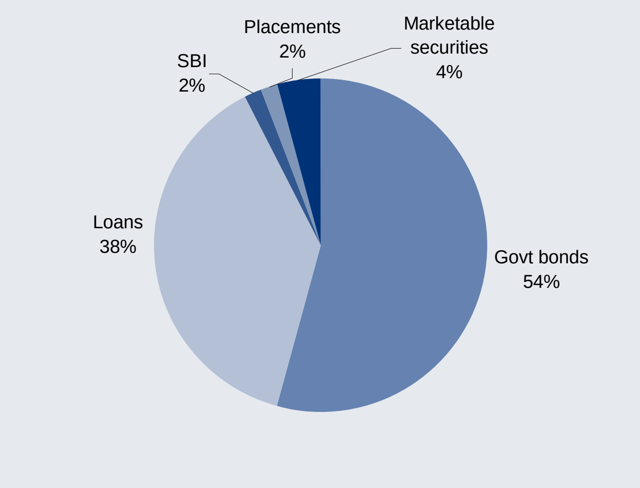
Source: ING estimates

Fig 229 Danamon's earning assets mix 1Q04



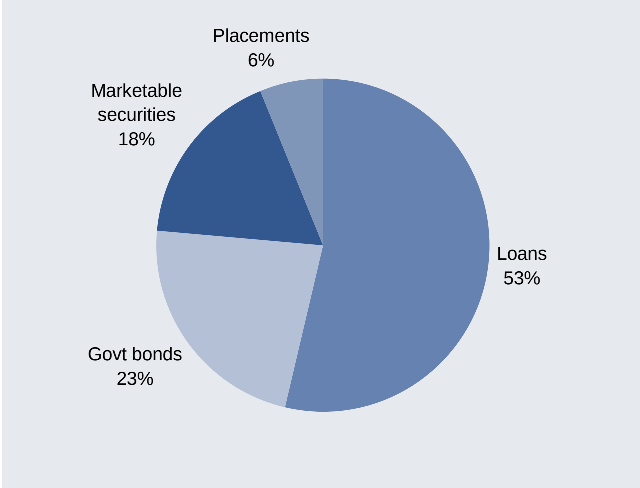
Source: ING estimates

Fig 230 BII's earning assets breakdown 1Q04



Source: Company data

Fig 231 Panin's earning assets breakdown 1Q04



Source: Company data

Expect banks to continue to unload bonds …

With a better-regulated secondary market for fixed income instruments, particularly the government recapitalisation bonds (a bill has just been passed on bond market trading regulations), we expect banks will be able to continue to unload their bonds, thereby further increasing their liquidity. Mandiri sold Rp26tr of bonds in 2003 while BCA sold Rp10tr. Despite the divestments, bonds still accounted for a significant proportion of the banks' earnings assets, 55% in the case of Mandiri as at December 2003, and 34% for BRI. For Danamon, bonds accounted for 32% of Danamon's earning assets as at March 2004, 36% of BCA's and 23% of Panin's. BII still had quite substantial government bonds on its books as well of 54% as per March 2004.

….to increase liquidity and reduce dependence

As a result, ING expects banks would want to continue to unload the government bonds to reduce their dependence on them, as variable-rate bonds (currently yielding 7.33%) have lower yields than loans (yielding 13% on average). Additionally, the fluctuations in bond prices make banks susceptible to gains or losses when they mark-to-market the 'trading portion' as well as the 'available for sale' portion of their bonds.

Fig 232 Net interest margins

	2003	1Q04
BCA	4.8	5.2
Danamon	6.1	7.6
BII	3.3	5.5
Panin	7.2	7.8

Source: Company data

Banks' net interest margins to improve in 1Q04

To recap, we expect the banks will continue to enjoy strong loan growth, which will in turn improve their earning assets mix (more higher-yielding loans and fewer lower-yielding government bonds). On the flip side, excess liquidity implies less pressure on funding; therefore, we expect the banks to remain aggressive in reducing their cost of funds. This should translate into better margins for the banking sector, which was evident in 1Q04 results where all banks enjoyed improvement in margins. We expect this to continue throughout 2004 as the banks benefited from an improving earnings mix thanks to high loan growth.

Fig 233 Fixed rate bonds as % of earning assets (Dec 03)

BCA	2%
Danamon	16%
Panin	12%
Mandiri	14%
BRI	26%
BII	25%

Source: Company data

BRI, Danamon and Mandiri also benefit due to their high proportion of fixed-rate bonds

Also, banks that have substantial fixed-rate government bonds on their books will also benefit as the yields on these bonds, ranging from 12-16%, remain unchanged, but their cost of funds would decline in line with falling rates. Among the major banks, BRI has the highest percentage of fixed-rate bonds as earning assets at 26%, followed by BII at 25%. In the case of BCA, the bulk of its bonds are variable rate. For Danamon, fixed-rate bonds account for 16% of its earning assets. Mandiri also has quite substantial fixed-rate bonds, which account for 14% of its earning assets.

BII and Danamon our top picks ….

BII and Danamon are our top picks in this sector, with the former as our top pick due to its cheaper rating. We expect both BII and Danamon to benefit from new management appointed by new owner Sorak (Temasek/Kookmin Bank) and Asia Financial Holdings (Temasek/Deutsche Bank) respectively. Under Danamon's new strategy, it plans to focus on lower-end consumer market and lower-end SMEs which it sees having huge potential. In the case of BII, the new management plans to leverage on the bank's valuable consumer banking franchise and its target market will remain on the mass affluent consumer market or the middle-income segment where it has a stronghold.

… followed by BCA

BCA is likely to benefit from high loan growth as well but the management expects the loan growth to be driven by corporate lending. Our view is that BCA is able to grow strongly in corporate lending due to its competitive loan pricing thanks to it having the lowest costs of funds. The high loan growth should thus translate into an improving earning assets mix, and hence better margins

Fig 234 Valuation matrix

		Share price	Target price	PER (x)		P/UP (x)		Unadj. P/BV (x)	
	Rating	(Rp)	(Rp)	2004F	2005F	2004F	2005F	2004F	2005F
BCA	Buy	3925	5000	7.9	6.6	7.4	5.2	1.7	1.5
Danamon	Buy	3500	4200	7.6	6.2	5.9	4.8	2.0	1.7
Panin	Hold	370	350	11.5	9.6	5.6	5.1	1.4	1.2
BII	Buy	150	220	6.3	5.1	5.2	4.3	1.8	1.5
Mandiri *	NR	1525	NR	6.9	6.4	N/A	N/A	1.3	1.2
BRI *	NR	1850	NR	8.2	7.3	N/A	N/A	2.1	1.8

* Based on IBES consensus estimates
Source: Company data, ING estimates

Fig 235 Operation statistics

	NIM (%)		Costs to income (%)		ROA (%)		ROE (%)	
	2003	2004F	2003	2004F	2003	2004F	2004F	2005F
BCA	4.8	5.3	52.2	43.2	1.9	2.2	22.9	23.8
Danamon	6.1	7.0	40.6	41.7	3.1	4.1	29.6	29.8
Panin	7.2	6.5	29.6	40.2	2.4	2.4	12.3	13.1
BII	3.3	6.3	77.4	51.2	3.3	3.9	30.9	31.4
Mandiri	3.4	N/A	40.4	N/A	2.8	N/A	N/A	N/A
BRI	9.5	N/A	65.3	N/A	2.7	N/A	N/A	N/A

Source: Company data, ING estimates

BII is cheapest in terms of PER

In terms of PER valuations, BII is the cheapest, trading on 6.3x for 2004F, even cheaper than Mandiri at 6.9x based on IBES consensus estimates. Danamon is also trading on an undemanding 2004F PER of 7.6x. Both BII and Danamon are trading on low PER thanks to their high ROE. Due to BCA's recent weak performance (as compared to its peers), it is now trading on a 2004F PER of 7.9x, but still lower than BRI at 8.2x.

Mandiri is cheapest in terms of P/BV due to its asset quality concerns

In terms of P/BV, Mandiri is the cheapest at 1.3x for 2004F due to concerns over its asset quality. Similarly, Panin is trading on a low P/BV as its provisioning policy remains an uncertain factor. BII is trading on a 2004F P/BV of 1.8x, slightly more expensive than BCA at 1.7x. BRI on the other hand is trading at the highest P/BV of 2.1x due to its micro lending focus, and hence higher margins.

Bank Danamon

Leading consumer bank

Rating: BUY

High proportion of fixed-rate consumer loans, thus, should benefit from lower rates

Danamon is one of our top picks in the banking sector as it has the highest proportion of consumer loans (38% of total), which are predominantly at fixed rates. Danamon benefits from widening margins, as yields on its loans remain the same while its cost of funds declines as interest rates fall.

Adira acquisition to jump-start low-end consumer penetration

The bank expects benefits from its new strategy rollout in 2004, focusing on consumers and SMEs, which are expected to account for 80% of total loans, up from 60% currently. Its consumer focus is evident in Danamon's recent move to acquire a controlling stake in leading car and motorcycle finance company Adira Finance which has a 12% share of the motorcycle financing market, paying Rp850bn, or at an entry price of Rp1,133. This translates into a 2004F PER of 3.5x, which is an attractive price, whereas Adira is now trading at Rp2,775. Hence Danamon is potentially enjoying gains of Rp1.2tr, although this will not be realised.

Expect Danamon to triple its consumer financing in 2004F helped by Adira

We are positive on the acquisition as we expect Adira will jump-start Danamon's low-end consumer penetration. The plan is for Danamon to provide the funding while Adira will channel the loans. The target is for Danamon to grow its consumer financing by Rp5.2tr in 2004F, vs the Rp1.7tr in 2003.

Expect Danamon's cost of funds to decline further

The new management appointed by Temasek made a bold move to reduce its paying rate for time deposits in 3Q03. This put Danamon's deposit rates in line with those of BCA, as opposed to being 100-150bp higher as they were previously. As the major banks all have strong liquidity (placed in SBIs), we do not expect any pressure in terms of funding, allowing the banks, including Danamon, to reduce their cost of funds.

One of the highest net interest margins

Danamon saw its net interest margin improve sharply to 7.6% in 1Q04 from 6.1% in 2003 led by lower costs of funds, as Danamon benefited from an improving deposit mix and lower pricing. Danamon's net profit rose 86% YoY in 1Q04 despite high operating expenses as the bank is rolling out its new strategy. Danamon's high net interest margin allows the bank to enjoy high ROA of 4.1% and ROE of 29.6% in 2004F. This compares favourably with BCA's ROA of 2.2% and ROE of 23.2% in 2004F.

Most conservative in loan provisioning

Under the direction of new management, Danamon decided to be even more conservative in its loan classification. Its new policy takes into account the business risk profile of the debtors in addition to the payment record in determining loan collectibility. Danamon booked Rp1.3tr provisions in 2003 and downgraded Rp765bn in loans to non-performing (category 3-5). However, provisions were down in 1Q04 as Danamon is already over-provisioned.

Limited free float

Danamon's free float is, however, limited to 18% as Temasek/Deutsche has been increasing its stake to 62.9%. IBRA has another 20% stake but the government indicated that it plans to divest its remaining stake in the various banks over the next five years. Due to BCA's recent weak performance (as compared to its peers), it is now trading on a 2004F PER of 7.9x

Bank Danamon

Indonesia

Share Price:	3,500	**Reuters Code:**	BDMN.JK	**Shares Outstanding**	4907
52 Week Price Range:	1,250 - 3,500	**Bloomberg Code:**	BDMN IJ	**Market Cap (US$m)**	2,032

INCOME STATEMENT	**02**	**03**	**04**	**05**	**06**
Interest income	6,883	5,966	5,581	6,063	6,421
Interest expense	-4,865	-3,142	-1,877	-1,876	-1,842
Net interest income	**2,018**	**2,824**	**3,705**	**4,187**	**4,579**
Non-interest income	433	1,654	1,270	1,671	2,178
Total operating income	**2,451**	**4,478**	**4,975**	**5,858**	**6,756**
Non-interest expense	-1,177	-1,818	-2,073	-2,281	-2,623
Pre provision profit	**1,275**	**2,660**	**2,901**	**3,578**	**4,134**
Loan loss provisions	-272	-1,324	-133	-182	-246
Non-operating income	-13	236	31	131	131
Consumer finance income	**0**	**0**	**331**	**412**	**576**
Pre tax profit	989	1,573	3,130	3,938	4,595
Tax	**-42**	**-43**	**-867**	**-1,161**	**-1,350**
Net profit	**948**	**1,529**	**2,264**	**2,778**	**3,245**

BALANCE SHEET	**02**	**03**	**04**	**05**	**06**
Gross loans	18,241	22,597	29,245	38,349	50,646
Loan loss reserves	*1,571*	*4,440*	*1,773*	*1,955*	*2,201*
Net loans	16,670	18,157	27,472	36,394	48,445
Total earning assets	42,425	50,318	54,854	61,423	71,282
Other assets	4,487	2,364	2,241	-2,052	-7,394
Total Assets	**46,911**	**52,682**	**57,094**	**59,370**	**63,888**
Deposits	35,084	39,699	39,275	39,921	41,127
Other paying liabilities	4,141	1,974	4,936	4,299	4,365
Other liabilities	3,034	4,343	4,400	5,000	5,000
Total Liabilities	**42,259**	**46,017**	**48,611**	**49,220**	**50,492**
Total Equity	**4,653**	**6,822**	**8,484**	**10,150**	**13,395**

ASSET QUALITY	**02**	**03**	**04**	**05**	**06**
Nonperforming assets	810	1,575	1,418	1,276	1,148
NPAs/total loans	4.4%	7.0%	4.8%	3.3%	2.3%
Reserve coverage of NPAs	194.0%	281.9%	125.0%	153.2%	191.7%

PER SHARE DATA (HK$)	**02**	**03**	**04**	**05**	**06**
EPS	193	312	461	566	661
DPS	116	125	185	226	265
Effective payout ratio (%)	*60%*	*40%*	*40%*	*40%*	*40%*
BVPS	948	1,390	1,729	2,069	2,730

BALANCE SHEET RATIOS	**02**	**03**	**04**	**05**	**06**
Loan-to-deposit	52.0%	56.9%	74.5%	96.1%	123.1%
Equity to assets	9.9%	12.9%	14.9%	17.1%	21.0%
Tier 1 CAR	21.6%	23.3%	27.1%	33.5%	36.7%
Total CAR	25.4%	26.8%	41.4%	43.0%	44.9%

VALUATION	**02**	**03**	**04**	**05**	**06**
Price to book value	3.7x	2.5x	2.0x	1.7x	1.3x
Price to earnings	18.1x	11.2x	7.6x	6.2x	5.3x
Price to underlying profit	13.5x	6.5x	5.9x	4.8x	4.2x
Yield at current price (%)	3.31	3.56	5.27	6.47	7.56

LOAN MIX	**02**	**03**	**04**	**05**	**06**
Consumer (%)	34.0	38.0	44.8	47.8	50.7
SME (%)	28.0	35.0	32.4	32.1	31.6
Corporate (%)	32.0	24.0	18.8	15.8	13.1
Commercial (%)	6.0	3.0	4.1	4.3	4.6

PROFITABILITY RATIOS (%)	**02**	**03**	**04**	**05**	**06**
Net interest margin	4.51	6.09	7.04	7.20	6.90
Yield on assets	15.37	12.87	10.61	10.43	9.68
Cost of liabilities	(11.73)	(7.77)	(4.37)	(4.24)	(4.11)
Non-int. inc (% Op income)	17.67	36.93	25.53	28.53	32.23
Cost to income	47.99	40.60	41.68	38.93	38.82
Overhead	2.01	2.68	5.04	5.83	6.31
ROA	1.90	3.07	4.12	4.77	5.27
ROE	21.48	26.65	29.58	29.81	27.57

GROWTH RATES (%,YoY)	**02**	**03**	**04**	**05**	**06**
Pre-provision earnings	91.9%	108.6%	9.1%	23.3%	15.5%
Net profit	31.0%	61.4%	48.1%	22.7%	16.8%
EPS	31.0%	61.4%	48.1%	22.7%	16.8%
DPS	296.2%	7.4%	48.2%	22.7%	16.8%
Net Loans	70.3%	8.9%	51.3%	32.5%	33.1%
Assets	-11.0%	12.3%	8.4%	4.0%	7.6%
Deposits	-12.3%	13.2%	-1.1%	1.6%	3.0%

BCA

Improving asset mix

Rating: BUY

Net interest income up 23% YoY in 1Q04…

BCA reported its 1Q04 results with net profit up 61% YoY to Rp768bn primarily due to its ability to rein in expenses. Net interest income increased by 23% YoY in 1Q04, as the decline in interest income of 16% YoY was offset by a larger decline in interest expenses of 39% YoY. As compared with 4Q03, BCA saw its net interest income improve as well, increasing by 11% QoQ thanks to widening margins.

Cost-to-income ratio fell to 44% in 1Q04 due to flat operating expenses

In a positive surprise, after a few years of high operating expense increases (50% YoY in 2001, 26% YoY in 2002 and 13% YoY in 2003), BCA was able to control its operating expenses in 1Q04. Operating expenses were flat YoY, as opposed to our forecast of a 13% YoY increase in operating expenses in full-year 2004. As a result, BCA saw its cost-to-income ratio improve to 44% in 1Q04, from 52% in 2003. Our previous forecasts were based on a cost-to-income ratio of 48% in 2004, which has been downgraded to 43% on our revised forecasts.

Loan growth up 2% QoQ in 1Q04

Similar to Danamon (BDMN IJ/JK, Rp3,375, BUY, Target price: Rp4,200), BCA saw weak loan growth in 1Q04. Its loan books increased by Rp477bn in 1Q04, up a mere 2% QoQ from December 2003 levels. However, if we were to compare with 1Q03, loan growth was a high 35% YoY.

BCA expects new 2004 loans to be driven by corporate sector

BCA recently indicated during our company visit that it is expecting the corporate sector to drive its new lending in 2004. It expects corporate lending to account for 40-45% of new loans to be booked in 2004, with small-to-medium companies accounting for 30-35% and consumer loans 20-30% of new lending.

…particularly to state-owned companies

BCA indicated that it had seen strong loan demand, particularly from state-owned companies. State banks are unable to lend further to the state-owned companies as the exposure already reaches their legal lending limit in certain cases. As a result, state-owned companies have to seek alternative funding from private banks such as BCA. Additionally, our view is that BCA is able to grow strongly in corporate lending due to its competitive loan pricing thanks to it having the lowest cost of funds. BCA is lending as low as 10-11% as compared to other banks still pricing their corporate loans at 12-13%.

BCA optimistic new lending will accelerate in 2H04

Management is optimistic that BCA will be able to grow its loan books by Rp8-10tr in 2004, translating into 27-34% YoY growth, in line with our estimates. Similarly, BCA's loan growth was weak in 1Q03, but it was able to book substantial loans in 4Q03, ending the year with close to Rp8tr in new loan disbursement (37% YoY).

Target price maintained as PER is already above Danamon and BII's

On the back of lower operating expenses, we have upgraded our 2004F net profit by 11% to Rp3.08tr and 2005F net profit by 13% to Rp3.66tr. We maintain our BUY rating for BCA, as we expect the bank to benefit from falling interest rates in terms of strong loan growth, and hence an improving earning assets mix and a lower cost of funds. As a result, despite our forecast upgrades, we maintain our target price of Rp5,000, reflecting a 2004F PER of 10.0x and P/BV of 2.2x, already above our targeted 2004 PERs of 9.0x-9.2x for Danamon and BII.

Bank Central Asia

Indonesia

Share Price:	3,925	**Reuters Code:**	BBCA.JK	**Shares Outstanding**	6182
52 Week Price Range:	2,350 - 4,000	**Bloomberg Code:**	BBCA IJ	**Market Cap (US$m)**	2,872

INCOME STATEMENT (Rpbn)	**02**	**03**	**04F**	**05F**	**06F**
Interest income	13,994	12,179	10,898	11,963	13,479
Interest expense	-8,530	-6,842	-4,390	-4,305	-4,546
Net interest income	**5,464**	**5,337**	**6,508**	**7,658**	**8,934**
Non-interest income	1,184	1,435	1,676	1,904	2,165
Total operating income	**6,648**	**6,772**	**8,184**	**9,561**	**11,099**
Non-interest expense	-3,125	-3,532	-3,532	-3,956	-4,431
Pre provision profit	**3,523**	**3,240**	**4,652**	**5,605**	**6,668**
Loan loss provisions	-159	-120	-281	-418	-438
Non-operating income	36	20	35	35	35
Pre tax profit	**3,400**	**3,140**	**4,406**	**5,223**	**6,265**
Tax	-858	-749	-1,322	-1,567	-1,879
Net profit	**2,542**	**2,391**	**3,084**	**3,656**	**4,385**

BALANCE SHEET (Rpbn)	**02**	**03**	**04F**	**05F**	**06F**
Gross loans	21,389	29,218	38,572	52,491	67,105
Loan loss reserves	*819*	*888*	*1,069*	*1,287*	*1,525*
Net loans	20,569	28,329	37,503	51,204	65,580
Total earning assets	102,849	117,710	129,885	141,057	153,662
Other assets	14,455	15,468	16,485	16,181	15,737
Total Assets	**117,305**	**133,178**	**146,371**	**157,238**	**169,400**
Deposits	103,903	117,993	129,399	138,143	147,761
Other paying liabilities	386	234	246	258	271
Other liabilities	1,508	2,408	2,408	2,408	2,408
Total Liabilities	**105,797**	**120,635**	**132,052**	**140,808**	**150,440**
Total Equity	**11,508**	**12,626**	**14,319**	**16,429**	**18,960**
	117,305	**133,260**	**146,371**	**157,238**	**169,400**

ASSET QUALITY	**02**	**03**	**04F**	**05F**	**06F**
Nonperforming assets (Rpbn)	735	680	617	560	509
NPAs/total loans	3.4%	2.3%	1.6%	1.1%	0.8%
Reserve coverage of NPAs	111.6%	130.7%	173.3%	229.6%	299.5%

PER SHARE DATA (Rp)	**02**	**03**	**04F**	**05F**	**06F**
EPS	411	387	499	591	709
DPS	225	225	250	300	300
Effective payout ratio (%)	*55%*	*58%*	*50%*	*51%*	*42%*
BVPS	1,862	2,042	2,316	2,658	2,658

BALANCE SHEET RATIOS	**02**	**03**	**04F**	**05F**	**06F**
Loan-to-deposit	20.6%	24.8%	29.8%	38.0%	45.4%
Equity to assets	9.8%	9.5%	9.8%	10.4%	11.2%
Tier 1 CAR	26.0%	24.5%	24.6%	25.5%	23.2%
Total CAR	32.6%	32.2%	28.0%	29.2%	26.3%

VALUATION	**02**	**03**	**04F**	**05F**	**06F**
Price to book value	2.1x	1.9x	1.7x	1.5x	1.5x
Price to earnings	9.5x	10.1x	7.9x	6.6x	5.5x
Price to underlying profit	6.9x	7.5x	5.2x	4.3x	3.6x
Yield at current price (%)	5.75	5.73	6.37	7.64	7.64

LOAN MIX	**02**	**03**	**04F**	**05F**	**06F**
Consumer (%)	8.4	11.4	10.3	9.1	8.5
SME (%)	46.4	45.9	45.2	43.2	43.9
Corporate (%)	45.7	43.1	44.4	47.7	47.5
Other (%)	-	-	-	-	-
	100.5	100.4	100.0	100.0	100.0

PROFITABILITY RATIOS (%)	**02**	**03**	**04F**	**05F**	**06F**
Net interest margin	5.69	4.84	5.26	5.65	6.06
Yield on assets	14.57	11.04	8.80	8.83	9.15
Cost of liabilities	(8.69)	(6.15)	(3.54)	(3.21)	(3.17)
Non-int. inc (% Op income)	17.82	21.19	20.48	19.91	19.51
Cost to income	47.00	52.16	43.16	41.37	39.92
Overhead	2.83	2.82	2.53	2.61	2.71
ROA	2.31	1.91	2.21	2.41	2.69
ROE	23.89	19.81	22.89	23.78	24.78

GROWTH RATES (%,YoY)	**02**	**03**	**04F**	**05F**	**06F**
Pre-provision earnings	-6.0%	-8.0%	43.6%	20.5%	19.0%
Net profit	-18.5%	-5.9%	29.0%	18.5%	20.0%
EPS	-18.5%	-5.9%	29.0%	18.5%	-100.0%
DPS	0.2%	-0.2%	11.1%	20.0%	-100.0%
Net Loans	49.6%	37.7%	32.4%	36.5%	28.1%
Assets	13.7%	13.5%	9.9%	7.4%	7.7%
Deposits	14.8%	13.6%	9.7%	6.8%	7.0%

Bank Panin

Provisioning remains a wild card

Rating: Hold

1Q04 results were below expectations

Panin reported its 1Q04 results with net profit up 24% YoY to Rp113bn. On an annualised basis, 1Q04 net profit was below our 2004 profit estimate of Rp555bn primarily due to higher-than-expected provision charges. Net interest income was flat YoY, as the 6% YoY decline in interest income was offset by a 16% YoY decline in the cost of funds. However, on a quarter-on-quarter basis, net interest income improved by 37% in 1Q04 from 4Q03.

Panin booked high provisions again in 1Q04

Pre-provision profit was seen at Rp342bn in 1Q04, above our full-year 2004 forecast of Rp887bn. However, to our disappointment, Panin booked another hefty provision of Rp215bn in 1Q04, higher than our estimate of Rp101bn for full-year 2004. This took its NPL coverage to 147% as at March 2004.

Provisioning policy differs from quarter to quarter

The wild card on Panin's earnings has always been its provisioning policy. This is why we rate the bank a HOLD. Management argued that heavy provisioning was due to a reduction in Panin's taxable income as well as providing for Category 2 loans or special mention loans (loans that are over 90 days interest overdue). To make things worse, Panin’s provisioning policy also differs from quarter to quarter. In 4Q03, the bank wrote back provisions of Rp40bn but then provided substantially again in 1Q04.

Taking into account the Category 2 loans, Panin's NPL coverage is lower at 58%. However, Panin's Category 2-5 NPLs showed a decline from 26.3% in December 2003 to 22.6% in March 2004; hence, we would argue that theoretically Panin does not have to book more provisions to increase its NPL coverage.

After contracting in 2003, loan growth did pick up in 1Q04

Whereas Panin's loans contracted in 2003, its loan growth picked up by 8% QoQ in 1Q04 (or 49% YoY), which is an encouraging trend. However, details on what is driving the loan growth are not yet available.

Lower 2004-05 profit forecasts by 13%

We have downgraded our profit forecast by 13% in 2004 to Rp478bn to reflect a higher provision charge. In our revised forecasts, we are assuming a provision charge of Rp303bn, bringing its NPL coverage (including Category 2 loans) to 71%. We have also lowered our 2005 profit forecasts by 14% to Rp571bn, again on the back of higher provision charges.

Panin is expensive on PER as its ROE is low

While we have a positive outlook on the banking sector, we maintain our HOLD rating on Panin due to the uncertainty over its provisioning policy. We also maintain our target price of Rp350, which is cheap on 2004F P/BV of 1.3x, but expensive on 2004F PER of 10.9x due to Panin’s low ROE. In comparison, BII and Danamon are trading on 2004F PER of 6.5x and 7.4x respectively, significantly lower than Panin. As the banks all have excess capital, we believe that it would be more appropriate to focus on PER in valuing the banks, as this would measure how efficient the management is in running the assets.

Panin Bank

Indonesia

Share Price:	370	**Reuters Code:**	PNBN.JK	**Shares Outstanding**	14,889
52 Week Price Range:	205 - 385	**Bloomberg Code:**	PNBN IJ	**Market Cap (US$m)**	652

INCOME STATEMENT	**02**	**03**	**04F**	**05F**	**06F**
Interest income	2,954	1,983	1,765	2,085	2,499
Interest expense	-1,912	-893	-618	-712	-828
Net interest income	**1,043**	**1,091**	**1,147**	**1,374**	**1,671**
Non-interest income	681	668	501	479	573
Total operating income	**1,723**	**1,759**	**1,648**	**1,853**	**2,244**
Non-interest expense	-372	-520	-662	-773	-928
Pre provision profit	**1,351**	**1,239**	**987**	**1,080**	**1,316**
Loan loss provisions	-1,184	-743	-303	-264	-343
Non-operating income	-28	5	0	0	0
Pre tax profit	**139**	**500**	**683**	**816**	**973**
Tax	-39	-82	-205	-245	-292
Net profit	**101**	**419**	**478**	**571**	**681**

BALANCE SHEET	**02**	**03**	**04F**	**05F**	**06F**
Gross loans	9,751	8,534	10,556	13,193	16,626
Loan loss reserves	*881*	*873*	*523*	*473*	*423*
Net loans	8,870	7,661	10,034	12,720	16,204
Total earning assets	13,428	15,554	18,148	21,077	24,826
Other assets	2,513	3,303	2,963	3,225	3,533
Total Assets	**15,941**	**18,857**	**21,111**	**24,301**	**28,359**
Deposits	10,976	11,606	13,495	15,842	18,764
Other paying liabilities	1,002	1,877	1,877	1,877	1,877
Other liabilities	461	1,671	1,658	1,957	2,574
Total Liabilities	**12,439**	**15,154**	**17,030**	**19,677**	**23,215**
Total Equity	**3,502**	**3,703**	**4,080**	**4,625**	**5,145**

ASSET QUALITY	**02**	**03**	**04F**	**05F**	**06F**
Nonperforming assets	735	680	617	560	509
NPAs/total loans	7.5%	8.0%	5.8%	4.2%	3.1%
Reserve coverage of NPAs	120.0%	128.3%	84.7%	84.3%	83.0%

PER SHARE DATA (Rp)	**02**	**03**	**04F**	**05F**	**06F**
EPS	7	28	32	38	46
DPS	7	21	24	29	34
Effective payout ratio (%)	*100%*	*75%*	*75%*	*75%*	*75%*
BVPS	235	249	274	311	311

BALANCE SHEET RATIOS	**02**	**03**	**04F**	**05F**	**06F**
Loan-to-deposit	88.8%	73.5%	78.2%	83.3%	88.6%
Equity to assets	22.0%	19.6%	19.3%	19.0%	18.1%
Tier 1 CAR	26.7%	19.6%	33.4%	31.2%	28.2%
Total CAR	32.9%	30.4%	45.4%	42.1%	38.1%

VALUATION	**02**	**03**	**04F**	**05F**	**06F**
Price to book value	1.6x	1.5x	1.4x	1.2x	1.2x
Price to earnings	54.7x	13.2x	11.5x	9.6x	8.1x
Price to underlying profit	4.1x	4.4x	5.6x	5.1x	4.2x
Yield at current price (%)	1.83	5.70	6.51	7.78	9.27

LOAN MIX	**02**	**03**	**04F**	**05F**	**06F**
Consumer (%)	25.0	26.0	28.0	30.0	30.0
SME (%)	29.1	30.0	30.0	30.0	30.0
Corporate (%)	45.9	44.0	42.0	40.0	40.0
Other (%)	-	-	-	-	-

PROFITABILITY RATIOS (%)	**02**	**03**	**04F**	**05F**	**06F**
Net interest margin	5.82	7.20	6.54	6.83	7.14
Yield on assets	16.49	12.97	10.06	10.37	10.68
Cost of liabilities	(12.38)	(7.01)	(4.28)	(4.30)	(4.32)
Non-int. inc (% Op income)	39.50	37.99	30.39	25.86	25.54
Cost to income	21.58	29.56	40.16	41.73	41.34
Overhead	1.88	2.99	3.31	3.40	3.52
ROA	0.51	2.41	2.39	2.52	2.59
ROE	2.89	11.62	12.29	13.12	13.94

GROWTH RATES (%,YoY)	**02**	**03**	**04F**	**05F**	**06F**
Pre-provision earnings	82.8%	-8.3%	-20.4%	9.4%	21.9%
Net profit	44.9%	315.5%	14.2%	19.5%	19.2%
EPS	44.9%	315.5%	14.2%	19.5%	19.2%
DPS	N/A	211.6%	14.2%	19.5%	19.2%
Net Loans	8.9%	-13.6%	31.0%	26.8%	27.4%
Assets	-32.4%	18.3%	11.9%	15.1%	16.7%
Deposits	-37.1%	5.7%	16.3%	17.4%	18.4%

BII

Turnaround story

Rating: BUY

Benefits from the new management

Similar to Danamon, we expect BII to benefit from the new management appointed by new controlling shareholder Sorak (Temasek/Kookmin bank) in late 2003. The Sorak consortium acquired a 51% shareholding in BII at end-October 2003, paying Rp82 per share. The split within the Sorak consortium is 50% Asia Financial Holdings (the financial arm of Temasek Holdings of Singapore), 25% Kookmin Bank of Korea, 20% ICB Financial Group of Malaysia (headed by Daim Zanuddin, former Minister of Finance) and 5% Barclays Bank of United Kingdom.

Expects Temasek to increase its shareholding

This translates into an effective ownership of 25.5% by Temasek Holdings. As was seen with Danamon, where Temasek subsequently increased its shareholding to 54% from an initial 43% by buying more shares from the market, we expect Temasek would similarly increase its ownership in BII to a controlling 51% in the medium term. We also expect BII to display strong corporate governance in tandem with its owner.

Improving earnings asset mix due to strong loan growth

BII was behind its peers in terms of recapitalisation by the government; hence, its lagging recovery. Despite growing its loan books only in 2003, BII managed to achieve an outstanding loan growth of 81% YoY and 10% QoQ in 1Q04 (34% YoY), ahead of its peers partly due to a lower base. We expect the new management to push forward the strong asset growth, leading to an improved earning asset mix.

1Q04 profit above expectation, up 294% YoY

BII's 1Q04 net profit rose 294% YoY to Rp267bn, coming in above ING's estimate. Net interest income grew 247% YoY thanks to a lower cost of funds. Management has reduced BII's time deposit rates by 150bp since coming on board in December 2003.

Focusing on middle-income consumer segment

The new management expects to finalise their new banking model over the next few months but the focus remains on leveraging on the bank's valuable consumer banking franchise. In terms of target market, the focus remains on the mass affluent consumer market, providing car loans, mortgages, credit cards, and other new products possibly including wealth management and bancassurance.

Focusing on SME lending

Management's approach in the corporate segment is selective lending, for example, to multinational companies. In addition, they plan to focus on SME lending, as they see strong potential in this segment despite competition in this segment from almost every other bank. BII's SME loans did increase by 149% YoY in 2003.

Strong growth prospects

We have upgraded our net profit forecasts by 33% in 2004 and 36% in 2005. This does not factor in the possibility of BII acquiring a consumer finance company to propel its growth and boost its margins. During our recent meeting with senior management, they indicated that BII may be looking at acquisition opportunities to propel growth. Although we have yet to confirm this with management, we understand that BII is talking to a consumer finance company, Wahana Ottomitra Multiartha (WOM), which has about Rp1.3tr of consumer finance receivables.

BII remains our top pick in the sector

The strong 1Q04 results reiterate our view that the bank is turning around strongly and we expect BII to continue to benefit from the new strategy under the direction of the new management. BII saw its ROE improve sharply to 53% in 1Q04, the highest in the sector. Despite the recent strong performance, BII's valuation remains undemanding. It is trading on a 2004F PER of 6.3x, even cheaper than state bank Mandiri, which is trading on a 2004F PER of 6.9x.

Bank Internasional Indonesia — Indonesia

Share Price:	150	**Reuters Code:**	BNII.JK	**Shares Outstanding**	47,783
52 Week Price Range:	70 - 150	**Bloomberg Code:**	BNII IJ	**Market Cap (US$m)**	848

INCOME STATEMENT	**02**	**03**	**04**	**05**	**06**
Interest income	3,088	3,343	3,079	3,347	4,009
Interest expense	-3,138	-2,324	-1,214	-1,084	-1,203
Net interest income	**-50**	**1,019**	**1,865**	**2,263**	**2,805**
Non-interest income	614	703	953	1,003	1,213
Total operating income	**564**	**1,722**	**2,818**	**3,267**	**4,019**
Non-interest expense	-1,121	-1,333	-1,442	-1,586	-1,695
Pre provision profit	**-556**	**389**	**1,376**	**1,680**	**2,323**
Loan loss provisions	677	-114	-232	-122	-181
Non-operating income	13	-5	0	0	0
Pre tax profit	**133**	**270**	**1,144**	**1,558**	**2,142**
Tax	-1	39	0	-156	-643
Net profit	**132**	**309**	**1,144**	**1,402**	**1,499**

BALANCE SHEET	**02**	**03**	**04**	**05**	**06**
Gross loans	5,668	10,232	14,867	20,989	30,042
Loan loss reserves	*560*	*605*	*838*	*960*	*1,141*
Net loans	5,108	9,626	14,029	20,029	28,900
Total earning assets	26,010	20,192	15,264	13,874	12,272
Other assets	10,315	14,537	19,145	23,948	29,267
Total Assets	**36,325**	**34,729**	**34,409**	**37,822**	**41,539**
Deposits	29,148	28,651	28,910	31,482	34,450
Other paying liabilities	2,113	499	452	452	452
Other liabilities	2,088	2,219	1,000	1,000	1,000
Total Liabilities	**33,348**	**31,369**	**30,363**	**32,934**	**35,902**
Total Equity	**2,977**	**3,360**	**4,046**	**4,888**	**5,637**

ASSET QUALITY	**02**	**03**	**04**	**05**	**06**
Nonperforming assets	510	621	694	625	562
NPAs/total loans	9.0%	6.1%	4.7%	3.0%	1.9%
Reserve coverage of NPAs	109.8%	97.5%	120.7%	153.7%	203.0%

PER SHARE DATA (HK$)	**02**	**03**	**04**	**05**	**06**
EPS	3	6	24	29	31
DPS	-	-	10	12	16
Effective payout ratio (%)	*0%*	*0%*	*40%*	*40%*	*50%*
BVPS	62	70	85	102	118

BALANCE SHEET RATIOS	**02**	**03**	**04**	**05**	**06**
Loan-to-deposit	19.4%	35.7%	51.4%	66.7%	87.2%
Equity to assets	8.2%	9.7%	11.8%	12.9%	13.6%
Tier 1 CAR	19.5%	13.2%	19.3%	18.4%	17.2%
Total CAR	33.2%	22.2%	28.3%	27.4%	26.2%

VALUATION	**02**	**03**	**04**	**05**	**06**
Price to book value	2.4x	2.1x	1.8x	1.5x	1.3x
Price to earnings	54.2x	23.2x	6.3x	5.1x	4.8x
Price to underlying profit	-12.9x	18.4x	5.2x	4.3x	3.1x
Yield at current price (%)	-	-	6.38	7.83	10.46

LOAN MIX	**02**	**03**	**04**	**05**	**06**
Credit cards (%)	8.6	7.3	7.5	7.5	7.3
Other consumer (%)	13.3	16.4	19.4	22.0	24.7
SME (%)	24.7	34.1	35.2	37.4	39.2
Corporate (%)	53.4	42.2	37.9	33.2	28.8

PROFITABILITY RATIOS (%)	**02**	**03**	**04**	**05**	**06**
Net interest margin	(0.17)	3.35	6.31	7.16	7.47
Yield on assets	10.62	10.97	10.42	10.59	10.68
Cost of liabilities	(9.87)	(7.42)	(3.93)	(3.43)	(3.55)
Non-int. inc (% Op income)	(1,229.00)	68.91	51.07	44.33	43.24
Cost to income	198.58	77.39	51.17	48.56	42.19
Overhead	3.35	3.75	4.17	4.39	4.27
ROA	0.40	0.87	3.31	3.88	3.78
ROE	4.44	9.76	30.90	31.39	28.49

GROWTH RATES (%,YoY)	**02**	**03**	**04**	**05**	**06**
Pre-provision earnings	N/M	N/M	253.4%	22.1%	38.2%
Net profit	N/M	133.7%	270.0%	22.6%	6.9%
EPS	N/M	133.7%	270.0%	22.6%	6.9%
DPS	N/A	N/A	N/A	22.6%	33.7%
Net Loans	8.8%	88.4%	45.7%	42.8%	44.3%
Assets	18.9%	-4.4%	-0.9%	9.9%	9.8%
Deposits	16.9%	-1.7%	0.9%	8.9%	9.4%

Philippines

In dire need of a catalyst

Rating: Neutral

Philippine banks

Loan growth overall remains sluggish

Strong loan growth has remained elusive for the banking industry since the start of the year. While on YoY basis there has been some growth over the last few months (see figure below), it remains at an unspectacular rate of around 3-5%. This is a disappointment, especially considering the current low interest rate environment. The culprit is that utilisation levels for manufacturing firms in the Philippines remain fairly low, at below the 80% level.

Since the 1997 crisis, there has yet to be a strong rise in demand to boost manufacturing utilisation to levels that would require significant new capital expenditure. Furthermore, banks have to grapple with an increasing incidence of corporates deciding to raise funds through bonds rather than debt. Most of the large corporates reason that raising bonds is often easier to pull off. Meanwhile, medium-scale enterprises have yet to recover fully from the crisis, and few of them meet the banks' more stringent credit standards.

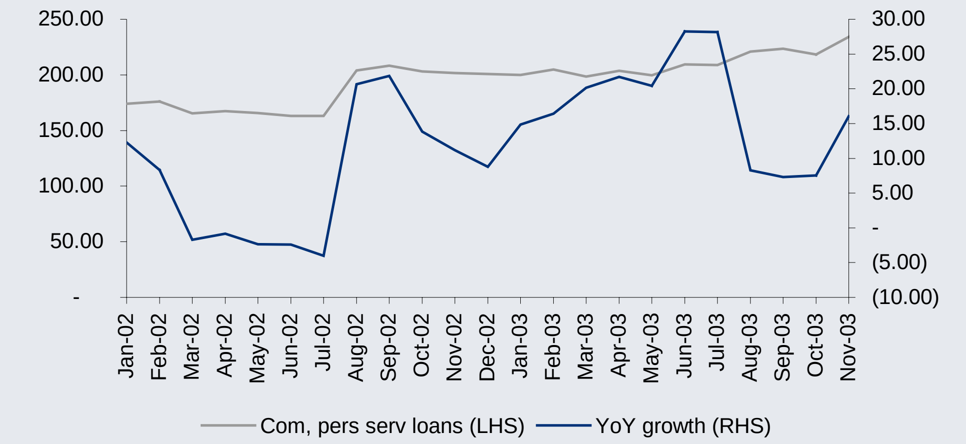
Fig 236 Loans

Source: BSP

Consumer loans have done better, but remain too small

An exception to the sluggish growth in total loans has been the growth in consumer lending. However, this is still a very small contributor, accounting for less than 5% of bank loans. The best proof of the relative insignificance of consumer loans is the fact that the Central Bank (BSP) does not keep track of this as a separate category. This is just part of 'community and personal services' loans, which has, nonetheless, exhibited steady growth in the last two years (see figure below) at a much faster pace than the growth in total loans. However, it must be pointed out that this category accounts for only 16% of total loans. Thus, even the 15-20% average growth that it experienced throughout FY03 is not enough to make a major difference to total loan growth. Furthermore, we believe the strong growth potential of consumer lending is often not realised, as many banks have not configured their operations to efficiently engage in this business.

Fig 237 Community and personal service loans



Source: BSP

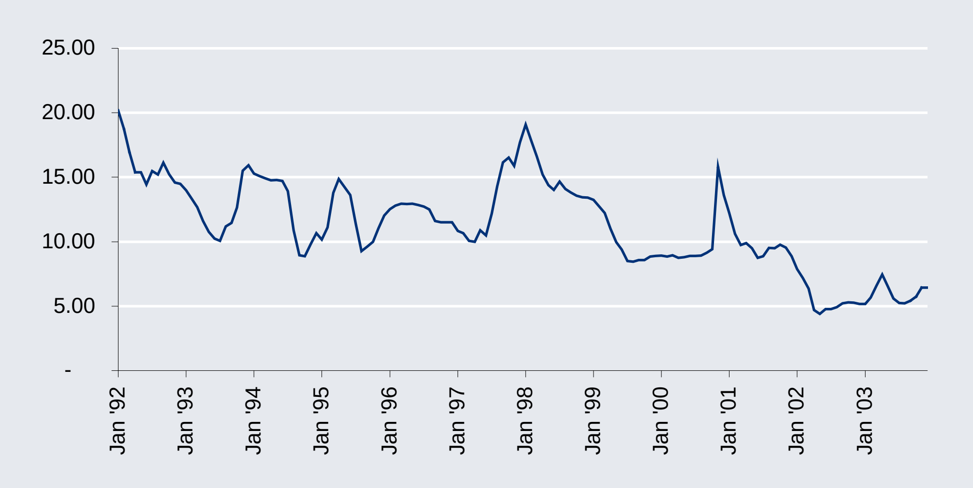
Loan growth to remain modest

We forecast loans to grow by an average of 5% annually in FY04-06. The reason for this is that we estimate overall economic growth will not be strong enough to create a strong surge in corporate loans. Much of the growth would be from consumer loans, which we expect to grow at double digits. Large banks that have a wide branch network are best positioned to capture the strong loan growth in this segment. At the top of this list would be BPI, which has the largest network, and has operations that are already properly configured to capture the demand from this area.

Sustainability of recent margin improvement still suspect

Net interest margins have improved slightly in FY03, in line with the slight increase in interest rates. The large drop in rates during early FY02 (see figure below), coupled with the continued lack of loan demand, resulted in a deterioration in net interest margins. For example, BPI, which enjoys one of the highest net interest margins in the industry, had to suffer through a 40bp decline in FY02 to 3.6%. The problem is that banks have much less leeway in reducing deposit costs, with some 30% of deposits already getting paid at a very low 1% rate of interest per annum. In our view, the fairly high net interest margin coupled with still sluggish loan demand is likely to lead to a downward bias for net interest margins over the long term. However, our expectation of a slight increase in the 91-day T-bill rate in FY04 of around 70bp should potentially result in a near-term rise in net interest margins or, at the very least, stabilisation.

Fig 238 91-day T-bill rate

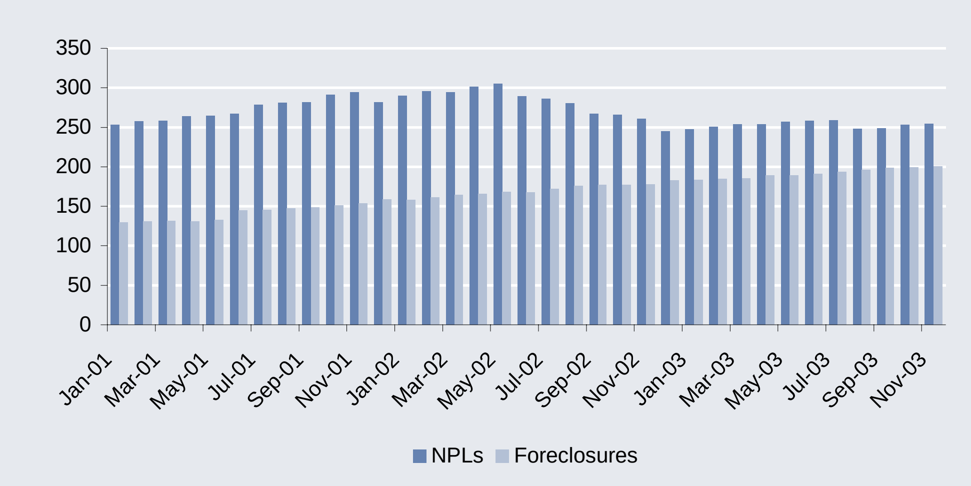


Source: Bureau of Treasury

Asset quality remains a problem, even though NPLs have declined

Asset quality remains a pressing issue for the banks, even though the headline non-performing loan (NPL) ratio has declined to around 15% from the peak of 19%. While NPLs of P255bn as of November 2003 represent a decline of 16% or P51bn from the peak in May 2002, foreclosures have increased steadily since then (see figure below). Foreclosures as of November 2003 totalled P200bn, an increase of 19% or P32bn from the May 2002 level. This indicates that while there are relatively few new NPLs, a large portion of the existing NPLs have merely become foreclosures rather than resolved outright. The sharper drop in NPLs relative to the increase in foreclosures nonetheless means that asset quality improvement is materialising. However, this should be expected given the drop in interest rates and, in our view, asset quality should be improving even more. Part of the reason is the continued reluctance of Philippine banks to undertake wholesale cleaning of their balance sheets. Not a single bank has taken advantage of the Special Purpose Vehicle (SPV) Law, which was designed to accelerate the improvement in asset quality. Recall that the SPV Law was set up to give banks incentives to dispose of distressed assets more easily, through such measures as exemption from transaction taxes. Ultimately the main reason for the non-usage of the SPV Law is attributable to the banks' lingering unwillingness to sell their foreclosures and NPLs at significant discounts. Thus far we do not see any indication on the part of the major banks that they will change their stance by aggressively disposing of their foreclosures even at significant losses.

Fig 239 NPLs



Source: BSP

Provisioning can be better

Provisioning for the banks has risen steadily to around 50% of NPLs, from a level of around 40% three years ago (see figure below). In our view, the provisioning cycle for most banks has already peaked, with new NPLs much lower than a few years earlier. However, when compared against non-performing assets (NPAs), which include foreclosures, banks' provisioning has declined slightly. In our opinion, an increase in provisioning relative to NPAs would depend primarily on the BSP. The regulator would probably need to be more stringent in its provisioning requirements for foreclosures.

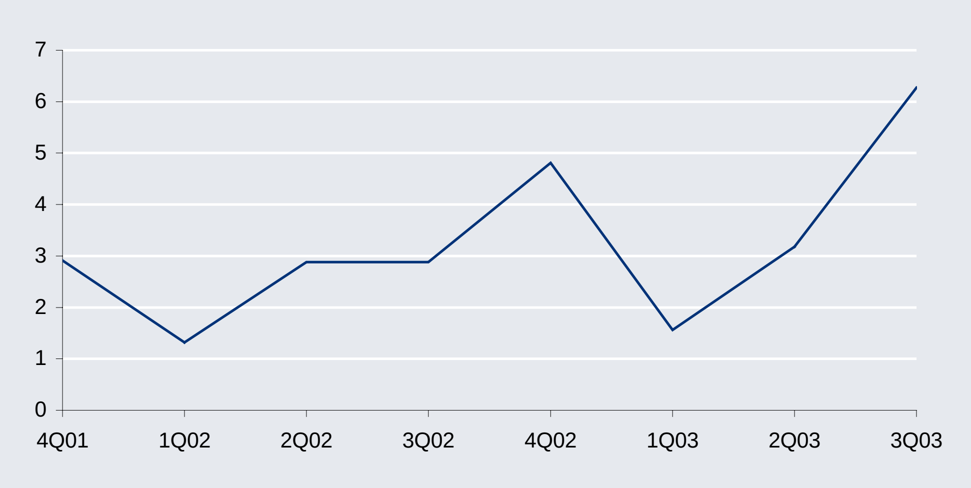
Fig 240 Provisioning (%)

Source: BSP

End result is low ROEs

The combination of sluggish loan demand and relatively poor asset quality results has resulted in a continuing low level of profitability for the overall banking sector (see figure below). Philippine banks' ROEs remain firmly in the single digits. Thus, we believe the current valuations of our banking sector universe of 1.4x P/BV, 12x PER and 10x P/UP for FY04F are relatively unattractive both on a regional basis and against other companies in the Philippines. Thus, we rate Philippine banks as NEUTRAL on a regional perspective. Our only BUY among the banks is BPI (BPI PM, P52, Target price: P60), which is the most attractively valued in the sector on an earnings basis and has more than double the profitability of its closest competitor. It also provides an attractive yield of 5%, which is easily the highest in the sector. In terms of valuations, the Philippine banks are still nearer their trough than their peak levels. Note that in terms of P/BV, the sector has traded at a peak of 3.5x and a trough of 1.1x. However, the peak was achieved prior to the 1997 crisis, when sector ROEs were at double-digit levels and the NPL ratio was in the low single digits. As expected, there are several smaller banks in the Philippines that trade at much lower valuations, with P/BV below 1.0x and single-digit PERs, based on consensus estimates. These include banks such as Security Bank (SECB PM, Not rated) and Rizal Commercial and Banking Corp (RCB PM, Not rated).

Fig 241 ROE – banking industry



Source: BSP

Consolidation is the best way out

Thus, for earnings prospects and valuations for the banks to be more compelling, the banking industry needs to undertake a major consolidation. We believe that M&A activity needs to accelerate. Bank mergers would likely result in greater cost efficiency among the banks, an area where the Philippine banks have clearly lagged their regional counterparts. Furthermore, this may result in a wholesale NPA clean up. This would be positive in terms of future earnings, as yields from earning assets should show improvement after the initial pain from sales at likely discounted levels. However, the recent success of several banks in being able to raise tier 2 capital may result in the management of banks deciding to stay put and not actively buy each other out. A possible breakthrough was the recent purchase by Banco De Oro (BDO PM, Not rated) of a 29% stake in Equitable PCI Bank (EBC PM, P41, HOLD, Target price: P40) that was owned by the Social Security System (SSS). If BDO were to successfully acquire other shareholders of EBC to effect a merger, this could compel other large banks to make their own acquisitions to retain their size advantage.

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BPI

Standing out in the Philippines

Rating: BUY

BPI reported FY03 net income of P5.7bn, an increase of 10% over the previous year. This is slightly ahead of our forecast of P5.47bn (+5.8% YoY), which had been about in line with consensus estimates. The positive results were due mainly to a better than expected performance for net interest margins and good cost control. The net interest margin performance was able to compensate for a slight shortfall in loan growth. BPI was able to bring down operating expenses in FY03 by 5% relative to the previous year.

Aside from some improvement in lending activity, BPI also appeared to get an earnings boost from continued improvements in its cost efficiency. The decline in operating expenses was mainly due to reduced premises costs and lower operating expenses, as BPI continued its branch rationalisation. The bank continues to convert a large part of its branch network from full-size into kiosk-type branches. As of the end of 3Q03, 235 out of a total of 708 branches had been converted into kiosks. Thus, BPI should be able to maintain its cost efficiency advantage over its peer banks. We estimate its cost-to-asset ratio at 2.8% and cost-to-income ratio at 55%, the best among the large banks.

BPI, in our view, is best positioned to grow its consumer loans substantially, mainly on the bank's experience in this segment and it having the largest network of branches in the Philippines. Consumer loans already account for 25% of the total loan portfolio, which is the highest among the major banks. A rising consumer loan mix should be positive, as these typically have higher yields and should be able to compensate for the likely continued weakness in demand for corporate loans.

Most recently, various media reports have said that there may soon be changes in top management at BPI. Chairman Jaime Zobel de Ayala is retiring and will be replaced by son Jaime Augusto Zobel de Ayala. More importantly, President Xavier Loinaz, who has reached retirement age, may be elevated to vice chairman and relinquish his old post to SEVP and COO Aurelio Montinola III. We would view positively Montinola taking over from Loinaz, given his long experience in the bank and the fact that his background in consumer lending would be ideal, as this has been identified as a growth area.

We are forecasting 5% loan growth for BPI in FY04, which we estimate would come mostly from consumer loans. Internally, the bank has raised its loan growth targets to 5-10% in FY04 (from 5% previously). We are forecasting stronger loan growth after the May 2004 elections, when political uncertainties are reduced.

BPI's asset quality remains a strength. As of the end of FY03, its NPL ratio was 6.5%, much lower than the previous year's 9.6%. This is less than half of the sector average, although it is worth noting this uses BSP's relaxed definition. However, the rise in foreclosures is still a concern; foreclosures stood at P17.1bn as of December 2003. While only 4.1% of assets, this is an increase over FY02's P14.9bn.

We maintain our BUY rating on BPI, which remains a standout among the Philippine banks. Valuations of 9x FY04F P/UP and 13x FY04F PER are attractive, given the bank's FY04F ROE of 12% and FY04F dividend yield of 4%.

Bank of the Philippine Islands

Philippines

Share Price:	46.00	**Reuters Code:**	BPI.PS	**Shares Outstanding**	1901
52 Week Price Range:	33.50 - 52.50	**Bloomberg Code:**	BPI.PM	**Market Cap (US$m)**	1,572

INCOME STATEMENT	**01**	**02**	**03**	**04F**	**05F**
Interest income	33,850	24,145	23,532	24,831	26,538
Interest expense	18,860	11,141	10,310	10,588	11,216
Net interest income	**14,991**	**13,004**	**13,222**	**14,243**	**15,322**
Non-interest income	6,631	6,964	6,977	7,326	7,692
Total operating income	**21,622**	**19,968**	**20,199**	**21,569**	**23,014**
Non-interest expense	12,668	12,157	11,634	11,867	12,104
Pre provision profit	**8,954**	**7,811**	**8,565**	**9,702**	**10,910**
Loan loss provisions	2,692	1,200	1,200	1,257	1,336
Non-operating income	0	0	0	0	0
Pre tax profit	**6,262**	**6,611**	**7,365**	**8,445**	**9,574**
Tax	1,010	1,439	1,691	1,858	2,106
Net profit	**5,253**	**5,172**	**5,674**	**6,587**	**7,468**

BALANCE SHEET	**01**	**02**	**03**	**04F**	**05F**
Gross loans	202,905	201,673	204,413	214,480	231,006
Loan loss reserves	*14,868*	*14,418*	*15,337*	*15,950*	*16,594*
Net loans	188,036	187,255	189,076	198,530	214,412
Total earning assets	154,534	158,034	170,201	181,490	189,267
Other assets	55,226	56,985	59,746	65,202	71,177
Total Assets	**397,796**	**402,274**	**419,023**	**445,222**	**474,857**
Deposits	316,676	314,919	324,512	340,738	357,774
Other paying liabilities	6,066	7,311	7,916	7,995	8,075
Other liabilities	26,681	29,263	34,454	41,976	51,807
Total Liabilities	**349,246**	**350,634**	**365,911**	**389,738**	**416,685**
Total Equity	**48,373**	**50,781**	**52,141**	**54,512**	**57,201**

ASSET QUALITY	**01**	**02**	**03**	**04F**	**05F**
Nonperforming assets	35,779	38,967	35,603	36,297	36,566
NPAs/total loans	17.6%	19.3%	17.4%	16.9%	15.8%
Reserve coverage of NPAs	41.6%	37.0%	43.1%	43.9%	45.4%

PER SHARE DATA (P)	**01**	**02**	**03**	**04F**	**05F**
EPS	2.76	2.72	2.99	3.47	3.93
DPS	2.62	1.44	2.60	2.22	2.22
Effective payout ratio (%)	*95%*	*53%*	*87%*	*64%*	*56%*
BVPS	25.64	26.09	27.08	28.06	30.11

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04F**	**05F**
Loan-to-deposit	59%	59%	58%	58%	60%
Equity to assets	12.2%	12.6%	12.4%	12.2%	12.0%
Total CAR	18.4%	20.0%	19.0%	18.0%	17.8%

VALUATION	**01**	**02**	**03**	**04F**	**05F**
Price to book value	1.8x	1.8x	1.7x	1.6x	1.5x
Price to earnings	16.7x	16.8x	15.4x	13.3x	11.8x
Price to underlying profit	9.8x	11.1x	10.2x	9.0x	8.0x
Yield at current price (%)	5.6	3.1	5.6	4.8	4.8

LOAN MIX	**01**	**02**	**03**	**04F**	**05F**
Mortgages (%)	13.5	14.1	15.1	15.5	15.6
Consumer (%)	10.0	10.8	11.7	12.3	12.5
SME (%)	30.3	31.1	30.3	31.7	34.7
Corporate (%)	46.2	44.0	43.0	40.5	37.3

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04F**	**05F**
Net interest margin	4.20%	3.63%	3.60%	3.70%	3.75%
Yield on assets	9.89%	7.02%	6.68%	6.72%	6.77%
Cost of liabilities	5.96%	3.45%	3.15%	3.11%	3.14%
Non-int. inc (% Op income)	30.67%	34.88%	34.54%	33.96%	33.42%
Cost to income	58.59%	60.88%	57.60%	55.02%	52.59%
ROA	1.33%	1.33%	1.33%	1.33%	1.33%
ROE	10.78%	10.43%	11.03%	12.35%	13.37%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04F**	**05F**
Pre-provision earnings	34%	-13%	10%	13%	12%
Net profit	72%	-2%	10%	16%	13%
EPS	72%	-2%	10%	16%	13%
DPS	269%	-45%	80%	-15%	13%
Net Loans	5%	0%	1%	5%	8%
Assets	1%	1%	4%	6%	7%
Deposits	7%	-1%	3%	5%	5%

Equitable PCI Bank

M&A in the offing?

Rating: HOLD

Equitable PCI Bank (EBC) may trigger a wave of M&A activity in the Philippine banking sector, after the Social Security System (SSS) agreed to sell its 29% stake in EBC to Banco De Oro (BDO PM, Not rated) at the start of the year. The SSS sold its stake at P43.50/sh, which is a 30% premium relative to the then-market price of EBC of P33.50/sh. In our view, there is a potential for renewed consolidation among the banks should BDO be able to eventually gain full control of EBC. The reason is that a combined BDO-EBC entity would result in the second-largest bank in the Philippines, marginally ahead of BPI. This could make the other banks decide to expand more aggressively through acquisitions, with their leadership being threatened.

However, we believe that expecting a merger between the two banks is far too premature. Thus far, the Go family, which exercises management control over EBC with a 28% stake, has disclosed to the media that it is not interested in selling its stake. Meanwhile another shareholder, the Government Service Insurance System (GSIS), in a media disclosure also said that it would agree to sell its 14% stake only at its acquisition price of over P90/sh.

In FY03, EBC enjoyed strong earnings growth mainly on a combination of improved net interest margins and higher non-interest income. As with most Philippine banks, loan growth for EBC remains minimal. Net loans as of 3Q03 were only 2.4% higher than at end-FY02. Making up for the sluggish loan growth was an improvement in net interest margins, which we estimate rose by 30bp YoY in 9M03 to 3.1%. This means that EBC is returning to its historical net interest margin level, which would be comparable to other banks of a similar size. Recall that the bank suffered through a large loss of deposits in late 2000 to early 2001, which resulted in a lengthy recovery process that kept its net interest margin at a depressed level in FY01 and FY02. Non-interest income has been driven primarily by a sharp rise in trading gains. These increased by 72% YoY in 3Q03, leading to a 17% YoY rise in non-interest income.

We remain concerned with EBC's asset quality. According to the bank's December 2003 statement of condition, non-performing loans (NPL) amounted to 14.8%. This would make it in line with the average 15% NPL ratio for the commercial banking sector. Combined with a growing foreclosure level of P17.4bn (6.2% of total assets) this would mean that EBC still has a lot of work to do in terms of improving its overall asset quality. To the bank's credit, it has undertaken a more aggressive disposal of its non-performing assets (NPAs) quite recently.

EBC, in our view, is fairly valued. Stripping out goodwill, it is trading at an FY03 P/BV of 1.1x. This is lower than the average for the Philippine banks of 1.5x, but is explained by its relatively low ROE. The bank has a ROE of only 3%, much lower than peer banks. Thus, on an earnings basis, EBC is trading at an FY04F PER of 20x and an FY04F P/UP of 11x. This would make it one of the highest in the Philippines in terms of earnings valuation, with the average market FY04F PER at only 13x. Thus, we rate EBC a HOLD, with our price target of P35.50/sh based on a target FY04F P/UP of 10x.

Equitable PCI Bank

Philippines

Share Price:	40.00	**Reuters Code:**	EBC.PS	**Shares Outstanding**	727
52 Week Price Range:	23.25 - 43.00	**Bloomberg Code:**	EBC.PM	**Market Cap (US$m)**	523

INCOME STATEMENT	**01**	**02**	**03**	**04F**	**05F**
Interest income	15,899	11,227	12,682	14,931	15,568
Interest expense	10,747	6,596	7,767	9,188	9,545
Net interest income	**5,152**	**4,631**	**4,615**	**5,744**	**6,023**
Non-interest income	5,544	7,080	8,548	6,918	7,211
Total operating income	**10,696**	**11,711**	**13,163**	**12,662**	**13,233**
Non-interest expense	10,313	9,954	9,376	10,078	10,311
Pre provision profit	**383**	**1,757**	**3,787**	**2,584**	**2,922**
Loan loss provisions	530	1,294	2,144	949	992
Non-operating income	0	111	-92	0	0
Pre tax profit	**-147**	**574**	**1,551**	**1,635**	**1,930**
Tax	-287	-155	686	264	293
Net profit	**140**	**729**	**1,165**	**1,372**	**1,637**

BALANCE SHEET	**01**	**02**	**03**	**04F**	**05F**
Gross loans	119,378	136,581	136,279	149,199	155,984
Loan loss reserves	*13,865*	*14,510*	*16,647*	*14,615*	*14,671*
Net loans	105,513	122,071	119,632	134,584	141,313
Total earning assets	63,444	72,873	94,627	82,216	86,327
Other assets	70,962	72,876	76,157	72,585	72,446
Total Assets	**239,919**	**267,820**	**290,416**	**289,385**	**300,086**
Deposits	141,078	160,049	185,422	176,454	185,276
Other paying liabilities	27,983	21,837	38,620	32,495	32,595
Other liabilities	30,461	44,716	24,109	36,678	36,819
Total Liabilities	**199,523**	**226,602**	**248,150**	**245,626**	**254,609**
Total Equity	**40,396**	**41,218**	**42,265**	**43,759**	**45,396**

ASSET QUALITY	**01**	**02**	**03**	**04F**	**05F**
Nonperforming assets	40,724	37,986	39,334	38,611	39,298
NPAs/total loans	34.1%	27.8%	28.9%	25.9%	25.2%
Reserve coverage of NPAs	34.0%	38.2%	42.3%	37.9%	37.3%

PER SHARE DATA (P)	**01**	**02**	**03**	**04F**	**05F**
EPS	0.19	1.00	1.61	1.89	2.25
DPS	0.00	0.00	0.00	0.00	0.00
Effective payout ratio (%)	*0%*	*0%*	*0%*	*0%*	*0%*
BVPS	32.78	34.52	36.56	39.22	42.08

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04F**	**05F**
Loan-to-deposit	75%	76%	64%	76%	76%
Equity to assets	16.8%	15.4%	14.5%	15.1%	15.1%
Total CAR	11.2%	11.0%	17.0%	13.8%	13.5%

VALUATION	**01**	**02**	**03**	**04F**	**05F**
Price to book value	1.2x	1.2x	1.1x	1.0x	1.0x
Price to earnings	207.5x	38.4x	24.9x	21.2x	17.8x
Price to underlying profit	75.9x	15.9x	7.7x	11.2x	10.0x
Yield at current price (%)	-	-	-	-	-

LOAN MIX	**01**	**02**	**03**	**04F**	**05F**
Manfacturing (%)	34.9	34.0	33.2	32.4	31.6
Whotesale and retail (%)	20.9	25.6	25.7	25.8	25.9
Real estate/comm & pers sen	11.8	10.5	11.1	11.7	12.3
Other (%)	32.5	29.9	30.1	30.2	30.2

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04F**	**05F**
Net interest margin	2.54%	2.36%	2.55%	2.54%	2.54%
Yield on assets	8.33%	6.17%	6.70%	7.06%	7.01%
Cost of liabilities	5.75%	3.78%	4.45%	4.51%	4.50%
Non-int. inc (% Op income)	51.83%	60.46%	64.93%	54.64%	54.49%
Cost to income	96.42%	85.00%	71.23%	79.59%	77.92%
ROA	0.05%	0.24%	0.43%	0.48%	0.56%
ROE	0.33%	1.79%	2.80%	3.18%	3.67%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04F**	**05F**
Pre-provision earnings	-88.1%	358.5%	115.5%	-31.8%	13.1%
Net profit	-58.0%	162.8%	59.8%	17.8%	16.7%
EPS	-58.0%	162.8%	59.8%	17.8%	16.7%
DPS	0.0%	0.0%	0.0%	0.0%	0.0%
Net Loans	-20.0%	15.7%	-2.0%	12.5%	5.0%
Assets	-14.4%	11.6%	9.0%	0.0%	3.7%
Deposits	-10.0%	13.4%	16.0%	-5.0%	5.0%

Metrobank

Asset quality still an issue

Rating: HOLD

Metrobank (MBT) was finally able to consummate a deal that would result in the sale of some P16.3bn in non-performing loans (NPLs) to an asset management company Asia Recovery Corp (unlisted). The bank first signed a memorandum of understanding (MoU) to sell the NPLs back in December 2001, but was only able to push through with the deal in November 2003 after getting Central Bank (BSP) approval. As part of the deal, MBT was able to avoid incurring a loss as the 70% discount that the NPLs were being sold at is covered by notes which would have a seven year term. MBT received cash upfront amounting to 30% of the NPLs being sold.

Even with the sale of the NPLs, MBT's asset quality continues to be a concern for us. According to the bank's March 2004 statement of condition, the NPL ratio was 13.3% at the parent-company level. This is only slightly lower than the sector average of 14%. It is also worth noting that the BSP calculation of the NPL ratio is quite lenient. Most recently, the BSP has allowed banks to strip out NPLs that have been 100% provisioned from the NPL ratio calculation. While this may be seen as a way of encouraging banks to be more aggressive in their provisioning levels, it nonetheless means that the NPL ratios reported by the BSP are understated.

Aside from NPLs, MBT also has to deal with a fairly sizeable amount of foreclosures. These totalled P27.1bn as of December 2003, equivalent to 5.7% of total assets. As a percentage of total assets, this is within the commercial banking industry average of 5.8% (based on November 2003 data).

Like most Philippine banks, MBT previously needed to raise its capitalisation. Most recently, it was able to raise US$200m in tier 2 capital in October 2003. This was used to retire the bank's first tier 2 capital raising in December 2001 amounting to US$100m. In addition, MBT raised tier 2 capital amounting to US$125m in November 2002, bringing the total amount of tier 2 capital currently on the bank's balance sheet to US$255m.

MBT recently reported FY03 unaudited net income of P3.02bn, which represented a 9.8% increase over the previous year's net income of P2.75bn. This is ahead of our forecast of P2.5bn. The variance to our forecasts was entirely outside of the core lending business. As we expected, net interest income remained sluggish by declining 8% in FY03. More than compensating for this was a 30% rise in non-interest income, which was in turn driven by strong growth in trading gains. We believe that this is not sustainable, especially given the recent steady rise in interest rates.

We continue to rate MBT a HOLD. We find MBT to be fairly valued with an FY04F PER of 17x and an FY04F P/UP of 8x. This would make it trade above the average valuation for the Philippines market and the Philippine banks. Meanwhile, its seemingly attractive 0.7x P/BV is explained by the bank's relatively low ROE. Due mainly to the drag from its large amount of NPLs and foreclosures, we estimate FY04F ROE at only 4%. Our price target for MBT remains at P30.50/sh, which is based on an FY04F P/UP of 10x.

Metrobank

Philippines

Share Price:	25.00	**Reuters Code:**	MBT.PS	**Shares Outstanding**	1635
52 Week Price Range:	23.50 - 32.00	**Bloomberg Code:**	MBT.PM	**Market Cap (US$m)**	730

INCOME STATEMENT	**01**	**02**	**03**	**04F**	**05F**
Interest income	38,307	28,905	27,295	29,872	31,047
Interest expense	25,078	15,857	15,269	16,675	17,448
Net interest income	**13,229**	**13,048**	**12,026**	**13,196**	**13,599**
Non-interest income	7,250	9,856	12,784	9,028	9,300
Total operating income	**20,479**	**22,904**	**24,810**	**22,224**	**22,899**
Non-interest expense	14,407	15,910	16,534	16,975	17,145
Pre provision profit	**6,072**	**6,994**	**8,276**	**5,249**	**5,754**
Loan loss provisions	2,873	4,643	3,527	2,008	2,244
Non-operating income	0	0	-271	0	0
Pre tax profit	**3,199**	**2,351**	**4,478**	**3,241**	**3,511**
Tax	1,088	-157	1,457	823	886
Net profit	**2,111**	**2,508**	**3,021**	**2,418**	**2,625**

BALANCE SHEET	**01**	**02**	**03**	**04F**	**05F**
Gross loans	222,993	235,896	256,227	257,324	270,646
Loan loss reserves	*15,682*	*16,001*	*18,506*	*19,508*	*20,939*
Net loans	207,311	219,895	237,721	237,816	249,707
Total earning assets	164,958	154,710	179,927	156,059	157,118
Other assets	98,457	97,858	83,257	107,888	113,283
Total Assets	**470,725**	**472,462**	**500,905**	**501,764**	**520,108**
Deposits	367,062	361,072	377,484	398,082	417,986
Other paying liabilities	26,133	30,370	40,761	30,370	30,370
Other liabilities	21,696	25,824	27,500	12,901	8,533
Total Liabilities	**414,892**	**417,266**	**445,745**	**441,353**	**456,889**
Total Equity	**51,121**	**52,906**	**55,160**	**57,778**	**60,403**

ASSET QUALITY	**01**	**02**	**03F**	**04F**	**05F**
Nonperforming assets	61,692	61,692	69,119	61,692	61,692
NPAs/total loans	27.7%	26.2%	27.0%	24.0%	22.8%
Reserve coverage of NPAs	25.4%	25.9%	26.8%	31.6%	33.9%

PER SHARE DATA (P)	**01**	**02**	**03**	**04F**	**05F**
EPS	1.29	1.53	1.85	1.48	1.61
DPS	0.00	0.40	0.40	0.80	0.80
Effective payout ratio (%)	*0%*	*26%*	*22%*	*54%*	*50%*
BVPS	31.26	32.35	33.73	35.33	36.94

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04F**	**05F**
Loan-to-deposit	56%	61%	63%	60%	60%
Equity to assets	10.9%	11.2%	11.0%	11.5%	11.6%
Total CAR	11.4%	14.0%	16.9%	12.7%	12.5%

VALUATION	**01**	**02**	**03**	**04F**	**05F**
Price to book value	0.8x	0.8x	0.7x	0.7x	0.7x
Price to earnings	19.4x	16.3x	13.5x	16.9x	15.6x
Price to underlying profit	6.7x	5.8x	4.9x	7.8x	7.1x
Yield at current price (%)	-	1.6	-	3.2	3.2

LOAN MIX	**01**	**02**	**03**	**04F**	**05F**
Manufacturing (%)	22.7	27.4	27.7	27.7	27.6
Real estate, renting (%)	20.9	22.4	23.3	23.9	24.5
Wholesale and retail (%)	19.8	18.2	18.4	18.4	18.4
Other (%)	36.6	32.1	30.6	30.0	29.5

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04F**	**05F**
Net interest margin	3.46%	3.35%	3.20%	3.24%	3.23%
Yield on assets	9.94%	7.37%	7.25%	7.35%	7.41%
Cost of liabilities	6.58%	4.04%	4.01%	3.98%	3.98%
Non-int. inc (% Op income)	35.40%	43.03%	51.53%	40.62%	40.61%
Cost to income	70.35%	69.46%	66.64%	76.38%	74.87%
ROA	0.46%	0.53%	0.65%	0.49%	0.51%
ROE	4.28%	4.82%	5.79%	4.27%	4.44%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04F**	**05F**
Pre-provision earnings	18%	15%	18%	-36%	10%
Net profit	34%	19%	20%	-20%	9%
EPS	34%	19%	20%	-20%	9%
DPS	N/M	N/M	0%	100%	0%
Net Loans	-5%	6%	8%	0%	5%
Assets	6%	0%	6%	0%	4%
Deposits	6%	-2%	4%	5%	5%

Phil National Bank Still a tough road ahead

Rating: HOLD

Philippine National Bank (PNB) recently reported its FY03 results, with net income of P168m. On the surface, PNB's positive net income is much better than our estimated net loss of P1.6bn. This is the first time since 1997 that PNB has achieved positive earnings, ending a five-year period of net losses. The better than expected earnings performance was due mainly to improvement in net interest margins and a much lower level of provisioning. PNB was able to lower its cost of funds while keeping loan yields relatively stable.

Notwithstanding the positive earnings, we continue to consider the outlook for PNB to be quite negative. The bank still has among the worst asset quality in the entire banking sector. As of December 2003, its non-performing loan (NPL) ratio was 49%, similar to the previous quarter's 50%. However, there was a marginal increase in NPLs of P0.5bn QoQ to P48.5bn. The bank has total foreclosures of P27.5bn, which is equivalent to 14% of total assets. This is an increase from the previous quarter's P27.4bn, despite PNB's efforts to dispose of foreclosures. Note that in the first nine months of FY03, PNB was able to sell off some P2bn of foreclosures. This would indicate a continuing flow of new foreclosures, usually conversions from NPLs.

PNB also joined the fray of other banks raising tier 2 capital, by raising P2.2bn (US$40m) in peso-denominated bonds in recent months. This was part of the US$140m in tier 2 capital that the board had approved. We view a successful tier 2 offering positively, as it could result in PNB's ability to remove non-performing assets from its balance sheet more aggressively. As with the other Philippine banks, we would prefer to see a wholesale sale of non-performing assets, rather than the current piecemeal mode, which could be quite lengthy and difficult to pull off successfully. At the moment, none of the Philippine banks has expressed a willingness to sell NPAs on a wholesale basis due to their aversion to the large discounts necessary for these to materialise.

PNB is in a unique position, with two major shareholders, Lucio Tan and the Philippine government, each holding an effective 45% stake. This was a result of the conversion of P7.8bn of the loans made by the government's Philippine Deposit Insurance Corp (PDIC) into convertible preferred shares in PNB. The management team of PNB is highly professional, and is headed by President Lorenzo Tan and Chairman Francisco Dizon. Tan, an ex-Citibanker, has brought in several top-level officials from various banks to help turn around PNB financially. So far both shareholders have allowed the professional management team to run the bank, which, in our view, is key for the bank to maintain its recent profitability over the long term.

We continue to rate PNB a HOLD. Our target price remains at P21.50/sh, which is based on a P/BV of 0.5x. In our view, PNB's profitability, at barely above breakeven, means that an earnings-based valuation is not applicable. We believe our target of 0.5x P/BV is justified by PNB's weak asset quality.

Philippine National Bank

Philippines

Share Price:	23.00	**Reuters Code:**	PNB.PS	**Shares Outstanding**	378
52 Week Price Range:	18.75 - 28.00	**Bloomberg Code:**	PNB.PM	**Market Cap (US$m)**	155

INCOME STATEMENT	**01**	**02**	**03**	**04F**	**05F**
Interest income	11,342	7,170	7,600	8,658	8,779
Interest expense	11,752	6,299	5,715	8,105	8,456
Net interest income	**-410**	**871**	**1,885**	**553**	**323**
Non-interest income	5,979	5,627	6,625	6,808	7,489
Total operating income	**5,569**	**6,498**	**8,510**	**7,361**	**7,812**
Non-interest expense	8,416	7,526	7,442	6,935	6,935
Pre provision profit	**-2,846**	**-1,028**	**1,068**	**426**	**877**
Loan loss provisions	2,398	2,171	447	1,717	1,723
Non-operating income	0	0	0	0	0
Pre tax profit	**-5,244**	**-3,199**	**621**	**-1,291**	**-846**
Tax	-1,114	-1,251	452	-258	-169
Net profit	**-4,130**	**-1,949**	**169**	**-1,033**	**-677**

BALANCE SHEET	**01**	**02**	**03**	**04F**	**05F**
Gross loans	93,358	84,809	78,066	86,233	86,106
Loan loss reserves	*19,021*	*18,987*	*18,127*	*21,720*	*22,238*
Net loans	74,337	65,822	59,939	64,513	63,867
Total earning assets	59,459	61,051	77,692	67,309	70,674
Other assets	57,490	57,625	61,163	61,806	64,055
Total Assets	**191,286**	**184,498**	**198,794**	**193,628**	**198,597**
Deposits	122,196	134,579	145,915	148,373	155,792
Other paying liabilities	39,002	12,002	12,550	12,002	12,002
Other liabilities	12,666	14,039	15,723	11,968	10,195
Total Liabilities	**173,864**	**160,620**	**174,188**	**172,343**	**177,989**
Total Equity	**17,422**	**23,878**	**24,606**	**21,284**	**20,607**

ASSET QUALITY	**01**	**02**	**03**	**04F**	**05F**
Nonperforming assets	67,534	70,073	70,073	70,183	70,238
NPAs/total loans	72.3%	82.6%	89.8%	81.4%	81.6%
Reserve coverage of NPAs	28.2%	27.1%	25.9%	30.9%	31.7%

PER SHARE DATA (P)	**01**	**02**	**03**	**04F**	**05F**
EPS	(10.93)	(5.16)	0.45	(2.73)	(1.79)
DPS	0.00	0.00	0.00	0.00	0.00
Effective payout ratio (%)	*0%*	*0%*	*0%*	*0%*	*0%*
BVPS	46.09	42.52	44.44	35.65	33.86

BALANCE SHEET RATIOS	**01**	**02**	**03**	**04F**	**05F**
Loan-to-deposit	61%	49%	41%	43%	41%
Equity to assets	9.1%	12.9%	12.3%	11.0%	10.4%
Total CAR	8.0%	14.3%	13.7%	11.0%	10.0%

VALUATION	**01**	**02**	**03**	**04F**	**05F**
Price to book value	0.5x	0.5x	0.5x	0.4x	0.4x
Price to earnings	N/M	N/M	55.5x	N/M	N/M
Price to underlying profit	N/M	N/M	8.2x	20.4x	10.0x
Yield at current price (%)	-	-	-	-	-

LOAN MIX	**01**	**02**	**03**	**04F**	**05F**
Manufacturing (%)	24.6	24.4	24.5	24.5	24.8
Real estate, renting (%)	16.6	17.0	17.0	17.1	17.3
Wholesale and retail (%)	14.7	13.9	13.9	14.0	14.1
Other (%)	44.0	44.7	44.6	44.5	43.8

PROFITABILITY RATIOS (%)	**01**	**02**	**03**	**04F**	**05F**
Net interest margin	-0.27%	0.58%	1.26%	0.36%	0.21%
Yield on assets	8.35%	5.50%	5.99%	6.63%	6.59%
Cost of liabilities	7.33%	4.09%	3.30%	5.17%	5.15%
Non-int. inc (% Op income)	107.36%	86.60%	77.85%	92.49%	95.87%
Cost to income	151.10%	115.82%	87.40%	94.21%	88.77%
ROA	-1.04%	-0.84%	0.01%	-0.35%	0.00%
ROE	-21.80%	-9.44%	0.70%	-4.74%	-3.23%

GROWTH RATES (%,YoY)	**01**	**02**	**03**	**04F**	**05F**
Pre-provision earnings	N/M	N/M	N/M	N/M	N/M
Net profit	N/M	N/M	N/M	N/M	N/M
EPS	N/M	N/M	N/M	N/M	N/M
DPS	N/M	N/M	N/M	N/M	N/M
Net Loans	-8%	-11%	-9%	8%	-1%
Assets	2%	8%	8%	-3%	5%
Deposits	12%	-14%	8%	2%	0%

Regional Exchanges Catching the liquidity

HK Exchanges and Clearing Ltd (HKEx)

Best positioned exchange in Asia

Hong Kong Exchange & Clearing Ltd (HKEx) is witnessing an unprecedented boom in equity market liquidity driven by an underlying economic recovery in the territory and a renewed interest in mainland stocks.

Key drivers attracting abundant liquidity to the Hong Kong market

Key liquidity earnings drivers:

- ***China.*** Despite recent measures to slow the Chinese economy, underlying long-term growth remains strong. We believe HKEx will benefit from its position as the primary source for mainland funding.
- ***CEPA.*** Aligning the interests and participation of mainland investors with the Hong Kong market.
- ***Reflation.*** With property and financial counters dominating the Hong Kong market, a reflationary environment will draw funds to HKEx.
- ***IPO scene remains active.*** With a robust pipeline of large cap IPOs, relative to the region, long-term liquidity will continue to favour Hong Kong.

Singapore Exchange Ltd (SGX)

Like HKEx, the Singapore market has experienced a surge in liquidity since the middle of 2003. In line with the uplift in sentiment, SGX's earnings are set to rebound strongly this year.

Carving out a niche

Focus on small cap regional plays

Whilst SGX has experienced a significant uplift in volume, this is coming mainly from existing participants – SGX doesn't have the surge in new market players that HKEx would have from its higher profile China exposure.

In order to compensate for this, the Singapore market has branded itself as the 'alternative' market of choice for smaller cap, independent Chinese companies that are finding themselves at 'the back of the queue' in terms of the long wait to list in Hong Kong. Many Chinese companies have listed in Singapore over the past eighteen months. Whilst this trend looks set to continue, SGX is setting its sights on India as the next potential source of new small cap companies that are looking for a viable 'international' exchange on which to raise funds.

Although market liquidity remains strong, the market fundamentally lacks the key long term drivers that should assist the Hong Kong market in keeping liquidity relatively high, relative to the past.

Valuation

HKEx: Attractive fundamentals

HKEx is our top pick amongst the Asian exchanges. Given the mainland angle, barring unforeseen circumstances that may lessen the investment case for being in China, the assumption that average daily turnover can settle at consistently higher levels than has been seen in the past is sound, in our view.

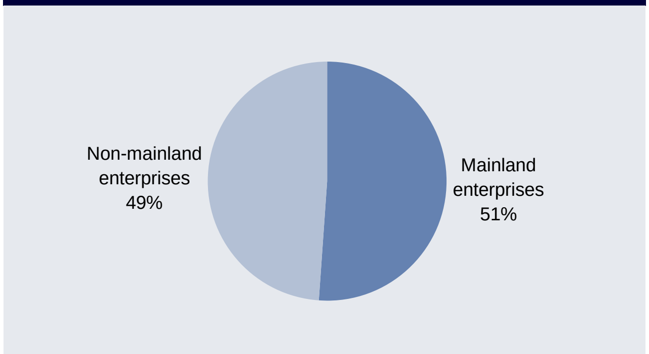
China: a clear driver for the Hong Kong market...

China a clear component of the market

The impact of China stocks on the Hong Kong market is clearly evident from the following charts. Of the total funds raised over the last 10 years, 51% related to Mainland enterprises, which also made up 46% of total market turnover in 2003. Mainland enterprises are disproportionately important to the Hong Kong market, making up 31% of total market capitalisation and 25% of total number of companies listed.

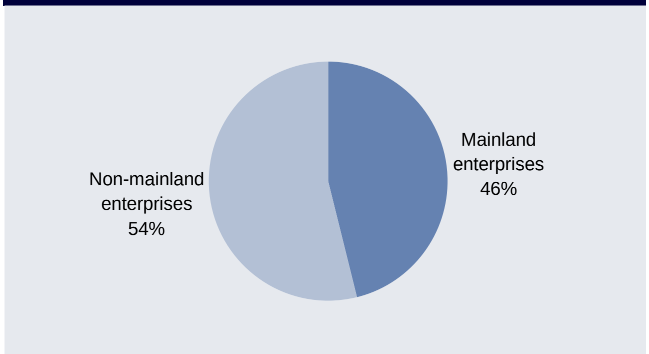
Given the momentum building in the China space, the importance of Mainland stocks to the Hong Kong cannot be underestimated.

Fig 242 Total funds raised in past 10-years



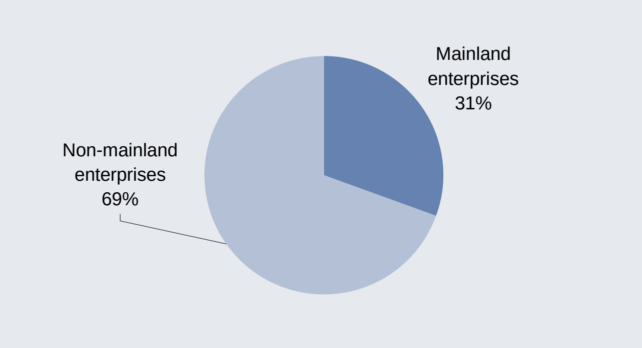
Source: HKEx

Fig 243 Equity turnover 2003



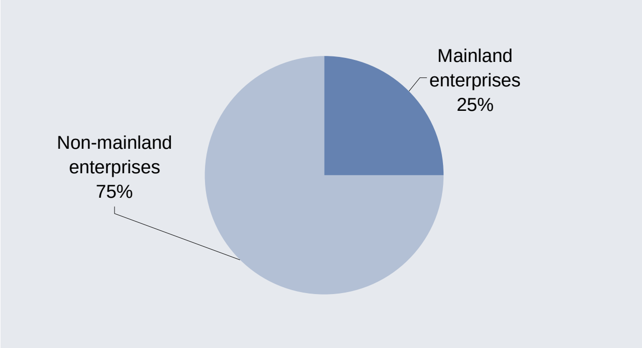
Source: HKEx

Fig 244 Market capitalisation (end 2003)



Source: HKEx

Fig 245 Number of enterprises (end 2003)



Source: HKEx

HKEx target price HK$18.38

At the current price, HKEx is trading on 17.5x FY04F EPS, slightly below the FY04 peer group average of 19.2x. Our target price for HKEx is HK$18.38, based on a 10% premium multiple to the developed market peers.

SGX: Liquidity strong, with an easy valuation

SGX target price S$1.99

Our target price for SGX is S$1.99 based on a 10% premium to the FY05F developed market peer group multiple of 16.9x.

We expect average daily turnover to equate to S$704m in FY6/05, an 11% decline from FY6/04, a period which has captured the significant wall of liquidity that has hit the market since SARS and global uncertainties began to dissipate.

We believe our forecast turnover for FY6/05 is relatively conservative and that should the global economic recovery begin to pick-up pace, our estimation could be subject to upside risk.

Cheapest in the region

At 14.6x and 15.7x FY6/04F and FY6/05F EPS respectively, SGX is one of the cheapest stock exchanges of the peer group, which averages 19.2x and 16.9x over the same period. We believe this discount is unwarranted in light of the consistent (albeit mainly smaller cap) IPO pipeline and the re-rating of Asian equities as an asset class.

Peer group table

Fig 246 Peer group comparison

	PER (x)				P/BV (x)				ROE (%)			
	FY02A	FY03F	FY04F	FY05F	FY02A	FY03F	FY04F	FY05F	FY02A	FY03F	FY04F	FY05F
Hong Kong Exchange & Clearing (HKEx)	**26.7**	**23.0**	**17.5**	**16.6**	**2.9**	**2.8**	**3.4**	**3.3**	**4.2**	**3.5**	**4.7**	**4.7**
Singapore Exchange (SGX)	**27.8**	**105.6**	**14.6**	**15.7**	**2.0**	**2.1**	**2.9**	**2.8**	**7.3**	**2.0**	**20.0**	**17.9**
Australian Stock Exchange (ASX)	27.6	28.4	19.5	18.4	8.3	7.7	7.9	7.3	33.2	28.2	40.0	41.3
Euronext (NXT)	17.3	22.9	18.3	15.1	1.9	1.8	1.7	1.6	11.8	13.5	10.4	11.3
OM AB (OM)	NM	NM	23.2	18.7	4.3	3.4	3.0	2.7	-3.3	-15.6	13.8	14.0
Deutsche Boerse (DB)	21.0	20.8	17.9	14.8	2.4	2.2	2.0	1.9	12.7	11.0	11.9	13.5
London Stock Exchange (LSE)	19.1	16.7	17.1	17.4	3.7	3.2	2.8	2.5	19.1	17.5	17.0	14.7
New Zealand Stock Exchange (NZSX)	NA	39.6	38.4	33.9		4.5	4.0	3.7	N/A	3.3	10.2	10.4
Average (excl NZSE)	**23.2**	**36.3**	**18.3**	**16.7**	**3.6**	**3.5**	**3.5**	**3.2**	**12.1**	**7.9**	**16.0**	**16.0**
Average (excl HKEx, SGX, NZSE)	**17.0**	**17.8**	**19.2**	**16.9**								

Source: Company data, ING estimates

Our target price for HKEx is HK$18.38, based on 21.1x FY04F EPS or a 10% premium to the FY04F peer group average. This is 21% above current levels. We have raised our rating from HOLD to BUY.

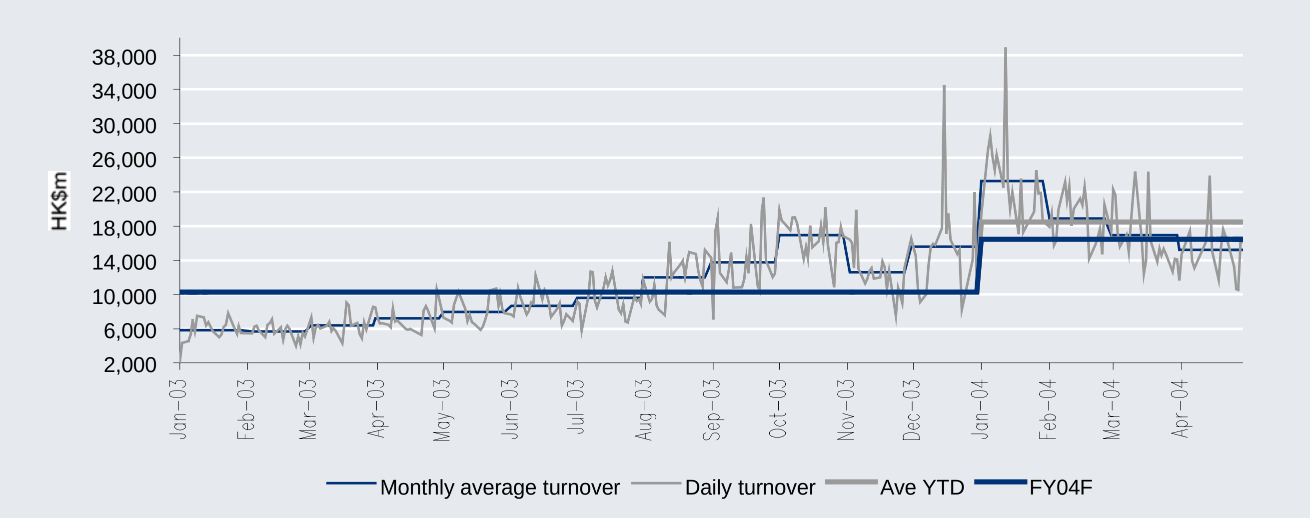
Our target price for SGX is HK$1.99, based on 18.6x FY05F EPS or a 10% premium to the FY05F peer group average. This is 18% above current levels. BUY maintained.

Market liquidity remains robust

Average daily turnover is relatively strong in both cities

As can be seen in the chart below, turnover in Hong Kong has risen strongly since the second half of 2003. Whilst turnover spiked upwards at the beginning of 2004 on the back of one-off placements and new listings, notional liquidity continues to be relatively strong.

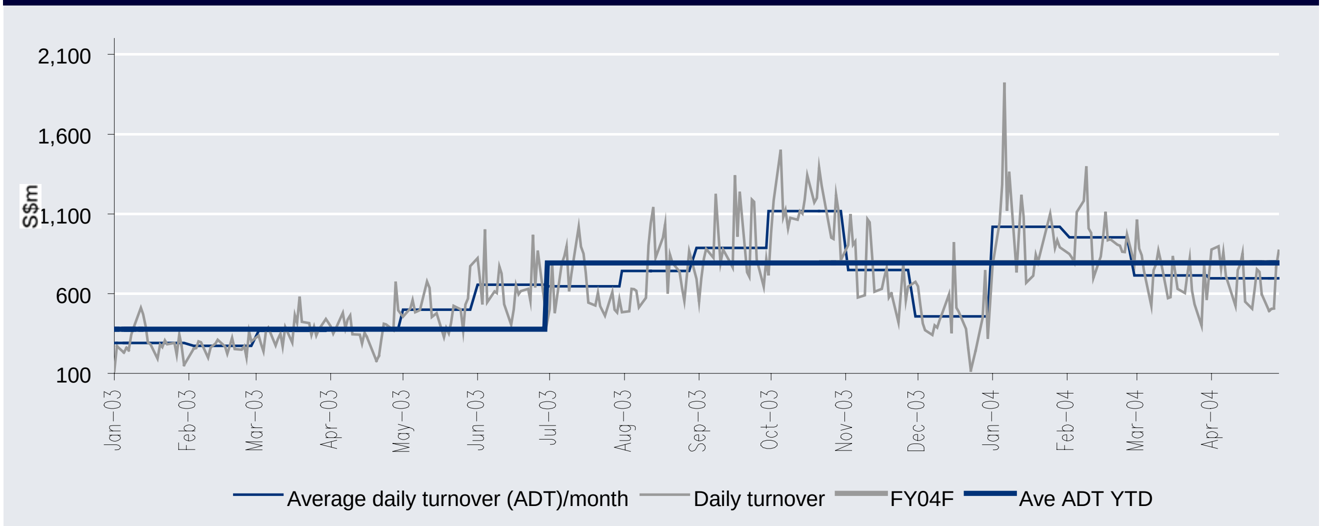
Fig 247 Equity market turnover – Hong Kong, 2003 to date



Source: Company data, ING estimates

In line with the rest of the region, market liquidity in Singapore has been rising since 2Q03. Interest has returned to the market after a relatively slow end to 2003.

Fig 248 Equity market turnover - Singapore, 2003 to date



Source: Company data, ING estimates

Pricing closely correlated to market turnover

Unsurprisingly the prices of both stocks correlate closely to movements in underlying market turnover, with both peaking in late-2003 when it became apparent the global economic recovery was genuine and looked set to gather pace – prompting a shift in the asset allocation decision towards equities.

Fig 249 HKEx share price performance vs equity market turnover (since listing)

Source: Bloomberg

Fig 250 SGX share price performance vs equity market turnover (since listing)

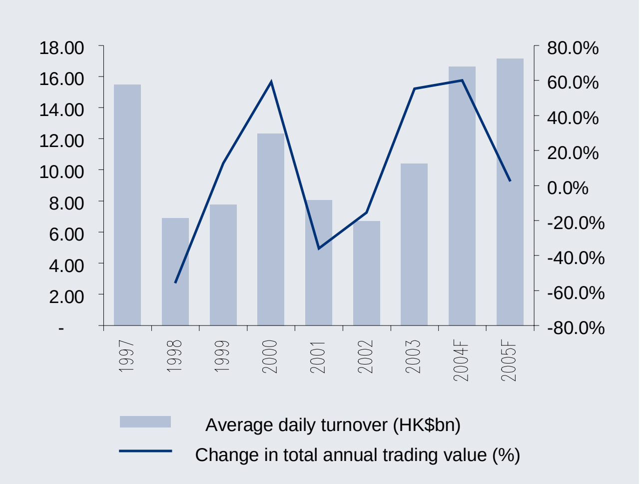
Source: Bloomberg

Equity turnover expectations

In Hong Kong, the previous peaks in market turnover on an annual basis occurred in 1997 and 2000 at HK$15.5bn and HK$12.3bn respectively. Moving forward it is becoming increasingly apparent that investors' interest in China stocks will translate into higher average turnover in the future relative to the past.

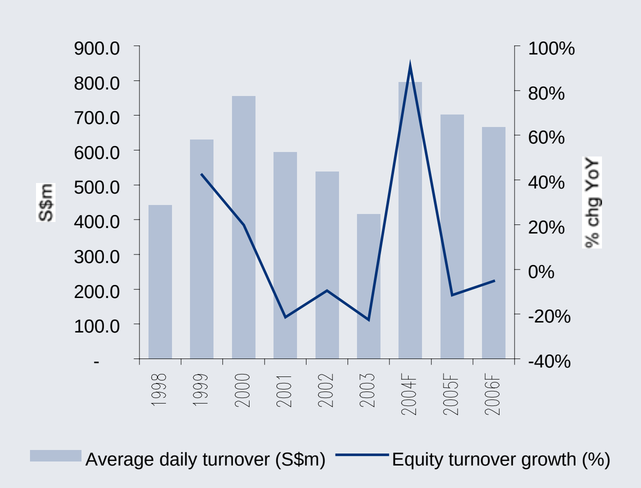
For Singapore we are forecasting a slight easing in market turnover, relative to FY04F, which, with a June year-end, caught the very start of the asset allocation shift into equities. Moving forward, with equity investors fully invested, we believe liquidity will become more discerning.

Fig 251 HK: Avg daily turnover pa 1997- 2005F



Source: Company data, ING estimates

Fig 252 S'pore: Avg daily turnover 1997- 2005F



Source: Company data, ING estimates

Sensitivity analysis

Market liquidity comes in waves and is notoriously difficult to forecast. It makes sense therefore to provide sensitivity to the valuation at various levels of market turnover around our base case.

Hong Kong

At our current base case average daily turnover for FY04F of HK$16.6bn it can be seen that, at a 10% premium to the developed market peers, or a multiple of 17.5x FY04F EPS, HKEx should trade at HK$18.38 (our target price).

Fig 253 HKEx: Sensitivity to FY04F average daily turnover

	HK$bn	% chg	EPS (HK$)	PER (x)	Fair value (HK$)	Chg to current shr px (%)
	21.63	30.0	1.10	13.8	23.23	53
	19.97	20.0	1.02	14.9	21.54	42
	18.30	10.0	0.95	16.0	20.07	32
Base case	**16.64**	**0.0**	**0.87**	**17.5**	**18.38**	**21**
	14.98	-10.0	0.79	19.2	16.69	10
	13.31	-20.0	0.72	21.1	15.21	0
	11.65	-30.0	0.64	23.8	13.52	-11

* Based on 20% premium to developed market peer group
Source: Company data, ING estimates

Bull case

However, should one prefer to take a more bullish stance, and assume average daily turnover will settle at much higher levels than our base case, say 20% higher, EPS would equate to HK$1.02 and the fair value would rise to HK$21.54, 42% higher than current levels.

Bear case

Alternatively, the bear case, implying a drop in average daily turnover by 20% to HK$13.31bn relative to our base case would translate into a fair value for the stock of HK$15.12, in line with the current share price.

Singapore

At our current base case average daily turnover for FY6/05F of S$703.5bn it can be seen that, at a 10% premium to the developed market peers, or a multiple of 18.6x FY6/05F EPS, SGX should trade at S$1.99 (our target price).

Fig 254 Singapore: Sensitivity to FY6/05F average daily turnover

	ADT (S$m)	% chg	EPS (S$)	PER (x)	Fair value (S$)	Upside to current shr px (%)
	914.6	30.0	0.135	12.54	2.50	48.2
	844.2	20.0	0.126	13.44	2.33	38.2
	773.9	10.0	0.117	14.51	2.16	28.0
Base case	**703.5**	**0.0**	**0.107**	**15.74**	**1.99**	**18.0**
	633.2	-10.0	0.098	17.21	1.82	7.9
	562.8	-20.0	0.089	18.97	1.65	-2.1
	492.5	-30.0	0.080	21.13	1.49	-12.1

Source: Company data, ING estimates

Bull case

However, should one prefer to take a more bullish stance, and assume average daily turnover will settle at much higher levels this year than our base case, say 20% higher at S$844.2bn, our fair value would rise to S$2.33, 38% higher than current levels.

Bear case

Alternatively, the bear case would imply a drop in average daily turnover, say by 20% to S$562bn relative to our forecast. This would imply fair value for the stock of S$1.65, 2% below the current share price.

We believe the market is being too harsh with regard to market turnover expectation next year. The fact that SGX is a June year-end may, to a certain extent, be to blame. Whilst the full earnings uplift in FY6/04 is pretty much well known, there remains some uncertainty with regard to the levels of liquidity in the market that can be sustained into 2005. To a certain degree, we believe this is weighing on the share price.

IPO pipeline

Singapore

Singapore has been an active small cap IPO market, with 58 new companies raising a total of S$7.6bn (US$4.5bn) since the beginning of 2003. Whilst the average per company of S$117m (US$69m) is relatively small, these new companies bring a greater level of depth to the market and encourage a greater level of participation by both retail investors and specialist funds. Thus encouraging a higher degree of liquidity than would otherwise be the case.

Hong Kong

The Hong Kong market is clearly the destination of choice for mainland firms to raise funds – both in terms of access to international capital, but also from a prestige perspective. As noted above the pipeline for potential listing candidates in Hong Kong is long and the wait can be troublesome for smaller, less ‘high profile’ candidates.

The Hong Kong market saw 73 new listings in 2003, with HK$59.2bn (US$6.8bn) raised, or an average of HK$811m (US$105m).

Capital management

HKEx: getting up to speed

At last, it paid out the cash

HKEx is committed to a 90% dividend payout ratio, which is attractive in a market with strong liquidity. Applying this benchmark to our three year forecast (2004 – 2006), the stock carries a gross yield of 4.9%, 5.2% and 5.5% respectively.

Given a distinct lack of viable acquisition opportunities for regional exchanges, HKEx followed in the footsteps of SGX by paying back cash to shareholders. With a robust earnings outlook, ROE, a key benchmark for ranking the efficiency of regional exchanges, is set to rise to a level more in line with the peer group.

SGX: ROE a key performance measure

Professional capital management

SGX has undergone a fundamental change since the arrival one year ago of the new CEO, Mr Hsieh Fu Hua, in terms of the group's clear focus on capital management, characterized by a one-off return of cash in September 2003. We believe management is likely to continue to keep shareholder returns high via a consistently high dividend for three key reasons:

- Very strong earnings expectations this year
- A distinct lack of viable acquisition opportunities.
- A sharp focus on ROE as a key performance measure.

SGX is yielding 5.0%, 4.7% and 4.7% over the next three years.

ASX: seen as the model regional exchange

ASX is extremely efficient

HKEx lags the peer group in capital management, with too much excess cash. ASX is the most efficient exchange, followed by SGX, which is placing great emphasis ROE as a key performance measure (see peer group table above).

Top pick: Prefer HKEx

The valuation of HKEx has retreated to such an extent that it is now our preferred pick over SGX. HKEx benefits from a superior strategic position and, despite the potential slowdown in China, it will benefit from global liquidity looking for exposure to the mainland.

SGX suffers from its June year-end, meaning growth prospects in 2005, over a spectacular FY04, will be hard to come by.

HKEx Abundant liquidity, strategic importance

Rating: BUY (from Hold)

Best positioned exchange in Asia…

Hong Kong Exchange & Clearing Ltd (HKEx) is witnessing an unprecedented boom in equity market liquidity driven by an underlying economic recovery in the territory and a renewed interest in mainland stocks.

Key drivers attracting abundant liquidity to the Hong Kong market…

Key liquidity earnings drivers:

- ***China.*** Despite recent measures to slow the Chinese economy, underlying long-term growth remains strong. We believe HKEx will benefit from its position as the primary source for mainland funding.
- ***CEPA.*** Aligning the interests and participation of mainland investors with the Hong Kong market.
- ***Reflation.*** With property and financial counters dominating the Hong Kong market, a reflationary environment will draw funds to HKEx.
- ***IPO scene remains active.*** With a robust pipeline of large cap IPOs, relative to the region, long-term liquidity will continue to favour Hong Kong.

Valuation becoming more attractive

With the above in mind, HKEx is our top regional pick. Given the mainland angle, the assumption that average daily turnover can settle at consistently higher levels than has been seen in the past is sound, in our view.

…valuation becoming more attractive

We forecast average daily turnover of HK$16.6bn per day, up from HK$11.9bn previously. This compares to the previous peaks of HK$15.5bn in 1997 and HK$12.3bn in 2000.

At this level the stock is trading on 17.5x FY04F EPS, against the peer group average of 19.2x. Given the strategic importance of HKEx to mainland capital raising and the sharper investor focus on Asian equities as an asset class, we value the exchange at a 10% premium to the developed market peers i.e. 21.1x FY04F EPS, or HK$18.38.

Fig 255 HKEx: Sensitivity to FY04F average daily turnover

	HK$bn	% chg	EPS (HK$)	PER (x)	Fair value (HK$)	Chg to current shr px (%)
	21.63	30.0	1.10	13.8	23.23	53
	19.97	20.0	1.02	14.9	21.54	42
	18.30	10.0	0.95	16.0	20.07	32
Base case	**16.64**	**0.0**	**0.87**	**17.5**	**18.38**	**21**
	14.98	-10.0	0.79	19.2	16.69	10
	13.31	-20.0	0.72	21.1	15.21	0
	11.65	-30.0	0.64	23.8	13.52	-11

* Based on 20% premium to developed market peer group

Source: Company data, ING estimates

Hong Kong Exchanges & Clearing Ltd

Hong Kong

Share Price:	15.20	**Reuters Code:**	388.HK	**Shares Outstanding**	1,046
52 Week Price Range:	7.90 - 21.85	**Bloomberg Code:**	388 HK	**Market Cap (US$m)**	2,044

INCOME STATEMENT	**02A**	**03A**	**04F**	**05F**	**06F**
Clearing fee revenue	513	740	1,075	1,115	1,157
Other reveue	1,295	1,280	1,150	1,175	1,220
Total income	**1,808**	**2,020**	**2,225**	**2,290**	**2,377**
Costs	(1,002)	(1,039)	(1,004)	(1,016)	(1,029)
EBITDA	**807**	**981**	**1,221**	**1,274**	**1,348**
Depreciation	(163)	(183)	(182)	(178)	(180)
EBIT	**643**	**798**	**1,039**	**1,096**	**1,169**
Associates	6	8	8	8	8
Pre tax profit	**650**	**805**	**1,047**	**1,104**	**1,177**
Tax & MI	(57)	(114)	(136)	(144)	(153)
Net profit	**593**	**692**	**911**	**960**	**1,024**

BALANCE SHEET	**02A**	**03A**	**04F**	**05F**	**06F**
Cash and equivalents	4,475	4,991	3,894	4,167	4,497
Other current assets	7,672	12,521	13,147	13,707	14,291
Fixed assets	748	586	589	559	529
Other non-current assets	1,141	1,705	1,785	1,872	1,963
Total Assets	**14,035**	**19,802**	**19,415**	**20,305**	**21,281**
Creditors	3,007	4,780	4,769	5,062	5,314
Other current liabilities	4,932	8,268	8,682	9,108	9,554
Non-current liabilities	600	1,151	1,342	1,378	1,502
Total Liabilities	**8,539**	**14,199**	**14,793**	**15,547**	**16,370**
Total Equity	**5,496**	**5,603**	**4,622**	**4,758**	**4,911**

BALANCE SHEET RATIOS	**02A**	**03A**	**04F**	**05F**	**06F**
Current ratio	1.5	1.3	1.3	1.3	1.3
Cash per share (S$)	4.3	4.8	3.7	4.0	4.3

PER SHARE DATA (HK$)	**02A**	**03A**	**04F**	**05F**	**06F**
Adj EPS	0.57	0.66	0.87	0.92	0.98
DPS	0.51	0.60	0.78	0.83	0.88
Effective payout ratio (%)	*90%*	*91%*	*90%*	*90%*	*90%*
BVPS	5.28	5.35	4.42	4.54	4.69

ROE DECOMPOSITION	**02A**	**03A**	**04F**	**05F**	**06F**
Asset Turnover (x)	0.13	0.10	0.11	0.11	0.11
Assets/Equity (x)	2.55	3.53	4.20	4.27	4.33
Net Profit Margin (%)	0.33	0.34	0.41	0.42	0.43
Du Pont ROE (%)	10.8	12.3	19.7	20.2	20.8

VALUATION	**02A**	**03A**	**04F**	**05F**	**06F**
Price to book value	2.9x	2.8x	3.4x	3.3x	3.2x
Price to earnings	26.7x	23.0x	17.5x	16.6x	15.5x
Yield at current price (%)	3.4%	3.9%	5.2%	5.4%	5.8%

EQUITY MKT TURNOVER	**02A**	**03A**	**04F**	**05F**	**06F**
Ave. HK$bn per day	6.7	10.4	16.6	17.1	17.7

PROFITABILITY RATIOS (%)	**02A**	**03A**	**04F**	**05F**	**06F**
EBITDA margin	44.6%	48.6%	54.9%	55.6%	56.7%
EBIT margin	35.6%	39.5%	46.7%	47.9%	49.2%
Net profit margin	32.8%	34.2%	40.9%	41.9%	43.1%
ROA	4.2%	3.5%	4.7%	4.7%	4.8%
ROE	10.8%	12.3%	19.7%	20.2%	20.8%

GROWTH RATES (%,YoY)	**02A**	**03A**	**04F**	**05F**	**06F**
Sales	-14%	-10%	12%	10%	3%
Net profit	-20%	17%	32%	5%	7%

SGX

Cheapest Asian exchange

Rating: BUY

Strong liquidity

Like other regional exchanges, the Singapore market has experienced a surge in liquidity since the middle of 2003. In line with the uplift in sentiment, SGX's earnings are set to rebound strongly this year.

Capital management to the fore

Managed by the book

SGX has undergone a fundamental change since the arrival of the new CEO one year ago in terms of the group's clear focus on capital management, characterised by a one-off return of cash in September 2003. We believe management is likely to continue to pay an attractive dividend for three key reasons:

1. Very strong earnings expectations this year.
2. A distinct lack of viable acquisition opportunities.
3. A sharp focus on ROE as a key performance measure.

Our model includes a final dividend of S$0.055 (bringing the full year to S$0.085), implying a 75% payout ratio and 5.0% yield at current levels.

Active small cap IPO market

Singapore has been an active small cap IPO market, with 58 new companies raising a total of S$7.6bn (US$4.5bn) since the beginning of 2003. Whilst the average per company of S$117m (US$69m) is relatively small, these new companies bring a greater level of depth to the market and encourage a greater level of participation by both retail investors and specialist funds. Thus encouraging a higher degree of liquidity than would otherwise be the case.

Valuation: Cheapest of the peer group

Enticing valuation

Our target price for SGX is S$1.99 based on a 10% premium to developed-market-listed peers. Our target multiple translates to 18.6x FY6/05F EPS. We expect average daily turnover to equate to S$704m per day in FY6/05.

At 14.6x and 15.7x FY6/04F and FY6/05F EPS respectively, SGX is one of the cheapest stock exchanges of the peer group, which averages 19.2x and 16.9x over the same period. We believe this discount is unwarranted in light of the consistent (albeit mainly smaller cap) IPO pipeline and the re-rating of Asian equities as an asset class.

Singapore Exchange Ltd

Singapore

Share Price:	1.69	**Reuters Code:**	SGX.SI	**Shares Outstanding**	1,000
52 Week Price Range:	1.18 - 2.13	**Bloomberg Code:**	SGX SP	**Market Cap (US$m)**	994

INCOME STATEMENT	**02A**	**03A**	**04F**	**05F**	**06F**
Clearing fee revenue	116	110	190	174	173
Other reveue	113	109	113	119	122
Total revenue	**228**	**219**	**304**	**292**	**295**
Costs	(141)	(141)	(135)	(136)	(139)
EBITDA	**88**	**77**	**169**	**157**	**156**
Depreciation	(24)	(24)	(22)	(22)	(23)
EBIT	**64**	**54**	**147**	**134**	**133**
Inv gains & other	9	(31)	2	3	3
Interest income	4	3	2	2	2
Pre tax profit	**77**	**26**	**151**	**139**	**138**
Tax & MI	-16	-11	-35	-31	-30
Net profit	**61**	**15**	**116**	**108**	**108**

BALANCE SHEET	**02A**	**03A**	**04F**	**05F**	**06F**
Cash and equivalents	588	578	320	327	334
Other current assets	348	374	377	381	385
Fixed assets	282	226	228	230	232
Other non-current assets	1	1	1	1	1
Total Assets	**1,220**	**1,178**	**926**	**939**	**952**
Creditors	337	335	303	293	278
Other current liabilities	33	32	33	33	33
Non-current liabilities	11	11	11	11	11
Total Liabilities	**382**	**378**	**347**	**338**	**323**
Total Equity	**838**	**800**	**579**	**601**	**630**

BALANCE SHEET RATIOS	**02A**	**03A**	**04F**	**05F**	**06F**
Current ratio	2.5	2.6	2.1	2.2	2.3
Cash per share (S$)	0.59	0.58	0.32	0.33	0.33

PER SHARE DATA (HK$)	**02A**	**03A**	**04F**	**05F**	**06F**
Adj EPS	0.068	0.069	0.116	0.107	0.108
DPS	0.073	0.405	0.085	0.080	0.080
Effective payout ratio (%)	*108%*	*587%*	*74%*	*74%*	*74%*
BVPS	0.84	0.80	0.58	0.60	0.63

ROE DECOMPOSITION	**02A**	**03A**	**04F**	**05F**	**06F**
Asset Turnover (x)	0.19	0.19	0.33	0.31	0.31
Assets/Equity (x)	1.46	1.47	1.60	1.56	1.51
Net Profit Margin (%)	0.27	0.07	0.38	0.37	0.37
Du Pont ROE (%)	7.3	2.0	20.0	17.9	17.2

VALUATION	**02A**	**03A**	**04F**	**05F**	**06F**
Price to book value	2.0x	2.1x	2.9x	2.8x	2.7x
Price to earnings	24.9x	24.5x	14.6x	15.7x	15.6x
Yield at current price	4.3%	24.0%	5.0%	4.7%	4.7%

EQUITY MKT TURNOVER	**02A**	**03A**	**04F**	**05F**	**06F**
Ave. S$bn per day	538	417	795	704	666

PROFITABILITY RATIOS (%)	**02A**	**03A**	**04F**	**05F**	**06F**
EBITDA margin	38.3%	35.4%	55.6%	53.5%	52.9%
EBIT margin	28.0%	24.6%	48.3%	45.9%	45.2%
Net profit margin	26.6%	6.7%	38.1%	36.8%	36.8%
ROA	5.0%	1.4%	12.5%	11.4%	11.4%
ROE	7.3%	2.0%	20.0%	17.9%	17.2%

GROWTH RATES (%,YoY)	**02A**	**03A**	**04F**	**05F**	**06F**
Sales	5%	-4%	39%	-4%	1%
Net profit (adj)	-2%	2%	67%	-7%	1%

Appendix: Performance

Fig 256 Asia-Pacific financials performance

Company	Price 4/22/04	Bloomberg code	ING rating	Mkt cap US$m	52 week High	52 week Low	% change 1m	3m	6m	12m	2003	2002
Hong Kong:												
HSBC	115.00	5 HK	HOLD	161,590	128.50	81.50	-1.3	-8.0	0.9	38.6	43.7	-6.6
STAN	123.50	2888 HK	BUY	18,483	138.50	82.50	-5.4	-8.5	-1.2	42.8	43.2	NM
HSB	98.25	11 HK	SELL	24,082	110.50	75.50	0.0	-5.5	-0.5	29.3	22.9	-3.2
BOCHK	13.95	2388 HK	HOLD	18,909	15.90	7.60	-4.8	-5.4	1.5	80.0	82.5	NM
BEA	22.80	23 HK	SELL	4,249	25.95	13.70	0.9	-10.4	-0.2	66.4	78.7	-20.5
DSF	55.25	440 HK	SELL	1,748	66.00	31.80	3.3	-10.9	-2.6	71.6	46.2	7.0
WHB	50.25	302 HK	NR	1,937	55.00	5.01	1.5	-7.4	11.9	99.8	85.2	-0.2
WLB	58.00	96 HK	NR	1,553	59.75	27.80	14.3	13.2	19.3	104.2	76.5	-1.2
CIFH	3.33	183 HK	NR	1,754	4.55	1.73	-5.7	-23.6	-7.6	75.0	86.7	13.6
ICBC(Asia)	9.85	349 HK	NR	992	12.80	5.90	-12.4	-23.0	-11.3	62.8	76.2	-17.0
IBA	3.28	636 HK	SELL	493	4.03	2.55	-1.5	-10.9	-9.0	28.4	45.5	33.6
LCH	11.25	1111 HK	NR	725	13.25	6.75	-5.9	-11.8	-6.6	66.7	71.4	-2.8
JCG	6.30	900 HK	SELL	572	7.25	3.18	-3.8	-3.1	9.6	85.3	59.5	-21.1
AEON	5.85	626 HK	BUY	314	6.20	2.38	0.0	21.9	33.7	136.4	100.0	-3.6
HKEX	15.20	388 HK	BUY	2,044	21.85	7.90	-24.9	-26.2	-11.9	84.2	71.9	-17.3
Average							-3.0	-8.0	1.7	71.4	66.0	-3.0
Index: Hang Seng	12,168				13,928	8,409	-3.1	-11.5	-0.6	41.9	34.9	-18.2
Currency: HKD	7.80				7.80	7.71	0.0	-0.4	-0.6	0.0	0.4	0.0
Japan:												
Banks												
MTFG	1,020,000	8306 JP	HOLD	57,788	1,100,000	354,000	5.7	24.5	27.2	154.4	29.6	-26.6
UFJ	654,000	8307 JP	BUY	29,941	790,000	86,000	7.9	24.6	33.7	595.7	329.2	-58.5
Mizuho	499,000	8411 JP	HOLD	48,004	550,000	58,700	22.6	54.0	79.5	678.5	192.8	-58.4
SMFG	781,000	8316 JP	BUY	41,152	843,000	164,000	11.3	36.8	33.5	331.5	53.9	-33.2
Sumitomo Trust	674	8403 JP	HOLD	8,372	722	305	3.4	12.5	3.5	120.3	31.0	-9.6
Resona	216	8308 JP	NR	12,766	232	48	26.3	61.2	30.1	292.7	107.7	-20.7
Mitsui Trust	770	8309 JP	NR	3,729	866	214	19.4	34.1	22.0	253.2	210.4	48.5
Mizuho Trust	251	8404 JP	NR	7,578	285	85	15.7	40.2	26.1	188.5	365.0	-11.1
Yokohama	652	8332 JP	BUY	6,749	693	362	10.1	38.4	34.2	61.4	6.2	2.6
Shizuoka	997	8355 JP	HOLD	6,799	1,013	747	14.5	28.6	27.3	28.5	3.5	-22.9
Fukuoka	606	8326 JP	BUY	3,497	625	413	16.1	35.0	30.9	28.4	-5.5	7.2
Average							13.9	35.5	31.6	248.5	120.3	-16.6
Brokers												
Nomura	1,815	8604 JP	HOLD	32,104	2,070	1,104	-1.8	-2.4	-5.1	62.9	36.8	-20.6
Daiwa	850	8601 JP	HOLD	10,320	955	434	4.9	11.0	-1.7	91.9	38.3	-23.5
Nikko	671	8603 JP	SELL	11,292	764	295	2.0	9.3	-2.3	124.4	49.3	-31.6
Matsui	3,660	8628 JP	HOLD	2,951	3,740	724	16.2	28.0	27.5	327.1	216.7	-58.9
Average							5.3	11.5	4.6	151.6	85.3	-33.7
Index: Nikkei	11,980				12,128	7,608	5.8	8.9	10.0	53.8	24.5	-18.6
Currency: JPY	109.40				120.55	103.68	-2.3	-3.1	-0.4	9.6	10.8	10.8
Singapore:												
Banks												
DBS	13.90	DBS SP	BUY	9,960	16.20	8.30	2.2	-12.0	-7.9	58.0	33.6	-20.3
UOB	13.70	UOB SP	BUY	11,943	14.40	10.00	3.0	-3.5	-2.1	30.5	11.9	-7.1
OCBC	12.20	OCBC SP	HOLD	9,254	12.80	8.85	5.2	-3.9	-0.8	29.8	25.4	-12.3
Average							3.5	-6.5	-3.6	39.4	23.6	-13.2
Non-Banks												
GE Life	12.00	GE SP	HOLD	3,333	13.00	8.60	5.3	6.2	4.3	23.7	25.9	-14.6
SGX	1.69	SGX SP	BUY	988	2.13	1.18	4.3	-8.6	-19.1	38.5	37.4	-0.8
Hong Leong Fin.	3.00	HLF SP	BUY	761	3.04	1.94	3.8	11.1	6.0	53.8	45.3	5.8
Average							4.5	2.9	-2.9	38.7	36.2	-3.2
Index: STI	1,864				1,905	1,229	2.8	-1.4	5.2	46.2	31.6	-17.4
Currency: SGD	1.70				1.78	1.67	-0.4	-0.3	2.2	4.8	2.1	6.4

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

Fig 256 Asia-Pacific financials performance – cont.

Company	Price 4/22/04	Bloomberg code	ING rating	Mkt cap US$m	52 week High	52 week Low	% change 1m	3m	6m	12m	2003	2002
Malaysia:												
Maybank	11.10	MAY MK	HOLD	10,370	11.70	7.85	-5.1	9.9	9.9	37.9	30.4	-10.8
Public Bank	3.02	PBK MK	BUY	4,088	3.12	1.71	-1.3	7.1	17.5	67.8	55.5	13.8
CAHB	5.20	CAHB MK	BUY	3,539	5.65	2.87	-7.1	12.1	22.1	78.1	26.5	-12.4
AMMB	3.98	AMM MK	BUY	1,049	4.14	1.87	-2.0	17.1	30.1	109.5	41.6	7.9
EON Capital	5.25	EON MK	BUY	958	5.75	2.64	-6.2	6.3	19.3	97.4	71.8	7.8
Hong Leong	5.35	HLBK MK	BUY	2,018	5.85	4.00	-5.3	0.9	-1.8	27.4	15.6	23.6
RHB Capital	2.27	PHBC MK	BUY	1,089	2.73	1.37	-7.0	2.7	-0.9	62.1	44.4	-37.7
Southern Bank	3.12	SBK MK	NR	987	3.54	2.29	-8.8	13.0	21.9	34.5	34.0	-10.7
CIMB	6.05	CBB MK	NR	1,323	6.65	2.14	-4.7	16.3	44.7	167.7	NM	NM
Average							-5.3	9.5	18.1	75.8	40.0	-2.3
Index: KLCI	512				533	367	-4.0	5.8	8.7	37.2	22.5	-5.9
Currency: MYR	3.80				3.81	3.80	0.0	0.0	0.0	0.0	0.0	0.0
Korea:												
Banks												
Kookmin	47,000	060000 KS	BUY	13,632	50,600	29,950	2.6	-4.7	12.8	42.0	6.3	-15.7
Shinhan	23,000	055550 KS	BUY	7,765	23,050	10,550	12.5	14.4	35.7	98.3	53.6	-29.3
Koram	15,200	016830 KS	HOLD	2,661	15,800	6,960	1.0	7.0	21.6	89.8	89.2	-38.1
Hana	27,800	002860 KS	BUY	4,611	29,000	8,980	10.1	17.8	46.3	178.3	35.0	-3.6
IBK	8,600	024110 KS	BUY	3,398	8,620	4,690	9.3	16.2	20.6	69.6	15.2	-28.3
Woori FG	8,790	053000 KS	NR	5,382	9,250	4,360	-0.1	14.2	38.2	89.8	60.5	NM
KEB	6,400	004940 KS	NR	4,296	8,350	3,220	-6.2	-7.0	24.8	84.4	65.9	-2.2
Pusan	7,430	005280 KS	BUY	921	8,100	4,710	-4.1	6.8	22.8	45.7	45.0	8.0
Daegu	7,230	005270 KS	BUY	824	7,590	4,405	4.2	11.6	41.8	52.1	21.2	40.0
Average							3.2	8.5	29.4	83.3	43.5	-8.6
Brokers												
Hyundai	6,080	003450 KS	BUY	731	7,671	4,331	0.2	-13.1	-4.7	25.4	-6.8	-56.4
Samsung	25,600	016360 KS	HOLD	1,475	32,700	23,000	-1.5	-10.2	-0.4	-1.7	-11.0	-40.1
Daishin	17,300	003540 KS	HOLD	725	23,200	15,100	0.6	-10.4	-1.7	3.0	22.4	-19.7
Daishin Pref.	8,840	003545 KS	BUY	725	10,800	6,510	-7.9	-11.3	-3.1	24.9	15.5	-17.0
LGIS	10,700	005940 KS	HOLD	1,127	15,200	7,350	0.0	8.0	-7.4	-7.8	-37.6	-10.7
Daewoo	4,715	006800 KS	HOLD	773	5,790	4,000	-4.6	3.2	3.6	1.3	-6.0	-55.7
Average							-2.2	-5.6	-2.3	7.5	-3.9	-33.3
Insurance												
Samsung F+M	82,100	000810 KS	BUY	3,511	86,000	54,300	6.6	21.6	21.3	37.3	5.7	15.7
Korean Re	43,700	003690 KS	HOLD	403	50,800	22,500	-1.5	-6.8	58.0	79.5	104.7	-23.8
Oriental F+M	17,600	000060 KS	BUY	130	20,850	10,700	-9.5	12.1	28.9	59.3	17.5	-0.8
Average							-1.5	9.0	36.1	58.7	42.6	-3.0
Index: KOSPI 200	120.76				121.93	72.07	6.6	7.2	19.6	57.4	31.7	-8.2
Currency: KRW	1,159.73				1,237.85	1,140.30	0.1	2.4	1.9	5.2	-0.5	10.8
Taiwan:												
Chinatrust	38.00	2891 TT	BUY	6,308	41.90	23.96	3.3	2.7	13.4	47.5	33.7	34.8
First FHC	27.00	2892 TT	SELL	4,525	29.50	18.30	15.4	4.2	14.9	17.9	3.0	6.5
Taishin	32.20	2887 TT	BUY	3,653	33.10	15.80	9.5	18.4	33.6	85.1	41.0	37.5
SinoPac	19.00	2890 TT	HOLD	2,151	21.00	10.85	9.2	7.3	6.1	47.9	18.2	NA
E.Sun	22.70	2884 TT	BUY	1,718	24.10	14.55	9.1	6.1	16.4	40.1	34.9	22.1
Cosmos	23.00	2837 TT	BUY	1,230	24.70	12.45	13.9	21.1	44.7	59.7	25.0	93.3
Mega Financial	22.90	2886 TT	NR	8,016	25.50	14.90	10.1	2.2	10.6	40.1	26.3	-12.9
Fubon FHC	34.10	2881 TT	NR	8,620	38.20	23.80	5.6	1.5	-3.4	28.2	17.8	-9.2
Cathay FHC	64.50	2882 TT	NR	15,296	68.00	37.80	12.2	13.2	14.2	53.2	38.2	-35.3
Hua Nan	30.80	2880 TT	NR	4,382	33.20	19.80	9.6	9.6	18.5	36.9	-2.0	33.3
Chang Hwa	21.60	2801 TT	NR	3,266	24.50	11.19	9.1	18.7	24.9	69.5	17.1	17.7
CDIB	19.90	2883 TT	NR	6,575	20.60	10.81	15.0	9.3	37.7	52.5	31.5	-30.8
Average							10.2	9.5	19.3	48.2	23.7	14.3
Index: TWSE	6,732.09				7,034.10	4,139.50	5.9	7.4	11.4	47.8	32.3	-19.8
Currency: TWD	33.11				34.95	32.80	0.2	1.8	2.7	5.1	2.0	0.9

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

Fig 256 Asia-Pacific financials performance – cont.

Company	Price 4/22/04	Bloomberg code	ING rating	Mkt cap US$m	52 week High	52 week Low	% change 1m	3m	6m	12m	2003	2002
Thailand												
Banks												
BBL	98.00	BBL TB	BUY	4,909	111.00	51.50	5.9	-3.0	25.6	81.5	120.2	35.6
KBANK	54.50	KBANK TB	BUY	3,353	65.00	30.25	10.7	-6.8	34.6	66.4	150.0	39.8
SCB	48.25	SCB TB	HOLD	3,828	55.50	33.25	3.2	-5.4	19.1	35.9	94.7	68.2
KTB	11.30	KTB TB	BUY	3,186	12.90	7.25	8.7	-6.6	29.1	49.7	82.1	-36.8
BAY	12.90	BAY TB	BUY	927	14.60	8.20	10.3	-3.7	13.2	33.7	118.6	21.7
TMB	4.12	TMB TB	NR	987	6.11	3.47	-5.9	-23.7	2.0	13.2	52.8	-18.4
IFCT	4.40	IFCT TB	NR	201	7.20	4.30	-7.9	-24.8	-22.1	-24.1	7.9	-15.1
BT	6.70	BT TB	NR	310	8.85	6.00	-10.7	-3.6	-13.5	-20.7	-22.6	-48.3
DTDB	3.46	DTDB TB	NR	150	6.50	3.12	-8.5	-28.5	-32.8	-38.2	4.0	-3.8
BOA	5.25	BOA TB	NR	706	6.50	4.22	-4.5	5.8	-5.4	5.0	11.6	-6.2
Average							0.1	-10.0	5.0	20.2	61.9	3.7
Finance Cos.												
NFS	16.20	NFS TB	SELL	521	19.20	12.00	8.0	-1.2	-1.8	29.6	25.6	40.7
SPL	38.50	SPL TB	SELL	193	42.50	30.50	0.0	0.0	-3.8	15.8	-5.1	84.3
TISCO	30.00	TISCO TB	BUY	520	36.25	18.80	4.3	-5.5	-9.1	48.5	46.2	38.3
AEONTS	141.00	AEONTS TB	BUY	178	210.00	98.50	2.2	-14.5	-26.9	27.0	52.2	32.2
MIDA	25.75	MIDA TB	BUY	12,875	35.00	17.50	-3.7	-5.5	-8.0	NA	NA	NA
KTC	28.75	KTC TB	NR	199	44.00	13.58	11.7	-14.8	-21.8	107.9	337.4	NA
Average							3.7	-6.9	-11.9	45.8	91.3	48.9
Index: SET	578.67				660.89	314.27	2.9	-7.6	24.6	77.9	112.2	14.0
Currency: THB	39.67				43.04	38.84	-0.6	-1.7	0.6	7.8	8.8	2.6
Indonesia												
BCA	3,925	BBCA IJ	BUY	2,872	4,000.00	2,350.00	3.3	6.8	1.9	58.6	33.0	69.5
Danamon	3,500	BDMN IJ	BUY	2,032	3,500.00	1,250.00	17.6	47.4	89.2	145.6	15.7	25.0
BII	150	BNII IJ	BUY	594	150.00	70.00	30.4	30.4	36.4	114.3	120.0	-80.0
Panin	370	PNBN IJ	HOLD	652	385.00	205.00	10.4	4.2	27.6	80.5	58.3	143.2
Mandiri	1,525	BMRI IJ	NR	3,583	1,550.00	750.00	8.9	15.1	64.9	NA	NA	NA
BRI	1,850	BBRI IJ	NR	2,243	1,950.00	975.00	21.3	NA	NA	NA	NA	NA
Lippo Bank	625	LPBN IJ	NR	289	700.00	395.00	8.7	19.0	25.0	58.2	73.1	-13.3
NISP	490	NISP IJ	NR	196	530.00	196.08	14.0	11.4	44.1	149.9	86.1	90.5
Average							14.3	19.2	41.3	101.2	64.4	39.1
Index: JCI	804.43				814.20	430.92	8.3	3.6	24.5	81.7	62.8	8.4
Currency: IDR	8,653.00				8,745.00	8,175.00	-1.0	-2.8	-2.2	0.9	6.3	16.2
Philippines:												
BPI	46.00	BPI PM	BUY	1,572	52.50	33.50	3.4	-8.9	1.1	24.3	38.8	-30.1
Metrobank	25.00	MBT PM	HOLD	730	32.00	23.50	3.1	-12.3	-9.1	-13.8	-12.7	-23.2
Equitable-PCI	40.00	EBC PM	HOLD	523	43.00	23.25	3.9	-3.6	12.7	48.1	24.1	10.2
PNB	23.00	PNB PM	HOLD	155	28.00	18.75	-1.1	-7.1	-17.9	-11.5	3.2	-65.2
Average							2.3	-8.0	-3.3	11.8	13.3	-27.1
Index: PCOMP	1,548.28				1,565.00	1,035.99	8.1	-0.8	12.0	38.6	41.6	-12.8
Currency: PHP	55.89				56.48	52.06	1.0	-0.4	-1.2	-6.1	-3.5	-3.7

A list of ING's corporate relationships with the companies featured in this report is available on request

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

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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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