ING FINANCIAL MARKETS

Hong Kong

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HSBC

Bermuda Longs

Maintained

Hold

30 October 2003

Banks

30/10/03

HK$ 115.5/ 874p

Target price: 12 months

HK$105 / 795p (-9%)

Bloomberg

5 HK / HSBA LN

HSBC has agreed to purchase Bank of Bermuda for US$1.3bn. After considering potential synergies and cost savings from both BoB and Losango (purchased earlier in the month), we raise earnings by 1.5-2.5% in 03-04F. HOLD.

What about BoB? HSBC's purchase of Bank of Bermuda makes the bank a player in mutual fund and hedge fund administration, with US$105bn in assets under administration and a blue-chip client list. This should bolster HSBC's existing asset management, custody, and pension businesses.

Private banking. BoB is also a respectably sized private bank, with US$22bn under management–much of it from Asia. This will increase HSBC's AUM by 16%. This acquisition is probably not HSBC's last in the quickly-consolidating private banking and asset management realm.

Further South. We have also included our estimates of increased earnings in 2004-05 from the purchase of Lloyds TSB's Brazilian operations (primarily consumer finance arm Losango) in this report.

Forecasts and ratings

Yr to December	2001	2002	2003F	2004F	2005F
Net int. income (US$m)	14,725	15,460	22,123	23,344	24,978
Core earnings (US$m)	6,208	7,590	9,918	11,209	12,956
Net profit (US$m)	4,992	6,239	7,860	9,199	10,876
EPS (US$)	0.53	0.66	0.73	0.86	1.01
Ch to previous EPS (%)	n/a	n/a	1.5	2.5	0.0
Core EPS (US$)	0.66	0.80	0.93	1.05	1.20
EPS growth (%)	-45.3	23.3	11.5	17.0	17.1
PER (x)	27.8	22.6	20.2	17.3	14.8
DPS (US$)	0.48	0.53	0.56	0.60	0.65
Yield (%)	3.2	3.6	3.8	4.0	4.4

Source: Company data, ING estimates

Financial data

	2002	2003F	2004F
ROE (%)	11.91	11.32	12.73
Core ROE (%)	14.48	14.28	15.51
ROA (%)	0.86	0.97	1.04
Core ROA (%)	1.04	1.22	1.27
NIM (%)	2.44	3.12	2.99
Cost/Income (%)	54.91	52.02	51.18
Overhead (%)	2.36	2.79	2.60
NPLs/Tot. loans (%)	2.63	2.43	2.21
BVPS (US$)	5.53	6.48	6.74
Price/book (x)	2.69	2.29	2.20

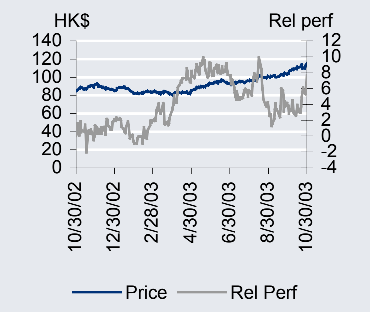
Share data

Market cap (US$m)	**159,047**
Number of shares (m)	10,713
Daily turnover (US$m)	136
Free float (%)	100.0
52-week hi/lo	80.25 - 115.5

Performance (%)

	1m	3m	12m
Absolute	11.1	20.6	34.7
Relative to HSI	2.9	0.6	7.7

Share price performance



Source: Bloomberg

HSBC to buy BoB

HSBC management announced Tuesday evening that the bank has concluded an agreement to buy 100% of Bank of Bermuda ("BoB"). The transaction, which is a friendly one, will be 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$1.3 billion.

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.

Nasdaq listing, US disclosure

BoB's primary listing is on the Bermuda Stock Exchange; however, the company did complete a secondary listing on Nasdaq (ticker: BBDA) in April, 2002. The company does file SEC disclosure documents with US GAAP financials on form 6-K and 20-F; our analysis is based on these US conforming figures.

Valuation

HSBC has offered US$40 per share plus a US$5 dividend to be paid to current holders before completion of the transaction. On a headline basis the total consideration of US$45 is 1.9x current book value and 14.9x annualised 3Q03 EPS (17.8x FY2002 EPS).

Fig 1 BoB Valuation at bid price

	2001	2002	3Q03
Share Price (US$)	45.00		
PER (x)	23.51	17.78	14.91
Core PER (x)	20.95	14.22	14.59
PUP (x)	20.32	16.86	13.48
P/BV (x)	2.24	2.09	1.90
P/ABV (x)	2.24	2.09	1.90

Source: Company data, ING estimates

However, this does not fully reflect the economics from HSBC's point of view, as it is allowing shareholders to take out cash at 1x book prior to closing. On an adjusted basis, HSBC is paying 2.14x book value for BoB.

Fig 2 Adjusted HSBC bid valuation

US$	
BVPS (3Q03A)	23.68
less: dividend	(5.00)
Adj. BVPS	18.68
Cash bid for shares	40.00
Adjusted PBV (x)	2.14

Source: Company data, ING estimates

Transaction approval

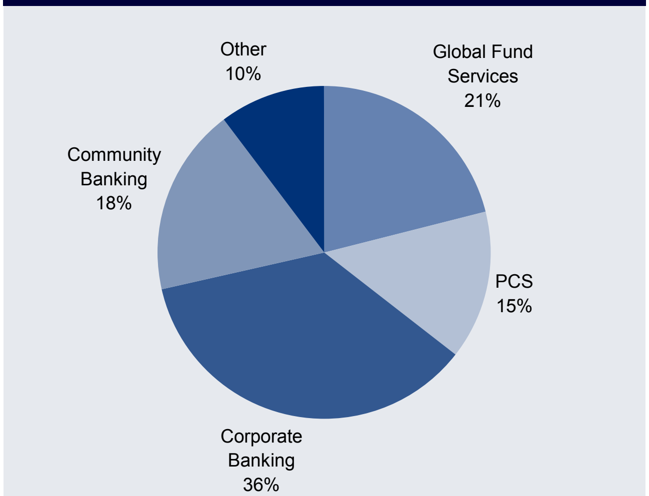
The BoB acquisition has already been approved by BoB's and HSBC's boards of directors, and the deal is expected to close in 1Q04. Required approvals include those of BoB shareholders (75% of voting shareholders' approval required) and regulators.

BoB's primary regulators are the Bermudian Monetary Authority and Ministry of Finance; approval of the New York State Banking Department will also be required for change of control of the company's US limited-purpose trust bank. We do not anticipate any difficulty gaining regulatory approval.

Business lines

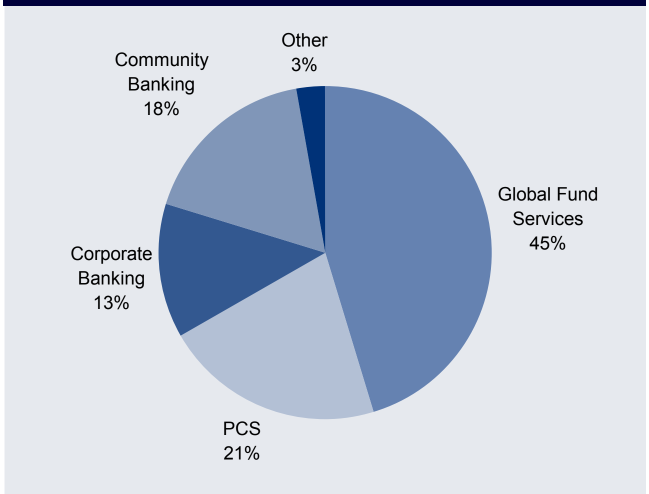
BoB has four major business lines, with fund management accounting for the major chunk of revenues and profits. Key points on each business area:

Fig 3 BoB profits by business line: FY2002



Source: Company data

Fig 4 BoB revenues by business line: FY2002



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.

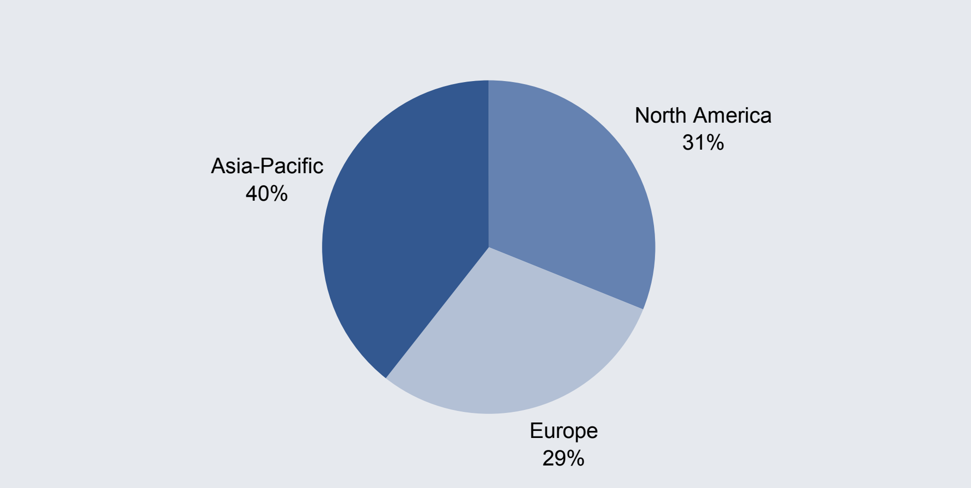
The last has become particularly important after a series of recent scandals at hedge and mutual funds over inaccurate pricing of exotic and/or illiquid securities held within the book, which resulted in faulty NAVs being given to clients and used in transactions. Hedge funds in particular tend to be 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.

Major competitors in fund administration include State Street (post its acquisition of IFS in 2002), Bank of New York (IFA), Citco Fund Services, BNP Paribas (which bought Cogent from AMP), and JP Morgan Chase.

Note that the largest proportion of BoB's fund adminstration 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.

Fig 5 Geographic distribution of fund management fees



Source: Company data

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.

Fig 6 Private banking leaders

Institution	Private banking AUM (US$m)
UBS Private Banking	433
Morgan Stanley Dean Witter	292
Credit Suisse Private Banking	265
JPMorgan Chase Private Banking	245
Goldman Sachs	230
Deutsche Bank Private Banking	196
Citigroup Private Banking	150
Merrill Lynch International Bank	136
HSBC Republic	135
BNP Paribas	92

AUM as of 12/31/01

Source: FinanceAsia

Cash management

BoB's corporate treasury operation specialises in offshore cash management, investment, and FX 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 a 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 year-end 2002. All retail deposit-taking and lending occurs in Bermuda.

Network

Bank of Bermuda has a comprehensive worldwide network for a bank with such small asset size, being represented in all the major offshore jurisdictions (Bermuda, Caymans, Guernsey, Jersey, the Isle of Man, and the Cook Islands), as well as popular private banking havens Geneva and Luxembourg.

We assume that it will be relatively simple to consolidate most of these overseas offices (which house over 40% of BoB's staff) with the existing HSBC platform–a major reason why we believe that cost synergies exist.

Fig 7 BoB global network

Country	Branches	Principal Entity	Year entered
Bermuda	8	Bermuda Trust Co. Ltd	1889
Cayman Islands	1	Bank of Bermuda (Cayman) Limited Bermuda Trust (Cayman) Limited	1988
New York	1	Bank of Bermuda (New York) Limited	1983
Bahrain	1	Rep Office	1997
Dublin	1	Bank of Bermuda (Europe) plc	1991
Geneva	1	JV: Banque Notz Stucki SA	
Guernsey	1	Bank of Bermuda (Guernsey) Limited	1973
Isle of Man	1	Bank of Bermuda (Isle of Man) Limited	1972
Jersey	1	Bermuda Trust (Jersey) Limited Le Masurier, James & Chinn Limited	1972
London	1	Rep Office	1968
Luxembourg	1	Bank of Bermuda (Luxembourg) S.A.	1987
Cook Islands	1	Bermuda Trust (Cook Islands) Limited	1994
Hong Kong	1	Restricted Licence Bank	1974
Singapore	1	Bermuda Trust (Singapore) Limited	1993
Japan	1	Bermuda Global Fund Services Limited	2003
South Africa	1	JV: Global Fund Services (South Africa)	2003

Source: Company data, ING estimates

Returns

Bank of Bermuda has had several years of sub-par returns, with ROE for the 2001-03 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 8 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 9 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%

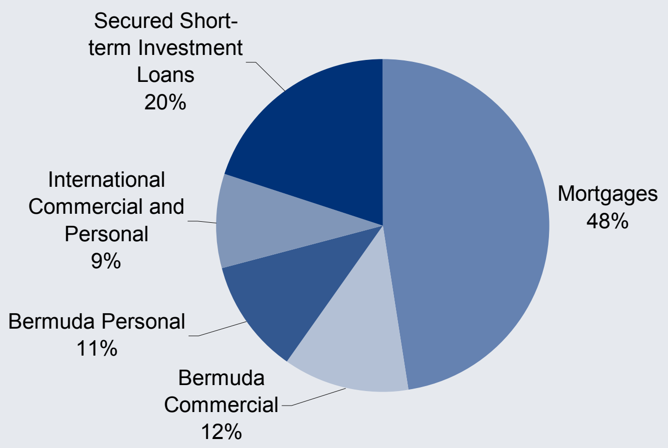
Source: Company data, ING estimates

Squeaky-clean asset quality

BoB takes very little traditional credit risk, with its portfolio of loans totalling only US$2.1bn at 3Q03, or 18% of total assets. Of these, 20% are secured short-term loans backed by clients' investments–also a very low-risk type of lending if good control of the collateral is maintained.

Mortgages represent over half of the remaining loan assets (90% of these are for Bermudian property), and have been boosted by the bank's acquisition of mortgage bank Bermuda Home Limited in 1999.

Fig 10 BoB loan portfolio breakdown: YE2002



Source: Company data

As should be expected given the low overall risk, BoB is well-reserved against losses, with loan loss reserves totalling just over 100% of our theoretical required amount, and most of this being general provision. Non-performing and classified loans amount to less than 1% of total loans, with the weighted classification ratio at 0.24% among the best in our universe.

Fig 11 BoB reserve adequacy: 3Q03

US$m	Gross Amount	Reserve Percentage	Required Reserve
Pass	2,152	1%	22
Special Mention	6	5%	0
Substandard	11	20%	2
Doubtful	6	50%	3
Loss	-	100%	-
ORE	-	20%	-
Excess AIR	-	20%	-
Total	2,175		27
Actual Reserves			27
Shortfall			(0)
Actual/Required			101%
Shortfall/Capital			0%

Note: classified asset breakdowns are ING estimates.

Source: Company data, ING estimates

Wealth management focus

Note that the purchase of BoB reinforces HSBC's commitment to wealth and asset management as a central part of the business, a strategy which has seemed less visible since the demise of the ML-HSBC joint venture and the renewed emphasis on consumer lending occasioned by the Household International acquisition.

We still think this is the brightest future for HSBC, given that it is more and more difficult to grow meaningfully by acquisition as the bank gets larger. Non-balance-sheet intensive wealth management businesses offer the potential for higher growth and better ROE–both are still serious issues for HSBC despite improving world markets and good execution by management.

Brazil acquisition also smart

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 1,600 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.

However, the game has changed in recent days as HSBC has finally concluded a long campaign to purchase the Brazilian assets of Lloyds TSB.

In addition to banking, HSBC has substantial interests in insurance (No. 7 in Brazil), asset management (No. 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, which were put up for sale in June. Lloyds reports total Brazilian exposure of GBP1.5bn (US$2.5bn) as of 1H03—a sharp contraction from year-end 2002 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 15,000 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 acounts, 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.

Falling rates, rising currency

However, bear in mind that 2003 interim results are likely to have been very strong due to falling interest rates throughout the period. Note that the benchmark SELIC rate peaked in February at 26.5% and has since fallen to 19%, potentially generating extraordinary gains. In addition, the Brazilian Real appreciated 20.3 per cent in 1H03. Even so, we believe that this transaction is likely to be accretive to HSBC.

HSBC Earnings and Valuation

Raising earnings estimates

We have increased our earnings estimates to take into account the effects of the BoB and Losango acquisitions, along with other minor effects, raising net income by 1.5% in 2003 and 2.5% in 2004. In addition, we have published 2005 forecasts which call for an 18% increase in net income over 2004.

As US economic growth is exceeding our estimates, we may have further upside to these numbers; we will be reviewing our HSBC Americas forecasts over the coming weeks.

Fig 12 New earnings estimates versus previous (US$m)

	2003F			2004F			2005F	
	Previous	Current	% Chg	Previous	Current	% Chg	Previous	Current
Net interest income	22,048	22,123	0.3%	23,091	23,344	1.1%	NA	24,978
Non-interest income	15,785	15,860	0.5%	15,984	16,321	2.1%	NA	17,301
Non-interest expenses	19,758	19,758	0.0%	19,964	20,302	1.7%	NA	21,092
Loan loss provisions	5,262	5,262	0.0%	4,750	4,750	0.0%	NA	4,250
Core income	9,803	9,918	1.2%	10,986	11,209	2.0%	NA	12,956
Net income	7,745	7,860	1.5%	8,976	9,199	2.5%	NA	10,876
EPS	0.72	0.73	1.5%	0.84	0.86	2.5%	NA	1.01

Source: Company data, ING estimates

Cost of capital valuation

HSBC is currently trading at 20x 2003F and 17.3x 2004F EPS, or 2.3x year-end reported book value.

Fig 13 Valuation at Current Price

	2001	2002	2003F	2004F
Share Price (US$)	14.85			
Share Price (HK$)	115.50			
Share Price (GBp)	874			
PER (x)	27.82	22.56	20.23	17.29
Core PER (x)	22.37	18.54	16.04	14.19
PUP (x)	11.47	11.46	8.73	8.21
P/BV (x)	2.99	2.69	2.29	2.20
P/ABV (x)	4.88	4.38	3.43	3.16

Source: Company data, ING estimates

Looking at our standard cost of capital valuation methodology, we assign HSBC one of the lowest costs of capital in our universe, despite using the US risk-free rate (5 year T-note) instead of the lower local-currency government rates of some of our Asian markets. We have also lowered our forward beta slightly, from 0.85 to 0.80 as the bank's overall risk does not seem to be increasing by as much as we had feared.

Fig 14 Cost of capital valuation summary

Risk-free rate	3.28%
Market risk premium	6.00%
Estimated forward Beta	0.80
Cost of capital	8.1%
Sustainable LT ROE	16.2%
Implied forward PBV (x)	2.00
2004F BVPS (HK$)	52.46
Implied target price (HK$)	105.06
Current price (HK$)	115.50
Difference	(10.44)
Upside	-9.0%

Source: Company data, ING estimates

Projecting a sustainable ROE of 16.2% (achievable by 2006) means that HSBC should be able to sustain a long-term growth rate of 3.2-4.5% given its historical payout ratio–possibly this is somewhat optimistic as the size of the bank grows, but near-term estimates do still show good bottom-line growth. On this basis we assign the bank a forward (year-end 2004) PBV multiple of 2x (equivalent to 2.9x tangible book) for a target price of HK$105. Our GBP target price thus becomes 795p versus our previous 775p target.

Fig 15 Valuation at Target Price:

	2001	2002	2003F	2004F
Share Price (US$)	13.50			
Share Price (HK$)	105.00			
Share Price (GBp)	795			
PER (x)	25.29	20.51	18.40	15.72
Core PER (x)	20.34	16.86	14.58	12.90
PUP (x)	10.43	10.42	7.93	7.47
P/BV (x)	2.72	2.44	2.08	2.00
P/ABV (x)	4.44	3.98	3.11	2.87

Source: Company data, ING estimates

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Recommendations

In Asia ex-Japan our recommendations are defined as follows:

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

Hold: Share price movement of between -10% and +10% is expected on a 12-month view.

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

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