Equity Markets

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Company results

Hong Kong

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Bank of East Asia

2H03 Results Review

Maintained

Sell

10 February 2004

Banks

10/02/04

HK$25.40

Target price: 12 months

HK$20 (-21%)

Bloomberg

23 HK

BEA reported street-beating earnings for 2H03 and FY03 this evening, but the increase was largely due to trading profits which are unexplained and significant. We maintain our SELL rating with a new HK$20 price target.

Big earnings increase. BEA's 2H net income rose by 125% YoY and 42% HoH to lift full year profit to HK$1.9bn, a 49% increase over 2002. Earnings were also strong on a core basis, up 44% for the full year—but contribution from China fell despite loan growth.

But still low ROE. It's a measure of how low the bar has been for BEA that even such whopping percentages only bring the bank to just under 10% ROE for the full year—a definite laggard in the sector.

Trading gains lead. BEA did well in several areas, including insurance and investment sales and the bank's corporate services business, but it was the very large trading profits which pushed earnings over the top. Although management did not explain the source, we attribute some of it to a timely investment in Resona.

Forecasts and ratings

	2001	2002	2003	2004F	2005F
Net int. income (HK$m)	3,977.4	3,825.6	3,596.1	4,106.5	4,442.4
Core earnings (HK$m)	1,824.4	1,517.1	2,191.6	2,177.4	2,432.0
Net profit (HK$m)	1,599.8	1,288.4	1,921.7	2,032.6	2,286.6
EPS (HK$)	1.12	0.89	1.32	1.40	1.58
Ch to previous EPS (%)	n/a	n/a	n/a	n/a	n/a
Core EPS (HK$)	1.27	1.05	1.51	1.50	1.68
EPS growth (%)	-17.9	-20.6	49.0	6.1	12.5
PER (x)	22.7	28.6	19.2	18.1	16.1
DPS (HK$)	0.54	0.56	0.85	0.88	0.95
Yield (%)	2.1	2.2	3.3	3.5	3.7

Source: Company data, ING estimates

Financial data

	2002	2003	2004F
ROE (%)	6.9	9.9	10.2
Core ROE (%)	8.2	11.2	10.9
ROA (%)	0.7	1.0	1.0
Core ROA (%)	0.8	1.1	1.1
NIM (%)	2.2	2.0	2.1
Cost/Income (%)	51.3	43.3	43.7
Overhead (%)	1.6	1.3	1.3
BVPS (??)	13.0	13.8	14.4
Price/book (x)	2.0	1.8	1.8
PER (x)	28.6	19.2	18.1

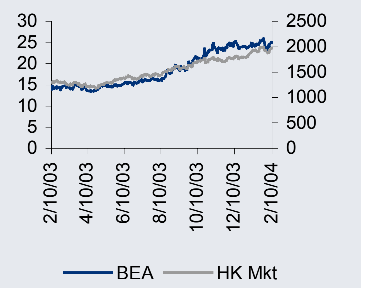
Share data

Market cap (US$m)	4,665
Number of shares (m)	1,449
Daily turnover (US$m)	7.5
Free float (%)	70.0
52-week hi/lo	13.5 - 25.95

Performance (%)

	1m	3m	12m
Absolute	1.4	7.1	70.4
Relative to HSI	-0.5	-5.6	19.2

Share price performance



Source: Datastream

Contents

Summary

A good set of results at the net line

BEA's results were stronger than we expected at the net income line, and well above consensus estimates for the company. The company's rapid earnings accretion only brought it to a 10% ROE for the year, however (11.5% for 2H03 alone).

Non-interest income leads

BEA continues to be very successful in its insurance business (Blue Cross) and its corporate services operations, which helped spur the group to a 22% rise in non-interest income. Corporate services income was up 27% YoY, while insurance and securities fees rose 47%.

But trading gains are somewhat a mystery

BEA booked a trading profit of HK$473m in 2003, most of it in the second half—an order of magnitude greater than any recent comparable period. Although a change in reporting accounts for some of the jump, management declined to any real additional information. We believe that the bank's Resona investment accounts for a big chunk of the gains, but not by any means all of them. With the securities portfolio concentrated in floating rate and sub-three year maturity bonds, we are scratching our heads a little on this one.

No loan growth, again....still

We hope to retire the above heading in 1H04 after several years of faithful service, but for now it still serves well: BEA's portfolio shrank again during the half, driven by a 13% YoY fall in mortgages. China and other non-HK loan growth is robust, but could not counteract the overall negative effect of BEA's largest market.

Margins dip slightly

Despite management's guidance in 1H03 that we had seen the nadir for margins, the bank dropped another 5bp by year end, mainly due to an inflow of deposits that the bank is hard pressed to reinvest.

Progress on costs

BEA's cost-to-income and overhead ratios both dropped in 2H, from 45.7% to 40.9% and 1.42% to 1.21% respectively. Overall costs were down 10% HoH and 18% YoY, despite a rise in staff costs. This has been a weak spot for BEA post its acquisitions, so it is positive to see it addressed.

China

Although lending and capital committed are both growing rapidly, overall contribution of the China business slipped by 19% YoY, which management attributes to increased capex and startup costs. Although we are sympathetic to this argument, the time has long since come when we should be seeing return on capital from the China business.

Results and returns

Hong Kong's Bank of East Asia reported 2H03 and FY2003 earnings this evening, posting a net profit of HK$1.92bn for the full year and HK$1.12bn for the second half. Earnings exceeded our forecasts of HK$1.71bn and HK$0.91mn, respectively, which were in turn above consensus estimates of HK$1.65bn and HK$0.81mn.

On a consecutive half and year-over-year basis, BEA made a good showing, with second half profit up 125% YoY and 42% HoH, and the full year numbers a 49% improvement over 2002's dismal HK$1.28bn net.

We consider this a pretty good result overall—but our enthusiasm is tempered by the low base from which BEA is improving.

Fig 1 Key Earnings components: 1997-2005

HK$000s	1997	1998	1999	2000	2001	2002	2003	2004F	2005F
Net Interest Income	3,228,936	3,326,655	3,504,522	3,695,330	3,977,418	3,825,638	3,596,080	4,106,542	4,442,432
Non-Interest Income	1,028,914	940,428	2,135,369	1,269,950	1,198,222	1,575,819	1,914,599	1,722,582	1,825,575
Non-Interest Expenses	1,676,015	1,699,679	1,802,738	2,082,963	2,762,704	2,769,213	2,385,453	2,547,779	2,676,575
Loan Loss Provisions	292,224	1,506,264	2,215,243	680,614	432,385	810,939	498,670	642,075	643,586
Core Income	2,105,187	1,011,620	367,584	1,885,247	1,824,448	1,517,095	2,191,624	2,177,398	2,431,973
Net Income	**2,083,103**	**927,788**	**1,488,889**	**1,887,078**	**1,599,806**	**1,288,378**	**1,921,714**	**2,032,639**	**2,286,557**
EPS	1.56	0.68	1.08	1.34	1.12	0.89	1.32	1.40	1.58

Source: Company data, ING estimates

Fig 2 Key Earnings components: 2H99-2H03

HK$000s	2H99	1H00	2H00	1H01	2H01	1H02	2H02	1H03	2H03
Net Interest Income	1,757,165	1,847,455	1,847,875	2,066,197	1,911,221	1,897,205	1,928,433	1,777,013	1,819,067
Non-Interest Income	510,718	547,556	775,202	591,154	607,068	829,860	745,959	975,538	939,061
Non-Interest Expenses	938,187	1,018,720	1,080,032	1,334,108	1,428,596	1,389,842	1,379,371	1,257,976	1,127,477
Loan Loss Provisions	1,555,276	220,403	460,211	49,406	382,979	321,224	489,715	291,211	207,459
Core Income	(1,460,236)	1,035,621	962,039	1,077,624	644,306	862,007	727,329	845,768	1,352,432
Net Income	**811,999**	**935,499**	**951,579**	**1,011,945**	**587,861**	**786,597**	**501,781**	**792,502**	**1,129,212**
EPS	0.59	0.67	0.68	0.71	0.41	0.55	0.35	0.55	0.78

Source: Company data, ING estimates

In addition, the 2003 fiscal year was muddied by a number of exceptional items both pro and con, including some about which we don't have full clarity.

Among these is the source of BEA's HK$412m in dealing and trading profit in the second half alone, versus HK$61m in the first half and HK$57m in the prior year period. This profit, which is larger than the sum of BEA's aggregate dealing profits for the five previous years combined[1], was explained by management today only to the extent of saying that it was "part equities and part bonds."

We believe that some of it might well come from BEA's timely investment in Resona Holdings last March. At that time, BEA invested approximately HK$74m (JPY1bn) in shares of the troubled bank group at a price of JPY54 per share. At the close of 2003, Resona shares were quoted at JPY135—a very shrewd investment by David Li Kwok Po and his team made over a chorus of objections including our own.

While we still don't like getting a slice of Japanese bank with our Hong Kong China play, we must concede that the timing was perfect and the resulting profit of HK$111m very welcome. Although we don't know exactly how this investment was booked (and

[1] Note that 2002 trading profits were restated upwards with this release, so that the same might have been true for prior years, making the numbers we have less comparable in magnitude.

be assured that you shall hear from us on the subject again as soon as we find out), we suspect that in some way its mark-to-market is part of this exceptional trading item for BEA during this period.

Fig 3 BEA's Resona holdings

		Per Share	Total (HK$)
# of shares purchased	18,500,000		
Purchase price:		JPY 54.00	73,754,223
Price at year-end		JPY 135.00	184,385,557
Profit		JPY 81.00	110,631,334

Source: Company data, ING estimates

What accounts for the remainder? We simply don't know...yet.

Return on capital is lifted

Both ROA and ROE improved substantially during the course of 2H03, with full year ROE of 9.86% the highest since FY2000. On a core basis, both ROE and ROA were higher—11.25% and 1.14% respectively—primarily due to the addition of goodwill amortization (HK$140m) and the exclusion of losses on sales of fixed assets (HK$114m).

Second half ROE was even stronger at 11.5% (13.77% on a core basis) versus 8.33% in the first half (8.89% on a core basis).

Fig 4 Key Earnings Ratios: 1997-2005

	1997	1998	1999	2000	2001	2002	2003	2004F	2005F
ROA	1.69%	0.69%	1.06%	1.16%	0.89%	0.70%	1.00%	1.02%	1.09%
Core ROA	1.71%	0.75%	0.26%	1.16%	1.01%	0.83%	1.14%	1.09%	1.16%
ROE	16.69%	6.77%	10.22%	11.67%	9.00%	6.94%	9.86%	10.19%	10.85%
Core ROE	16.87%	7.39%	2.52%	11.66%	10.26%	8.17%	11.25%	10.91%	11.54%
NIM	2.75%	2.58%	2.61%	2.39%	2.32%	2.21%	1.97%	2.14%	2.20%
Cost/Income	39.36%	39.83%	31.96%	41.95%	53.38%	51.27%	43.29%	43.71%	42.70%
Overhead	1.43%	1.32%	1.34%	1.35%	1.61%	1.60%	1.31%	1.33%	1.32%
Effective Tax Rate	15.06%	12.57%	7.74%	13.15%	14.09%	14.59%	16.50%	17.50%	17.50%

Source: Company data, ING estimates

Fig 5 Key Earnings Ratios: 2H99-2H03

	2H99	1H00	2H00	1H01	2H01	1H02	2H02	1H03	2H03
ROA	1.14%	1.29%	1.17%	1.12%	0.65%	0.87%	0.55%	0.85%	1.16%
Core ROA	-2.06%	1.42%	1.19%	1.19%	0.71%	0.95%	0.80%	0.91%	1.39%
ROE	10.95%	12.12%	11.48%	11.49%	6.50%	8.52%	5.34%	8.33%	11.50%
Core ROE	-19.69%	13.41%	11.61%	12.24%	7.13%	9.33%	7.74%	8.89%	13.77%
NIM	2.59%	2.66%	2.39%	2.39%	2.20%	2.20%	2.23%	2.00%	1.95%
Cost/Income	41.37%	42.54%	41.17%	50.20%	56.73%	50.96%	51.58%	45.70%	40.88%
Overhead	1.38%	1.47%	1.40%	1.54%	1.64%	1.61%	1.60%	1.42%	1.21%
Effective Tax Rate	-12.72%	14.32%	11.45%	16.15%	10.38%	15.25%	13.75%	18.70%	14.64%

Source: Company data, ING estimates

Capital remains an issue

One of the steps BEA management has taken that we very much like is to exit low-ROE areas of the loan portfolio. However, this only works for investors if the excess capital is returned to shareholders—an action notably absent from management's list of remedies for low ROE.

Fig 6 Capital adequacy

	2000	2001	2002	2003
Tier 1 CAR	12.9%	12.5%	12.4%	13.0%
Total CAR (Unadjusted)	16.3%	17.5%	17.0%	17.2%
Total CAR (Adjusted)	16.2%	17.4%	16.9%	17.1%

Source: Company data, ING estimates

Management did note that BEA's subordinated debt issue (US$550m at 7.5%) becomes callable in 2006 (5 years before its scheduled maturity of 2011, or when the issue starts to lose its tier 2 qualification), and that there was not yet a firm decision on whether or not to redeem the bonds and reissue them or simply redeem them and take the capital hit. For ROE purposes replacing the sub debt with equity would have a dampening effect, unless the return of the business in 2006 is less than 7.5%—which we highly doubt.

The company's 2% convertible bond issue (with effective conversion price of HK$26.16) was redeemed in July, avoiding potential dilution but further de-gearing the balance sheet.

Rates and Margins

BEA continues to lose net interest margin, primarily because the size of the bank's balance sheet is largely controlled by depositors. A 9.8% rise in deposits during the year added HK$15bn to the liability book, matched by a HK$13bn rise in assets over the same period. Loans, however, were shrinking, so the excess funds wound up swelling the interbank (+HK$9bn) and securities (+HK$6bn) accounts—an unrewarding business in a low-rate environment.

Fig 7 Key Net Interest Margin Components: 1998-2003

	1998	1999	2000	2001	2002	2003
Yield on Earning Assets	8.72%	7.12%	6.25%	5.63%	3.79%	3.01%
Cost of Interest-bearing Liabilities	6.86%	5.26%	4.95%	3.65%	1.70%	1.30%
Interest Spread	1.86%	1.86%	1.30%	1.98%	2.09%	1.72%
Net Interest Margin	2.58%	2.61%	2.39%	2.32%	2.21%	1.97%

Source: Company data, ING estimates

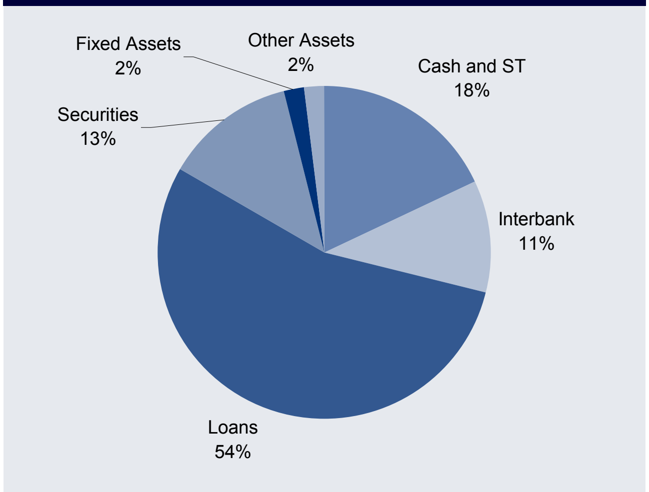
Fig 8 Key Net Interest Margin Components: 2H00-2H03

	2H00	1H01	2H01	1H02	2H02	1H03	2H03
Yield on Earning Assets	6.45%	6.37%	4.83%	3.78%	3.79%	3.24%	2.94%
Cost of Interest-bearing Liabilities	5.19%	4.44%	2.84%	1.73%	1.70%	1.43%	1.18%
Interest Spread	1.25%	1.92%	1.98%	2.05%	2.10%	1.81%	1.76%
Net Interest Margin	2.39%	2.39%	2.20%	2.20%	2.23%	2.00%	1.95%

Source: Company data, ING estimates

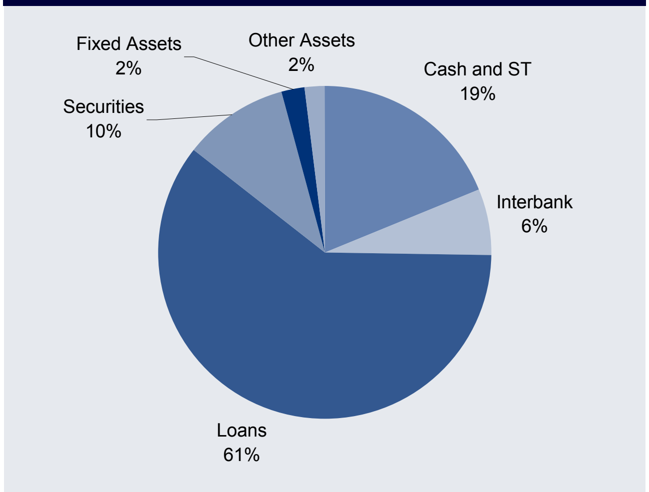
Although the bank has lowered rates commensurately (less than 1bp out to 90 days), the compressed yield on assets has declined even more quickly, in particular as interbank rates have hit an historic low of 3bp for overnight funds and 11bp for 1 month money. BEA needs a turnaround in interest rates (which we do see in 2H04) to begin increasing margins again.

Fig 9 BEA asset breakdown: YE2003



Source: Company data, ING estimates

Fig 10 BEA asset breakdown: YE2002



Source: Company data, ING estimates

Loan Growth

BEA's loan book continues to run off overall, despite healthy growth outside its main Hong Kong business. Overall loans were down 1.6% HoH and 4.6% YoY, with customer lending down slightly more at –1.9% and –5.1% over the comparable periods.

One of the major decisions that BEA has made with regard to the loan book is to let the mortgage portfolio run down, with management not willing to chase loans aggressively at the current rate of prime – 260bp, or 2.4%. In addition, BEA sold an additional HK$1.3bn of mortgages to the Hong Kong Mortgage Corporation in early 2003, after a HK$2.8bn sale in late 2002.

We think this is very sensible considering BEA's options, but the rate of runoff (-13% YoY and –6% HoH) is punishing.

Fig 11 BEA loan growth: 2H02-2H03

	2H02	1H03	2H03	YoY %chg	HoH %chg
Total loans:	109,497	106,133	104,473	-4.6	-1.6
To banks	1,089	1,190	1,564	43.7	31.4
To customers	108,409	104,943	102,909	-5.1	-1.9
Loans for use in Hong Kong	84,344	79,379	75,469	-10.5	-4.9
industrial, commercial and financial	33,908	32,861	31,327	-7.6	-4.7
- property development	4,848	4,952	4,970	2.5	0.4
- property investment	11,745	11,924	11,884	1.2	-0.3
- financial concerns	2,224	1,909	2,045	-8.0	7.1
- stockbrokers	105	131	322	207.9	146.7
- wholesale and retail trade	2,108	1,956	1,790	-15.1	-8.5
- manufacturing	1,460	1,363	1,250	-14.3	-8.3
- transport and transport equipment	4,512	4,330	4,565	1.2	5.4
- others	6,908	6,296	4,501	-34.8	-28.5
Individuals	47,164	43,352	40,827	-13.4	-5.8
- HOS Mortgages	2,207	2,047	1,848	-16.3	-9.7
- other mortgages	39,931	36,716	34,596	-13.4	-5.8
- credit card advances	1,692	1,384	1,433	-15.3	3.5
- others	3,333	3,204	2,950	-11.5	-7.9
Trade finance	3,273	3,167	3,315	1.3	4.7
Loans for use outside Hong Kong	24,064	25,564	27,440	14.0	7.3

HK$m
Source: Company data, ING estimates

China book gets bigger

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.

Fig 12 China loan growth: 2H00-2H03 (HK$000)

	2H00	1H01	2H01	1H02	2H02	1H03	2H03
China Loans	3,188,183	3,359,005	3,491,205	3,638,106	4,132,169	4,593,239	5,588,249
Growth rate (%, HoH)	NA	5.4%	3.9%	4.2%	13.6%	11.2%	21.7%

Source: Company data, ING estimates

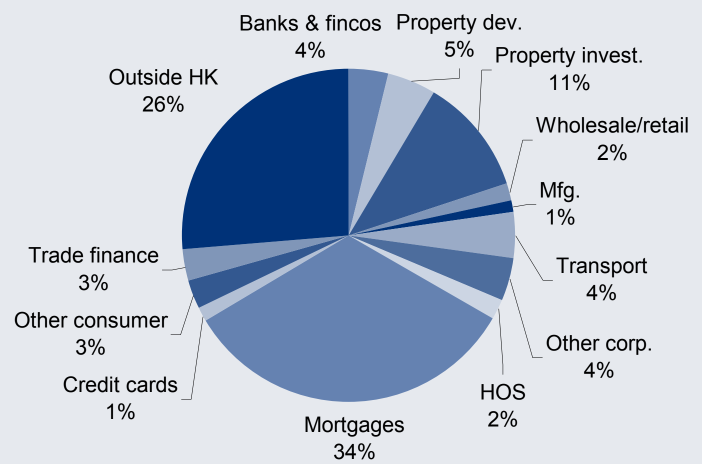
Loan mix

BEA's portfolio continues to be driven by Hong Kong lending, with over half the book dependent on property lending of one sort or another. The bank is also quite aggressive in taxi finance—a sometimes risky area that has seen much of the competition (*e.g.* JCG's Winton) pull out in recent years.

BEA hasn't ventured too much into consumer finance or credit cards, but management has indicated that this is a critical part of their plan to increase margins and revenues going forward. We believe that the strategy of acquiring excess deposits in this low-rate environment is an attempt to increase the number of BEA's retail customers in preparation for an aggressive campaign to sell them high margin investment products and consumer loans.

In general we approve of the strategy, but the market is so crowded that we think BEA will have a difficult time making an impact.

Fig 13 Loan mix



Source: Company data, ING estimates

Asset Quality

BEA's asset quality is definitely getting better and was one of the highlights of the result, and one which we hope is generally indicative of what we will see from the other banks in this reporting season.

Gross NPLs on our broad definition decreased by 11% HoH and 16% YoY to 2.9% of total loans. NPLs also declined on a weighted basis, with our estimate of weighted classified loans falling from 1.52% of total loans at mid-year to 1.16%.

Our NPL migration analysis shows that loans have started to be upgraded to performing on a net basis in the second half; this is strong evidence of a broad-based economic recovery.

Fig 14 NPL migration: 1H02-2H03

	1H02	2H02	1H03	2H03
NPLs at beginning of period	3,527,700	3,677,473	3,407,932	3,187,182
Net charge-offs	286,065	686,141	381,933	236,756
Net new NPL inflows	435,838	416,600	161,183	(99,938)
NPLs at end of period	3,677,473	3,407,932	3,187,182	2,850,488

Source: Company data, ING estimates

One slight cavil to our enthusiasm is that the rise in restructured loans (+71% HoH and +80% YoY) is an area of potential worry. We consider even performing restructured loans as Special Mention in our NPL methodology, with a 5% specific reserve.

Charge-offs continue to fall, dropping from an annualized 71bp in the first half to 45bp in the second. Although charge-offs are still slightly outrunning provisions, a shrinking loan book and rising credit quality mean that coverage is rising slightly in any case.

Fig 15 Charge-off summary: 1998-2003

BP on average loans	1998	1999	2000	2001	2002	2003
Provisions	179.04	261.89	71.87	40.55	74.32	46.61
Net Charge-offs	108.33	30.50	246.79	42.48	89.10	57.83
Provisions less charge-offs	70.71	231.39	(174.92)	(1.93)	(14.78)	(11.22)
Accumulated Reserves	195.07	425.41	205.04	180.19	161.29	153.29

Source: Company data, ING estimates

Fig 16 Charge-off summary: 2H00-2H03

BP on average loans	2H00	1H01	2H01	1H02	2H02	1H03	2H03
Provisions	44.04	4.65	35.33	29.08	44.18	27.01	19.70
Net Charge-offs	148.07	11.97	30.05	25.90	61.91	35.42	22.48
Provisions less charge-offs	(104.03)	(7.32)	5.28	3.18	(17.72)	(8.41)	(2.78)
Accumulated Reserves	185.81	175.38	177.25	177.12	158.79	154.83	155.74

Source: Company data, ING estimates

China NPL problem persists

The core of BEA's remaining bad loan problem remains the mainland book, which is very stubborn and slow to clear. Note that the absolute amount of mainland NPLs barely budged from 1H to 2H—although the percentage did decline due to rapid growth in China lending.

China loans remain 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. Almost 30% of BEA's remaining problem loans come from China lending.

Fig 17 NPLs by booking location: 1H03 (HK$000)

1H03	Total Loans	NPLs	NPLs/Loans	% of total NPLs
Hong Kong	84,694,817	1,911,321	2.3%	66.3%
Mainland China	4,593,239	745,156	16.2%	25.9%
Other Asia	4,990,938	159,451	3.2%	5.5%
Non-Asia	10,663,986	66,350	0.6%	2.3%

Source: Company data, ING estimates

Fig 18 NPLs by booking location: 2H03 (HK$000)

2H03	Total Loans	NPLs	NPLs/Loans	% of total NPLs
Hong Kong	81,092,324	1,587,928	2.0%	62.9%
Mainland China	5,588,249	747,602	13.4%	29.6%
Other Asia	5,150,091	108,408	2.1%	4.3%
Non-Asia	11,078,172	82,451	0.7%	3.3%

Source: Company data, ING estimates

Reserve Adequacy

BEA's reserves have improved markedly on our standard regional methodology. Although the bank's actual reserves are only 73% of our theoretical required figure, this is an increase from the low of 51% hit in 2H00. In addition, the shortfall amounts to only 3% of shareholders' equity—a marginal difference and one well short of the 11% peak.

Fig 19 BEA reserve adequacy: 2H03

HK$000s	Gross Amount	Reserve Percentage	Required Reserve
Pass	101,622,329	1%	1,016,223
Special Mention	1,123,114	5%	56,156
Substandard	505,500	20%	101,100
Doubtful	339,092	50%	169,546
Loss	882,782	100%	882,782
ORE	176,265	20%	35,253
Excess AIR	-	20%	-
Total	104,649,082		2,261,060
Actual Reserves			1,639,951
Shortfall			621,109
Actual/Required			73%
Shortfall/Capital			3%

Source: Company data, ING estimates

China business

Good news: we're #1

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.

Fig 20 BEA mainland China network

Region	Offices*	Status	Licenses held
Beijing	1	Branch	FX
Shanghai	3	Branch	RMB-Domestic
Shenzhen	1	Branch	RMB
Xiamen	1	Branch	FX
Guangzhou	2	Branch	RMB
Zhuhai	1	Branch	RMB
Dalian	1	Branch	FX
Xi'an	1	Branch	FX
Fuzhou	1	Rep. Office	
Qingdao	1	Rep. Office	
Wuhan	1	Rep. Office	
Tianjin	1	Rep. Office	
Chongqing	1	Rep. Office	
Chengdu	1	Rep. Office	
Total Mainland	17		

* includes branches, sub-branches, and rep offices.

Source: Company data, ING estimates

Bad news: there's no money in it

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. According to management, China currently accounts for 6.7% of total profit versus 12.4% in 2002.

This is despite the commitment of substantially more capital to upgrade the business: each branch requires HK$200m in capital to begin with, plus an additional HK$100m when an RMB license is granted. In total management estimates that an additional HK$540m in capital has been injected into the mainland business in 2003, lowering the ROE from 2002's 8-9%

Bear in mind that the capital commitment will get worse before it gets better: management expects that in 2006 when full consumer RMB powers are granted the per-branch minimum capital will rise to a whopping HK$600m.

Valuation

BEA is simply too expensive for us to recommend given its limited overall growth and poor ROE. It is perfectly fair to note that we have been consistent in that view almost all the way up for the stock, but we're not about to change our principles now!

At its closing price of HK$25.40 BEA is trading on 19.2x the just-announced 2003 EPS, and at 1.84x book value per share (2.08x tangible BVPS). Even projecting steady earnings growth for next year and looking at core earnings instead of net (adding back the goodwill amortization as we should properly do when valuing the company) brings us to just under 17x.

In our recent note on Hong Kong bank valuations[2] we discussed why historically this is a statistical bad bet, and it's easy to maintain discipline in this case as it coincides with our view that over 1.8x book is too much to pay for a current 10% ROE stock.

Fig 21 Valuations

	2001	2002	2003	2004F
Share Price (HK$)	25.40			
PER (x)	22.73x	28.62x	19.21x	18.11x
Core PER (x)	19.93x	24.31x	16.85x	16.90x
PUP (x)	15.07x	14.01x	11.81x	11.22x
P/BV (x)	1.99x	1.95x	1.84x	1.80x
P/ABV (x)	2.49x	2.37x	2.08x	2.01x

Source: Company data, ING estimates

We have adjusted our valuation for BEA, mainly to take into account a better economic environment for Hong Kong and commensurately-lower credit costs in out years, as well as a fall in swap rates and our market risk premium (now 6% vs 6.95% at last results). In addition, we are all another year older and have thus rolled forward our target book multiple to YE2004 figures.

On this basis we have lifted our valuation from HK$17.50 to HK$20, leaving just over 20% downside to BEA from current prices.

Fig 22 Cost of capital valuation summary

5yr swap rate	3.27%
Market risk premium	6.00%
Estimated forward Beta	1.00
Cost of capital	9.3%
Sustainable LT core ROE	13.0%
Implied PBV (x)	1.40
2004F BVPS	14.38
Implied target price (HK$)	20.16
Current price (HK$)	25.40
Upside	-20.6%

Source: Company data, Bloomberg, ING estimates

[2] *Hong Kong Banks: The Slippery Slope*, dated January 28, 2004

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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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