

Company results

Hong Kong

HSBC

2003 results: A first look

Banks

2/3/04

HK\$127.50/867p

HSBC reported an improved set of results last evening, with net income +41% and EPS +22% YoY. However, the bank still seems dependent on acquisitions for profit growth. We maintain our HOLD and 795p price target.

Higher profits, better returns. HSBC's net income rose 41% to US\$8.8bn in 2003, although EPS lagged due to share dilution from the Household transaction. ROE improved to 11.8% from a low of 10.7% in 2001, or 14.6% on a core ROE basis. This is still well below the level of most of its peers.

Organic growth is slow. HSBC's underlying organic growth is relatively low at 7% on a net profit basis and 2% on a top-line basis. Most of the improvement in income comes from the inclusion of Household and other acquisitions as well as currency movements.

High valuation. HSBC is trading at 20.4x 2003 earnings and 17.5x 2004 net, with a price-to-book multiple of 2.4x on YE2003 BVPS and 4.3x tangible book value. We maintain our HOLD rating.

Forecasts and ratings

Yr to Dec	2000	2001	2002	2003	2004F
Net int. income (HK\$m)	13,723.0	14,725.0	15,460.0	25,598.0	27,681.8
Core earnings (HK\$m)	7,642.7	6,207.7	7,590.0	10,845.3	12,795.9
Net profit (HK\$m)	6,457.0	4,992.0	6,239.0	8,774.0	10,212.8
EPS (HK\$)	0.70	0.53	0.66	0.80	0.93
Ch to previous EPS (%)	n/a	n/a	n/a	n/a	n/a
Core EPS (HK\$)	0.82	0.66	0.80	0.99	1.17
EPS growth (%)	-21.9	-45.3	23.3	21.7	16.4
PER (x)	23.5	30.6	24.8	20.4	17.5
DPS (HK\$)	0.43	0.48	0.53	0.60	0.63
Yield (%)	2.6	2.9	3.2	3.6	3.9

Source: Company data, ING estimates

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Maintained

Hold

2 March 2004

Target price: 12 months

795p (-8%)

Bloomberg

5 HK/HSBA LN

Financial data

	2002	2003	2004F
ROE (%)	11.91	11.78	13.13
Core ROE (%)	14.48	14.56	16.46
ROA (%)	0.86	0.98	0.96
Core ROA (%)	1.04	1.21	1.20
NIM (%)	2.44	3.29	2.98
Cost/Income (%)	54.91	50.61	49.31
Overhead (%)	2.36	2.71	2.35
NPLs/Tot loans (%)	2.63	0.00	0.00
BVPS (HK\$)	5.53	6.79	7.10
Price/book (x)	2.96	2.41	2.30

Share data

Market cap (US\$m)	179,154
Number of shares (m)	10,960
Daily turnover (US\$m)	491
Free float (%)	100.0
52-week hi/lo	80.25 - 128.50

Performance (%)

	1m	3m	12m
Absolute	4.2	-3.3	26.7
Relative to HSI	-2.9	-15.1	-25.9

Share price performance



Source: Datastream

Summary

High profit acceleration...

HSBC's net income is racing ahead on the consolidation of Household International, with net interest income up 66% YoY and pre-provision profit up 67% YoY. EPS is also going up, albeit more slowly as new shares were issued to Household shareholders.

...but set to stall

Although HSBC does not have the problems of its Hong Kong affiliate Hang Seng, in that it is able to redeploy its lending officers wherever needed, the majority of the bank's income comes from acquisitions and currency movements.

Acquisitions

HSBC has backed away from the idea of "transformational" M&A, and disavowed the thought of buying a European Insurance company. We suspect they will buy a series of banks, possibly beginning with Germany. In addition, it will not be possible for HSBC USA to meet its goal of being a top 5 player in the US without participating in domestic consolidation

Maintain HOLD

We like HSBC as a company, but management needs to lift the ROE up to be able to make headway against our valuation. We continue to value the company on approximately 15.5x 2005 EPS, maintaining our price target of 795p and HOLD rating.

Results and returns

HSBC reported 2003 results last evening in Hong Kong, posting a net profit of US\$8.8bn, or US\$0.80 per share, a 41% increase over the prior year. The overwhelming majority of the increase is attributable to the Household acquisition, with 9 months of HI's results consolidated into HSBC's group net for 2003.

EPS expanded by 22% YoY due to the dilution of the Household transaction, with some 1.4bn shares issued during 2003, a 16% increase.

Note that HI has boosted HSBC's top line due to its vastly higher spreads, and also hiked group provisions by some 256% to US\$6.2bn. Ex-HI, which now accounts for some 75% of provisions, HSBC's P&L charge for bad debt actually would have fallen by approximately 15%.

Note also that these figures are on a UK GAAP basis; management reports that net income under US GAAP was more than US\$1.5bn lower at US\$7.23bn.

Fig 1 Key earnings components: 1997-2005

US\$m	1997	1998	1999	2000	2001	2002	2003	2004F	2005F
Net Interest Income	10,944	11,547	11,990	13,723	14,725	15,460	25,598	27,682	29,619
Non-Interest Income	8,332	8,866	9,585	11,176	11,990	11,774	16,030	16,576	17,505
Non-Interest Expenses	10,056	10,994	11,313	13,577	14,605	14,954	21,067	21,825	22,677
Loan Loss Provisions	1,119	2,866	2,244	1,039	3,331	1,752	6,243	5,750	5,500
Core Income	5,629	4,603	5,644	7,643	6,208	7,590	10,845	12,796	14,495
Net Income	5,487	4,318	5,408	6,457	4,992	6,239	8,774	10,213	11,825
EPS (US\$)	0.66	0.51	0.64	0.70	0.53	0.66	0.82	0.95	1.09

Source: Company data, ING estimates

Fig 2 Key earnings ratios: 1997-2005

	1997	1998	1999	2000	2001	2002	2003	2004F	2005F
ROA	1.26%	0.90%	1.03%	1.04%	0.73%	0.86%	0.98%	0.96%	1.04%
Core ROA	1.29%	0.96%	1.07%	1.23%	0.91%	1.04%	1.21%	1.20%	1.28%
ROE	20.26%	15.76%	16.19%	14.17%	10.76%	11.91%	11.78%	13.13%	14.43%
Core ROE	20.79%	16.80%	16.90%	16.77%	13.38%	14.48%	14.56%	16.46%	17.68%
NIM	2.87%	2.77%	2.59%	2.52%	2.46%	2.44%	3.29%	2.98%	2.94%
Cost/Income	52.17%	53.86%	52.44%	54.53%	54.67%	54.91%	50.61%	49.31%	48.12%
Overhead	2.63%	2.63%	2.45%	2.49%	2.44%	2.36%	2.71%	2.35%	2.25%
Effective Tax Rate	25.40%	27.30%	25.42%	23.43%	22.64%	24.07%	21.79%	23.30%	23.50%

Source: Company data, ING estimates

ROE remains stubbornly low due to HSBC's expanded equity base and large goodwill charges. We base our analysis more on core earnings, which exclude the goodwill charge—but also exclude disposals. On this basis, ROE rises to 14.5%—still low given the size of HI and the accretion promised by the transaction.

Geographic breakdown

HSBC's geographic distribution has changed markedly from 2002 due to HI and Bital, with North American (which includes Mexico in the HSBC atlas) pre-tax income now accounting for 32% of the group total, up from 11.4% in 1H02. Europe has grown fairly consistently and remains HSBC's largest market by a hairbreadth.

Note that Hong Kong and Asia have shrunk in importance for HSBC. We think that the timing of this bodes poorly for the valuation of HSBC given that growth is returning to Asia and HSBC has generally been seen as a broadly leveraged play on Asia during previous expansions.

Fig 3 Pre-tax income by market (US\$m)

	2H03	% Tot	1H03	% Tot	2H02	% Tot	1H02	% Tot
Europe	2,482	33.0%	2,380	34.6%	1,981	39.2%	2,179	39.9%
Hong Kong	1,887	25.1%	1,843	26.8%	1,810	35.8%	1,900	34.8%
Asia	673	8.9%	753	10.9%	623	12.3%	670	12.3%
North America	2,424	32.2%	1,833	26.6%	760	15.0%	624	11.4%
South America	56	0.7%	70	1.0%	(119)	-2.4%	85	1.6%
Group Total	7,522		6,879		5,055		5,458	

Excludes goodwill amortisation

Source: Company data, ING estimates

HSBC's profits are growing in almost all markets when expressed in US dollar terms, but bear in mind that a material portion of the increase in European profits did come from currency translation as the pound gained almost 11% against the dollar during 2003.

Fig 4 Pre-tax income growth by market: 2002-2003

	2H03	%chg YoY	%chg HoH	2003	%chg YoY	2002	%chg YoY
Europe	2,482	25.3%	4.3%	4,862	16.9%	4,160	-0.5%
Hong Kong	1,887	4.3%	2.4%	3,730	0.5%	3,710	-4.5%
Asia	673	8.0%	-10.6%	1,426	10.3%	1,293	18.0%
North America	2,424	218.9%	32.2%	4,257	207.6%	1,384	113.6%
South America	56	-147.1%	-20.0%	126	NM	-34	NM
Group Total	7,522	48.8%	9.3%	14,401	37.0%	10,513	19.4%

Excludes goodwill amortisation

Source: Company data, ING estimates

Organic versus acquisition

One of HSBC's central problems is the group's inability to generate consistently strong organic growth ex-currency gains. Based on management's own internal figures, pre-tax profits grew only 7% on an organic basis in 2003 while top-line net interest income grew only 2%.

We see HSBC's high multiple as a historical premium for growth—something that management has almost always delivered. Where will we see such growth in 2004? Clearly, Hong Kong is bouncing back, although increased margins, and hence top-line growth, will have to await a reversal in the rate cycle, which seems to be taking its time. So too will Bital, Losango, and Bank of Bermuda add their clients to the mix, but possibly not enough to move the entire group forward.

If this internal growth will not suffice, HSBC will have to go back to what it does best (or thinks it does best): buying.

- **Asia.** In Asia, Citibank and JP Morgan are sniffing around HSBC's home turf, and StanChart is becoming a significant player as well. It is likely that HSBC will go on the offensive with a Korean acquisition, as well as potentially a Taiwanese one, which would fit in with the bank's China strategy.
- **China.** Naturally, China remains a focus for HSBC. As the state banks look for partners, HSBC has got to be a name on everyone's mind. With existing stakes in Bank of Shanghai, Industrial Bank, and Ping An, HSBC is spreading its bets.
- **Australia.** Mentioned by management as one of the large markets in which HSBC could make a profitable acquisition.
- **Europe.** Management has stated that they have no intention of buying an insurance company in Europe for distribution, but are still open to banks. We suspect that any (as is rumoured) HSBC/Deutsche merger would create some interesting opportunities for HSBC to hack away at the entrenched bureaucracy, but for that very reason, such a deal is unlikely to happen.
- **US.** HSBC has an avowed goal of being a top five banking group in the US within the next five years, up from #12 currently. Even with no further consolidation, this would require that HSBC USA triple in size—unlikely to happen organically. As the industry rolls up, we believe that HSBC will look seriously at the US banks, in particular those on the West Coast.

Valuation

HSBC is currently trading at 20.4x trailing (2003) EPS and 17.5x forward EPS, a premium to its 10-year average trailing PER of 16.1x. The shares trade at 2.4x trailing BVPS, or a hefty 4.3x tangible book.

Our fair value price target for HSBC is some 8% below the current price, at GBp795, which is based on our standard cost of capital methodology using a cost of equity of 8.1% and a sustainable ROE of 16.2%.

At our target price, HSBC would be valued at 18x trailing and 15.5x 2004 EPS, and on 2.1x stated book value.

Fig 5 Valuation at current price

	2001	2002	2003	2004F
Share Price (GBp)	867			
PER (x)	30.63x	24.84x	20.42x	17.54x
Core PER (x)	24.63x	20.42x	16.52x	14.00x
PUP (x)	12.63x	12.62x	8.71x	7.99x
P/BV (x)	3.30x	2.96x	2.41x	2.30x
P/ABV (x)	5.38x	4.82x	4.34x	3.65x

Source: Company data, ING estimates

Fig 6 Valuation at current price

	2001	2002	2003	2004F
Share Price (GBp)	867			
PER (x)	29.49x	23.92x	19.66x	16.89x
Core PER (x)	23.72x	19.66x	15.90x	13.48x
PUP (x)	12.16x	12.15x	8.39x	7.69x
P/BV (x)	3.17x	2.85x	2.32x	2.22x
P/ABV (x)	5.18x	4.64x	4.18x	3.52x

Source: Company data, ING estimates

Fig 7 Valuation at target price

	2001	2002	2003	2004F
Share Price (GBp)	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

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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.

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