ING FINANCIAL MARKETS

Company update

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Hong Kong

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HSBC

5 HK/HSBA LN

Hold

Maintained

¿Como se dice "*Shareholder value?*"

HK$86/717p 18/10/02

HSBC's Latin American operations are a test case for the theory that HSBC can grow by acquisition and earn its cost of capital. The results are unfavourable: since inception in 1997, HSBC has earned almost no money in the region.

Tequila hangover. HSBC, which entered Latin America on the heels of the last banking crisis, has been beset by continuing economic weakness and extraordinary losses, culminating in the collapse of the Argentinean banking system in 2001, which cost the group US$1.2bn.

Returns poor. HSBC average pre-tax return has been far less than 1% on capital utilised in Latin America, with net pre-tax profits of only US$2m from 1997-1H02. Latin American operations' failure to earn a ROI has helped drag the group's ROE down below 14% in the most recent period.

Maintain Hold; still downside to come. Given the group's recent poor acquisitions and low returns, a P/BV of 2.24x is unattractive. Though we take into account a FY03 earnings recovery, our sustainable ROE of 16.5% leads us to peg fair value at 2.05x trailing book, or HK$78.

Forecasts and ratings

Yr to Dec	99	00	01	02F	03F
Net profit (US$m)	5,408	6,628	4,992	6,252	6,591
EPS (US$)	0.65	0.76	0.54	0.67	0.71
EPS growth (%)	20.37	16.92	-28.95	24.07	5.97
PER (x)	16.96	14.51	20.42	16.46	15.53
P/BV (x)	2.79	2.24	2.24	2.16	2.07
DPS (US$)	0.34	0.43	0.48	0.51	0.55
Yield (%)	3.08	3.90	4.35	4.61	4.97

Source: Company data, ING estimates

Target price: 12 months

HK$78/648p (-9.3%)

Financial data

	FY01	FY02F
ROA (%)	0.73	0.87
Leverage (x)	15.14	15.63
ROE (%)	13.5	13.3
NTA (US$)	4.91	5.11
FD EPS (US$)	0.54	0.67

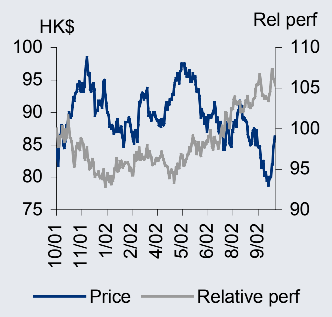
Share data

Market cap (US$m)	104,669.1
No of shares (m)	9,464.2
Daily turnover (US$m)	108.4
Free float (%)	100
52-week hi/lo (HK$)	98.5-78.8

Price performance (%)

	Absolute	Relative to HSI
1m	1.17	-0.29
3m	-2.54	5.97
12m	2.37	5.22

Price chart



Source: Bloomberg

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Executive summary

HSBC is not backing away from Latin America ...

Quite the reverse: the bank has reiterated its commitment to emerging markets and is once again looking for an entry point into Mexico via the purchase of Grupo Bital. With Latin America consolidating more quickly than the US and valuations still comparatively low due to rampant economic crises, HSBC's Americas strategy is being led by the Southern hemisphere for the moment.

... but uncertainty abounds.

HSBC has taken a series of blows in Latin America, including the return of Banco Serfin to government administration and the gigantic credit and currency losses in Argentina in 2001. In the first half, a US$40m increase in provisioning in the group's Panama operation and additional losses in Argentina continued to drag down results.

HSBC has yet to see return on investment.

Our analysis reveals that between 1997 and 1H02, HSBC has made a grand total of US$2m in pre-tax income, while using an average of US$3bn per year in capital. This record casts serious doubt on management's strategy of growth by acquisition in emerging markets.

Bital investment costly but strategically well placed.

HSBC is in the process of tendering for full ownership of Grupo Financiero Bital, parent of Mexico's fifth-largest bank. At 1.5x book value (a total of US$1.14bn), Bital is not cheap given its distressed balance sheet and 5% ROE, but the acquisition was HSBC's only chance to enter the market in a material way. Cost control and credit quality will be the key issues determining HSBC's ability to make this acquisition accretive – but accretion is a very high bar given the starting multiple of 24x earnings.

Further losses on the horizon.

We expect HSBC Latin America to be unprofitable in 2H02 on additional write-offs of US$400m, but to return to profitability in 2003 with pre-tax earnings of US$163m. Bear in mind that this will still represent an ROA of less than 100bp – less than half the level of the group's core Hong Kong banking operations despite substantially more risk.

Share downside anticipated.

HSBC's strategy of buying expensive growth, as exemplified most recently by Bital and CCF, does not justify the bank's premium valuation. We maintain our Hold recommendation and share price target of HK$78, which is based on 2.05x trailing BVPS and an anticipated sustainable ROE of 16.5%.

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Fig 1 HSBC's Latin America operations

Source: Company reports, ING estimates. Map courtesy of The General Libraries, The University of Texas at Austin.

Share of group profits

Latin America is a small net profit contributor for HSBC in a normal year, and for that reason has received relatively little scrutiny. However, as 2001 showed, in a bad year, Latin America has the ability to take an outsized bite out of overall profitability: the region lost US$994m pre-tax for HSBC on an asset base of only US$17bn – a return on assets of -6%.

Put another way, Latin America operations lost more than twice what the US banks (the former Republic and Marine Midland) made last year, and almost as much as HSBC made in the Asia-Pacific region outside of Hong Kong. Has management (and have investors) fundamentally misjudged the risk/reward of operating in Latin America?

Fig 2 Profit on ordinary activities before tax by segment (US$m)

	1H02	FY01	FY00	FY99	FY98	FY97	FY96
Europe	1,867	3,542	3,658	3,322	2,884	3,201	2,368
Hong Kong	1,900	3,883	3,691	3,054	2,427	3,246	2,775
Rest of Asia-Pacific	653	1,088	1,265	329	39	651	1,101
North America	586	481	850	959	987	950	792
Latin America	51	(994)	311	318	234	82	16
Total	5,057	8,000	9,775	7,982	6,571	8,130	7,052

Source: Company data

Fig 3 Average assets (US$m)

	1H02	FY01	FY00	FY99	FY98	FY97	FY96
Europe	316,577	296,483	253,248	201,023	178,073	156,020	129,757
Hong Kong	177,528	176,145	170,983	157,274	166,615	148,591	119,572
Rest of Asia-Pacific	66,504	59,507	55,984	56,272	52,515	52,007	45,641
North America	138,874	127,335	114,087	87,012	72,566	67,740	50,168
Latin America	12,997	17,146	18,127	15,898	11,458	9,178	-
Total	712,479	676,615	612,428	517,477	477,407	437,032	377,200

Source: Company data

Fig 4 Pre-tax ROAA (annualised) (%)

	1H02	FY01	FY00	FY99	FY98	FY97	FY96
Europe	1.18	1.19	1.44	1.65	1.62	2.05	1.82
Hong Kong	2.14	2.20	2.16	1.94	1.46	2.18	2.32
Rest of Asia-Pacific	1.96	1.83	2.26	0.58	0.07	1.25	2.41
North America	0.84	0.38	0.75	1.10	1.36	1.40	1.58
Latin America	0.78	-5.80	1.72	2.00	2.04	0.89	NA
Total	1.42	1.18	1.60	1.54	1.38	1.86	1.87

Source: Company data

The answer appears to be yes, as 2001's extraordinary loss wipes out all profit accrued over the previous five years, dating back to the group's first forays into the region.

Although the events in Argentina are somewhat extraordinary – not that they don't seem to reoccur with alarming regularity – HSBC has also failed to capitalise on its last foray into Mexico (where the acquisition of a stake in bankrupt Banco Serfin from the government resulted in the return of a bankrupt Banco Serfin to the government in 2000) and seems to be teetering on the brink in Brazil, where an uncertain government direction following the elections and an interest rate spike (to a 21% overnight rate) seem to presage an inevitable rise in charge-offs.

A comparison of pre-tax ROAA tells the story: Latin America earned only 78bp on average assets in 1H02 despite sharply reduced provisions, versus 214bp for Hong Kong and 196bp for the rest of Asia. Taking into account the fact that approximately 44% of HSBC's lending assets in Hong Kong are residential mortgages which have had almost zero loss experience in the past, it would appear that a risk-adjusted return would be skewed even more in favour of Asia.

Regional breakdown

HSBC has been making most of its money in Brazil and Argentina, although Chile has become a major contributor in 1H02. Other Latin American operations mainly consist of the former Chase Manhattan branch network in Panama, which was purchased in 2000. Large profits in Chile in 1H02 were augmented by a US$38m gain on the sale of HSBC's stake in Banco Santiago in April.

Fig 5 Profit before tax – Cash basis (US$m)

	1H02	2H01	1H01	2H00	1H00
Brazil	79	38	98	84	124
Argentina	(50)	(1,191)	39	50	62
Chile	62	2	15	-	8
Mexico	(1)	6	8	4	5
Panama	(27)	4	7	(2)	4
Other LatAm	(6)	(7)	4	(11)	(4)
Total	57	(1,148)	171	125	199

Source: Company data

Fig 6 Gross customer loans by market (US$m)

	Mortgage			Consumer			Real estate			Commercial and other			Total		
	YE01	YE00	% chg	YE01	YE00	% chg	YE01	YE00	% chg	YE01	YE00	% chg	YE01	YE00	% chg
Brazil	276	344	-19.8	1,140	1,076	6	57	63	-10	1,484	2,008	-26.1	2,957	3,491	-15.3
Argentina	263	459	-42.7	140	285	-51	59	145	-59	1,584	1,808	-12.4	2,046	2,697	-24.1
Panama	317	290	9.3	159	153	3.9	57	48	18.8	386	444	-13.1	919	935	-1.7
Other LatAm	9	6	50	1	3	-66.7	45	46	-2.2	276	250	10.4	331	305	8.5
Total	865	1,099	-21.3	1,440	1,517	-5	218	302	-28	3,730	4,510	-17.3	6,253	7,428	-15.8

Source: Company data

Argentina

Argentina's huge losses in FY01, amounting to some US$1.2bn, were caused by extraordinary provisions of US$600m and by a US$520m currency loss stemming from pesification. Although the initial crisis has abated and HSBC has been able to write back US$114m of its original general provision, risk in Argentina remains high and losses have continued into 1H02.

We believe that the Argentina operation – based around the Banco Roberts network acquired in 1997 – will take at least four years to regain its former size. However, once profitability begins to rebound, HSBC should have room to increase its sustainable ROE, as many foreign players have exited the market entirely, and the remaining domestic financiers are capital-constrained.

Nevertheless, we continue to believe as a house that the macro/political crisis is far from over and that there will be significant defaults from corporates without multinational parent support or substantial non-Argentina cash flows.

Our local credit and economics team expects the ensuing debt restructuring to be a "lengthy and laborious process", and adds that these risks are still not being adequately priced in by the credit markets, meaning that even a rigorous mark-to-market based on traded spreads will underestimate eventual losses.

Mexico

Mexico will clearly grow in importance once the pending acquisition of Grupo Financiero Bital is completed (see our full analysis of Bital on page 12), but we do not expect to see substantial profit contribution until FY05 at the earliest. Bear in mind that Mexico is the most exposed to a decline in US GDP, which we fully expect as part of our double-dip scenario.[1] In addition, we continue to expect at least a 10% further devaluation of the peso.

Brazil

Brazil has been the steadiest performer, consistently bringing in more money than any other country in Latin America – an average of US$211m per year since the purchase of Bamerindus in 1997.

The key question about Brazil: will it follow Argentina down into the abyss despite its historic steady performance? Our economic analysis tells us that it almost certainly will not – but even the optimistic scenario must take into account slowing growth, higher volatility and increased defaults due to rising rates. All of these factors will sharply limit growth opportunities in the market. On the positive side, real interest rates are still comparatively low by the standards of the last five years.

Although we agree that a Lula victory is all but certain at this point, market fears about a Venezuela-like leftward lurch in policy do not appear to be supported by Mr da Silva's recent statements, which include such banking-friendly measures as:

- Instituting a formal legal structure for central bank independence, a reversal of the previous Workers Party stance.
- Potentially increasing the fiscal budget surplus (ie, excluding debt service costs) above the IMF-mandated level of 3.75% of GDP to restore market confidence in Brazil's sovereign debt.

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[1] For full details, please refer to our regional strategy report: "*Gulf War II: Taking aim: Asian implications of a US double-dip*", dated 19 September 2002.

- Pledging to avoid "surprises," which many have taken to mean capital controls or the freezing of bank deposits.

Fig 7 Brazil: Earning assets and liabilities: 1999–2001

	YE01		YE00		YE99	
	US$m	Interest rate (%)	US$m	Interest rate (%)	US$m	Interest rate (%)
Short-term funds and loans to banks	1,306	15.77	1,039	15.30	672	17.23
Loans and advances to customers, net	2,879	31.12	2,706	33.56	1,800	36.55
Trading securities	104	7.69	95	24.21	173	28.66
Investment securities	2,745	16.83	2,781	16.79	3,026	23.05
Other interest-earning assets	370	5.41	302	10.26	140	18.00
Deposits by banks	1,177	9.01	920	10.98	705	14.39
Customer accounts	4,086	14.64	4,275	12.94	3,715	15.05
CDs and other money market instruments	29	13.79	53	9.43	4	7.83
Loan capital	208	5.29	72	11.11	82	10.67
Other interest-bearing liabilities	633	21.01	261	18.77	422	11.02
Net interest margin		9.99		12.60		14.29

Source: Company data, ING estimates

Potential impact of Fleet acquisition

HSBC is widely reported to be considering making a bid for FleetBoston Financial, although such a bid is unconfirmed by the company. A purchase would be aimed mainly at increasing the group's retail and middle-market franchises in the Northeastern US. In our view, Fleet is one of a number of banks which would be a good fit and extend the former Republic and Marine Midland footprints further.

However, the potential acquisition would also have the secondary effect of increasing HSBC's Latin American exposure via Fleet's branch network in Argentina and Brazil.

Fig 8 FleetBoston Latin America exposure (US$bn)

YE01	Argentina	Brazil	Total
Branches	133	67	200
Loans	6.7	7.3	14.0
Placements with banks and treasury assets	1.3	1.0	2.3
Securities and repos	0.3	3.0	3.3
Fixed assets and other non-earning assets	1.0	0.7	1.7
Total assets	9.3	12.0	21.3

Source: Company data

Fig 9 FleetBoston Latin America loans by category (US$bn)

YE01	Argentina	Brazil	Total
Consumer	1.8	0.4	2.2
Corporate	3.7	6.4	10.1
Banks and Middle market	0.8	0.5	1.3
Sovereign	0.4	-	0.4
Total loans	6.7	7.3	14.0

Source: Company data

In total, Fleet has over US$20bn in Latin America assets, mainly in the form of loans and bonds. This would increase the group's asset size in the region by 140%, based on pro-forma YE01 figures.

Fig 10 HSBC – Fleet pro-forma assets by region (US$m)

	HSBC		Fleet		Combined	
Assets	YE01	% total	YE01	% total	Pro-forma	% total
Europe	297,691	43.3	-	-	297,691	33.4
Hong Kong	175,744	25.6	-	-	175,744	19.7
Rest of Asia-Pacific	62,338	9.1	-	-	62,338	7.0
North America	136,617	19.9	182,338	89.5	318,955	35.8
Latin America	15,218	2.2	21,300	10.5	36,518	4.1
Total	687,608	100.0	203,638	100.0	891,246	100.0

Source: Company data, ING estimates

Shareholder returns

Return on capital employed

In order to assess the efficacy of HSBC's Latin American strategy, we focus on return on capital employed. As many of the current businesses were built organically, we look at actual capital utilisation with risk-weighted assets as a proxy, and then assign a portion of HSBC's corporate capital based on an 8% CAR for marginal assets.

We estimate RWA/average assets at HSBC Latin America to be only 48%, considerably lower than the average 61% rate in Hong Kong, due to a generally higher proportion of government bonds held on balance sheet.

On this basis, we estimate that HSBC Latin America has used a total of US$37.6bn risk-weighted asset/years from 1 January 1997 to 30 June 2002, meaning that at an 8% CAR the operations have used US$3.01bn capital/years over the same period. During this time, HSBC Latin America generated aggregate pre-tax income of US$2m, an annualised return on capital of under 1%.

However, excluding FY01 and its large losses would produce a healthy ROC of 24% for remaining years – a set of event-driven return characteristics that will look acutely familiar to investors who experienced the Asian crisis.

Note that this does not include the impact of the Serfin transaction, which did not, as far as we are aware, result in any capital loss, but which did tie up approximately US$200m of capital for almost three years – which has a definite cost to shareholders.

Return on acquisition costs

HSBC has grown by acquisition in Latin America, paying substantial franchise premiums in most cases. We can also look at cash returns on investment as a measure of HSBC's strategy in the region. Bear in mind that we are unable to determine the amount of additional capital which has been injected into the acquired vehicles; any increase would further lower returns.

Fig 11 HSBC acquisitions (US$m)

	Investment	Date	Country
Banco Roberts	633	Aug-97	Argentina
Bamerindus	1,000	Mar-97	Brazil
Chase Manhattan (Panama)	107	Feb-00	Panama
Banco Serfin	174	Dec-97	Mexico
Grupo Bital	1,140	Pending	Mexico

Source: Company data

On this basis, HSBC's profits also appear exceedingly slim – a near-zero rate of return over the 1997–1H02 period. We have also calculated an annualised return that excludes the currency effects of pesification in Argentina (although it does properly include the credit costs of defaulting borrowers); when calculated under this more lenient methodology HSBC has reaped a pre-tax average return of 5.9%.

Fig 12 Return on acquisitions

	(US$m)
Total LatAm acquisition costs (excludes pending)	1,914
Less: Serfin	(174)
Net	1,740
Pre-tax earnings (1997-1H02)	2
Annualised return (%)	0.0
Pre-tax earnings without currency losses (1997-1H02)	567
Annualised return (%)	5.9

Source: Company data

Ideally, we would prefer to do a full DCF analysis on a market-by-market basis, but the granularity of reported data is not sufficient to do so. However, we do not believe that such an analysis would alter our conclusion – that HSBC has failed to earn an acceptable return on its Latin American bank investments.

Grupo Financiero Bital

Acquisition terms

In late August, HSBC announced that the group intends to acquire Mexico's Grupo Financiero Bital, parent of the country's fifth-largest bank[2], and that it had reached agreement with Bital's controlling shareholders on a valuation of US$1.14bn for the company. HSBC had previously done due diligence, and so we see no major obstacles to the completion of this transaction. We therefore expect HSBC to open and complete a tender offer in November 2002 for all of Bital's shares, and to wind up with 100% ownership. This will mean full consolidation of Bital in HSBC's financial statements by 1H03 at the latest.

Bital had little choice but to sell, as the group is operating under an agreement with Mexican regulators to raise its Tier 1 capital ratio to 8% by October and to 10% by year-end 2002 (from 6.32% at 30 June 2002), which would appear impossible without outside assistance.

Fig 13 Grupo Financiero Bital (Pm)

	1H02
Tier 1 capital elements	4,185
Tier 2 capital elements	1,945
Total capital	6,130
Risk-weighted assets	58,207
Tier 1 CAR	7.19%
Total CAR	10.53%
Risk-weighted assets (including market risk)	66,170
Tier 1 CAR	6.32%
Total CAR	9.25%
Required additional capital for 10% Tier 1	2,435

Note: Peso (P) currency referred to is Mexican pesos
Source: Company data

Bital had previously been close to securing US$200m in fresh capital from ING Group for a 19% stake in Bank Bital, and was also planning an international placement of up to US$250m in capital notes in September. However, these measures would have left the group short of its committed goal, and thus both were scrapped in favour of the HSBC alliance.

Bital's management has publicly stated that the bank will be unable to meet the 8% hurdle without HSBC's assistance, and has asked for a waiver of capital requirements until year-end, at which time management expects the HSBC take-over to be complete. We assume, based on the need for additional capital, that HSBC will contribute at least an additional P2.4bn (US$241m) at the time of Bital's acquisition, bringing the total purchase price to US$1.38bn. In our view, HSBC is likely to contribute at least US$400m rather than the minimum required, in order to fund new business and prepare for the integration of Banco Atlantico.

[2] Behind BBVA – Bancomer, Banamex Citibank, Santander Serfin and Banorte.

Valuation

HSBC is paying a seemingly heavy price for Bital on an earnings basis, at 23-24x FY01 PER and annualised 1H02 net income. Although the P/BV of 1.5x is not a high valuation on the face of it, bear in mind that Bital has not exceeded a 6% ROE at any point in the last two and a half years.

Fig 14 Valuation of Bital acquisition (US$m)

	1H02	FY01	FY00
Purchase price	1,140		
Total equity	782		
Price/BV (x)	1.46		
Net income	23.2	49.1	42.5
PER (annualised) (x)	24.62	23.23	26.82

Source: Company data

Two other factors to keep in mind are potential cost savings and additional capital needs. Bital's efficiency and overhead ratios (82.1% and 7.7%, respectively, in the most recent period) are plainly horrible. To the extent that HSBC can combine back office operations, retrench staff and complete the integration of Banco del Atlántico, returns can be dramatically improved – any cost savings would drop directly to the bottom line.

As a counterweight, remember that HSBC will need to inject substantial additional capital into Bital, which will further dilute ROE.

History and structure

Grupo Bital is a bank holding company with five major subsidiaries: Almacenadora Bital, Banco Internacional (Bank Bital), Casa de Bolsa Bital, Fianzas México Bital and Seguros Bital. The group was formed in 1992 when Grupo Financiero Prime acquired Bank Bital from the Mexican government.

Fig 15 Grupo Bital's subsidiaries

	Total assets		Net income (Pm)	
	30/6/02	(%)	FY01	(%)
Grupo Bital	130,482	100.0	481	100.0
Banco Internacional	128,864	98.8	401	83.4
Almacenadora Bital	132	0.1	2	0.3
Casa de Bolsa Bital	945	0.7	1	0.3
Fianzas México Bital	659	0.5	28	5.9
Seguros Bital	1,397	1.1	45	9.4

Note: Peso (P) currency referred to is Mexican pesos
Source: Company data

Fig 16 Grupo Bital's subsidiaries – Financial highlights

	Total assets				Total equity				Net income			
Pm (constant)	YE99	YE00	YE01	1H02	YE99	YE00	YE01	1H02	FY99	FY00	FY01	1H02
Banco Internacional	136,783	117,643	134,929	128,864	7,612,5	7,247	7,660	6,993	505	698	401	127
Almacenadora Bital	133	128	138	132	120	102	108	104	3	1	2	2
Casa de Bolsa Bital	981	596	604	945	155	137	144	121	18	9	1	(1)
Fianzas México Bital	678	602	663	659	228	214	253	247	40	11	28	14
Seguros Bital	1,314	748	1,063	1,397	1,108	376	498	594	233	(3)	45	81

Note: Peso (P) currency referred to is Mexican pesos

Source: Company data

Seguros Bital

Seguros Bital (SB) is the insurance arm of the group, and incorporates a 51%-owned joint venture with ING Group (ING Seguros (Mexico)) as well as Pensiones Bital. SB and Finanzas México Bital are not fully consolidated in the Group's results, but are accounted for under the equity method.

Casa de Bolsa Bital

Casa de Bolsa Bital engages in broking and securities investment – neither of which has been extraordinarily profitable over the past several periods due to low volumes and a falling market.

Banco Atlántico: Paradise deferred?

In 1997, Bital agreed to purchase Banco del Atlántico (Atlántico) from the Mexican government, Atlántico previously having failed and been taken over by the Bank Savings Protection Institute (IPAB). The initial agreement, under which Bital was to pay P300m (US$30m) for Atlántico and inject additional capital, has never been finalised as the two sides continue to disagree about the true level of impaired assets inside the bank and how much IPAB will have to inject into Atlántico before the bank is transferred.

BITAL has been in charge of the administration of Atlántico since January 1998, although the banks have not been legally merged. After taking over the operations of Atlántico, Bital transferred all deposits of the bank to its own network (thereby assuming Atlántico's customer base) and integrated its branches into Bital's own network. In the process, a substantial number of Atlántico's staff were eliminated – meaning that we should not expect much in the way of additional cost savings once the merger is completed.

Currently, Atlántico exists as a shell organisation that funds its assets in large part by borrowing from Bital. As the troubled bank remains government-owned, these loans are treated as loans to IPAB and, as such, do not carry any risk.

IPAB is reported to be in the final stages of completing an audit of Atlántico that will establish the amount of loss the agency must shoulder, after which the sale can be consummated. We expect this to happen either prior to or alongside the HSBC purchase of Bital, ie, by year-end.

Whatever the final bill, IPAB will pay for most if not all of it with money borrowed from Bital; the agency has already inked an P48.8bn loan from the bank to cover its outlays from recapitalising and rehabilitating Atlántico. The loan yields 100bp over the 91-day *Cetes* rate, and matures in December 2009.

Returns

Bital's income has been weak despite a fall-off in provisions in 1H02, with ROAA totalling only 30bp in 1Q and 9bp in 2Q02 on an annualised basis. Return on equity has languished in the sub-6% range since early 2000. Note also that core income has been weaker than reported profits, mainly due to securities gains and other one-time effects excluded from our core figure.

Fig 17 Key earnings components – Bital (Pm) (constant)

	FY00	FY01	1Q02	2Q02
Net interest income	9,023	8,712	2,010	1,877
Non-interest income	3,876	4,853	1,128	994
Non-interest expense	10,075	9,441	2,457	2,357
Provisions	2,310	3,289	636	201
Core income	309	322	(311)	185
Net income	445	480	102	29

Note: Peso (P) currency referred to is Mexican pesos
Source: Company data

Fig 18 Key earnings ratios – Bital (%)

	FY00	FY01	1Q02	2Q02
Yield on earning assets	25.40	17.59	14.74	12.98
Cost of interest-bearing liabilities	17.95	11.43	8.45	7.03
Interest spread	7.45	6.16	6.29	5.95
Net interest margin	7.48	7.17	6.32	6.14
Efficiency ratio	78.11	69.60	78.31	82.11
Overhead ratio	8.35	7.77	7.73	7.71
ROAA	0.35	0.37	0.30	0.09
Core ROAA	0.24	0.25	-0.92	0.56
ROAE	5.57	5.56	5.20	1.47
Core ROAE	3.87	3.73	-15.85	9.47

Source: Company data

Asset quality

Bital's reported asset quality is poor and has experienced some continued deterioration in 1H02, although overall portfolio health has been improving due to better reserves. By our standards, 21.9% of the loan book is impaired in some fashion and falls into one of our criticised categories. Bital reports that 7.1% of loans (9.9% excluding risk free government lending) are actually non-performing – the difference being that we classify weak loans which may be current but which have higher risk of loss.

Fig 19 NPLs – Bital

% of average loans	2Q01	3Q01	4Q01	1Q02	2Q02
Criticised loans + ORE	21.8	22.8	21.8	21.4	21.9
Criticised but not classified (SM)	9.5	10.2	10.4	11.1	11.4
Classified loans (SS+D+L)	11.1	11.4	10.4	9.3	9.5
ORE	1.2	1.2	1.0	0.9	1.0
Weighted classification ratio	5.91	6.11	5.90	6.40	6.46

Source: Company data

In order to assess Bital's asset quality more completely, we segment these weak loans into categories based on the severity of anticipated loss, and base both our measure of weighted classified assets and our reserve adequacy methodology on the categorisation. Without direct experience of the specific institution, we have based our assessment on the bank's reported loan data – which could well be understated.

On this basis, we have translated Bital's internal risk grading system (shown in Figure 15 along with that of the National Banking and Securities Commission, or CNBV) to fit into our standard methodology as follows:

Fig 20 Risk grading system – Standard methodology

Bital risk grade	Risk Level	CNBV risk grade	ING loan category
1	Minimum	A1	Pass
2	Low		Pass
3	Low	A2	Pass
4	Medium		Pass
5	Medium	B	Special mention
6	High	C1	Substandard
7	High		Substandard
8	Very high	C2	Substandard
9	Very high	D	Doubtful
10	Maximum	E	Loss

Source: Company data, ING estimates

This sets our threshold for criticism just slightly above Bital's own internal definition of an "unacceptable" risk, giving us some comfort in our mapping, as Special Mention loans are meant to be those which have "potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may, at some future date, result in the deterioration of the repayment prospects for the credit or the institution's credit position".

Such weaknesses might include relationships where:

- "The lending officer may be unable to properly supervise the credit because of an inadequate loan or credit agreement.
- Questions exist regarding the condition of and/or control over collateral.
- Economic or market conditions may unfavourably affect the obligor in the future.
- A declining trend in the obligor's operations or an imbalanced position in the balance sheet exists, but not to the point that repayment is jeopardised.

- Other deviations from prudent lending practices are present.[3]

Fig 21 Bital loan classification criteria

Risk Level		Description
Acceptable Credit Risks	Minimum	Businesses with positive and growing trends. Institutional management with strong cash flow. Exceptional liquidity and profitability ratios, with favourable market conditions and good standing relationships with customers and suppliers. No legal problems and clean credit history for the last 12 months.
	Low	Businesses with positive trends, able and experience management. Good payment capacity and cash flow to finance investments. Liquidity and debt ratios according to its activity and adequate profitability. Competitive cash flow, with favourable market conditions and good relationships with suppliers and customers. No legal problems and with occasional delays in payments in the last 12 months.
	Medium	Businesses similar to those described as Low risk that are going through a lapse of unfavourable results, but with clear factors that show a recovery in the short term. Family type management. Adequate payback capacity; more sensitive to the economic environment. Levels of liquidity, debt and profitability at a slight disadvantage with comparison to its peers. Possible concentration of customers or suppliers with stable employee relationship. In the last 12 months, might have shown past due status for periods under 90 days, possibly with restructuring without capitalisation of interests.
Unacceptable Credit Risks	High	Businesses performing below the sector average. Weak family type management. Deficient payback capacity and clear downward trends. High dependency on the economic environment. Weak market conditions and dependent on customers and suppliers. Possible legal problems, but with stable employee relationship. In the last 12 months, might have shown past due status for periods between 90 and 270 days, possibly with restructuring without capitalisation of interests.
	Very High	Businesses on clear downward trends with elements that show no clear elements that show recovery signs. One man only type management or management without the capacity to manage the business. Low payback capacity and high dependency on the economic environment. Cash flow is insufficient for financial obligations. Restricted liquidity and high debt ratios. In the last 12 months, it may show past due status for periods between 270 and 360 days. Could have several restructures in the same operation.
	Maximum	Businesses with negative trends or without evidence of recovery. Management incapable of managing the business. No liquidity or payment capability and excessive debt ratio. Deteriorated cash flow and operating losses. Legal conflicts that could affect its assets and possibility of a strike. Declining market with systematic customer or supplier loss. Null payment capacity, thus rendering its obligations as unrecoverable. Non-performing loans in legal process.

Source: Company data

Impaired loans by borrower type

An interesting view of the impaired asset data shows that although the greatest share of criticisms come from the commercial lending book, commercial lending has the lowest percentage of criticised loans to total loans at 25.3%, with mortgage loans showing the highest at 61%.

[3] Federal Reserve Board of Governors, *Commercial Bank Examination Manual*

Fig 22 NPL breakdown (Pm)

	Criticised loans 2Q02	% of category total	Criticism rate on gross loans (%)
Special mention	8,306	100	
Commercial loans	2,416	29	10.2
Consumer loans	1,910	23	18.5
Mortgages	3,972	48	48.5
Other	8	0	0.0
Substandard	2,480	100	
Commercial loans	1,371	55	5.8
Consumer loans	402	16	3.9
Mortgages	683	28	8.3
Other	24	1	0.1
Doubtful	1,331	100	
Commercial loans	513	39	2.2
Consumer loans	380	29	3.7
Mortgages	342	26	4.2
Other	96	7	0.4
Loss	3,126	100	
Commercial loans	1,718	55	7.2
Consumer loans	1,223	39	11.9
Mortgages	0	0	0.0
Other	185	6	0.8
Total criticised	15,243		
Commercial loans	6,018	39.5	25.3
Consumer loans	3,915	25.7	38.0
Mortgages	4,997	32.8	61.0
Other	313	2.1	1.3

Note: Peso (P) currency referred to is Mexican pesos
Source: Company data

Reserve adequacy

Although Bital's book is significantly distressed, we nonetheless calculate that the group has sufficient reserves to cover identified problems, as well as a healthy general reserve of around 400bp on average loans. Barring either a severe downturn in the economy or a material re-statement of Bital's asset quality position, the group should not require abnormal levels of provisioning (or recapitalisation) going forward.

Fig 23 Reserve adequacy – Bital (Pm)

2Q02	Gross amount	Reserve percentage	Required reserve
Pass	57,503	1	575
Special mention	8,306	5	415
Substandard	2,480	20	496
Doubtful	1,331	50	666
Loss	3,126	100	3,126
ORE	692	20	138
Excess AIR	N/A	20	-
Total	73,437		5,416
Actual reserves			7,187
Shortfall			(1,771)
Actual/required (%)			133
Shortfall/capital (%)			-23

Note: Peso (P) currency referred to is Mexican pesos
Source: Company data, ING estimates

Another potential risk is the quality of the Banco Atlántico book, which may not be as well reserved against as is Bital's own. As management has identified P1.5bn in reserves (21% of reported total reserves of P7.2bn) as associated with potential losses in the Atlántico book, we have also looked at Bital's reserve adequacy excluding this amount. We do not yet have the ability to examine the Atlántico book separately as audits for the past several fiscal years are still not finalised.

Fig 24 Reserve adequacy – Bital excluding Banco Atlántico (Pm)

2Q02	Gross amount	Reserve percentage (%)	Required reserve
Pass	57,503	1	575
Special mention	8,306	5	415
Substandard	2,480	20	496
Doubtful	1,331	50	666
Loss	3,126	100	3,126
ORE	692	20	138
Excess AIR	N/A	20	-
Total	73,437		5,416
Actual reserves			5,687
Shortfall			(271)
Actual/required (%)			105
Shortfall/capital (%)			-3

Note: Peso (P) currency referred to is Mexican pesos

Source: Company data, ING estimates

In general, Bital has been provisioning in excess of its actual net losses, so that the reserve has been increasing. Although we saw 2Q02 charge-offs outrun period provisions, the full sufficiency of the loan loss reserve means that this does not cause us any immediate concern – although we would not recommend it to management as a continuing strategy.

Fig 25 Net charge-offs and provisioning – Bital

bp on average loans	2Q01	3Q01	4Q01	1Q02	2Q02
Provisions	140.51	110.57	88.32	88.22	27.68
Net charge-offs	126.68	70.47	78.99	(154.55)	36.67
Provisions less charge-offs	13.83	40.10	9.33	242.77	(8.99)
Accumulated reserves	755.54	794.46	786.04	1,005.83	987.89

Source: Company data

Earnings projections

The earnings outlook for HSBC's Latin America business is less than promising in the near term. We foresee an additional need for provisioning in 2H02, which will cover mainly Brazilian credit exposure deterioration. Bear in mind that this charge does not mean that we subscribe to the extreme bear case for Brazil; rather, it is simply a recognition that slowing growth and spiking interest rates (along with negative momentum from US GDP) will cause pressure on corporate and retail borrowers.

Fig 26 Key earnings components – HSBC Latin America (US$m)

	98	99	00	01	1H02	2H02F	02F	03F
Net interest income	1,195	1,097	1,219	1,113	423	398	821	788
Non-interest income	912	790	953	919	375	338	713	684
Non-interest expenses	1,707	1,440	1,635	1,549	602	512	1,114	1,091
Goodwill amortisation	4	10	13	17	6	6	12	9
Provisions	193	133	204	940	127	400	527	208
Disposals and other	-	-	-	(520)	(12)	-	(12)	-
Pre-tax profit	203	304	320	(994)	51	(183)	(132)	163

Source: Company data, ING estimates

However, this charge (an aggregate of US$400m in net P&L provisions) is considerably smaller than the one taken for Argentinean loans in 2001, both in absolute terms and relative to the size of exposure. If we do not see these losses realised in 2H02, we will be tempted to roll them forward at least through 1H03 before concluding that the credit situation is improving.

As an offset against deterioration in Brazil, note that we do expect to see further writebacks from the large general provision made against Argentina credits.

Interest spreads will remain robust in Latin America, mainly to compensate for the higher risk profile bankers now face. From HSBC's risk disclosure measurements, it appears that the bank is fairly well hedged against shifts in the interest rate curve in its Latin American operations, with a slight degree of liability sensitivity (-US$2m in net interest income estimated for a +100bp parallel instantaneous rate shift).

Based on these factors, we see a return to profitability in FY03, with HSBC Latin America earning a pre-tax profit of US$163m, versus a US$994m loss in FY01 and a forecast loss of US$132m in FY02.

Note that we have not included earnings stemming from the integration of Bital, pending finalisation of the acquisition and an assessment of the additional capital injections required; expect that the consummation of this transaction will increase HSBC Latin America earnings beginning in FY03.

Global earnings estimates

On a global basis, we expect 2H02 to be another weak reporting period for HSBC, with the bank posting a 9% HoH decline in net profit and EPS. Strong contributors are expected to be the European consumer business and Asia ex-Hong Kong, while our forecast of rate cuts will begin to tell on the Hong Kong and US franchises.

Fig 27 Key earnings components – HSBC Holdings Plc (US$m)

	98	99	00	01	1H02	2H02F	02F	03F
Net interest income	11,547	11,990	13,723	14,725	7,593	7,455	15,048	14,679
Non-interest income	8,739	9,210	11,067	11,420	5,652	5,747	11,399	12,192
Non-interest expenses	11,225	11,511	13,794	14,862	7,288	7,287	14,575	14,872
Goodwill amortisation	10	36	510	799	396	392	788	764
Provisions	2,637	2,073	932	2,037	715	1,044	1,759	1,303
Disposals and other	157	402	221	(447)	211	-	211	-
Pre-tax profit	6,571	7,982	9,775	8,000	5,057	4,479	9,536	9,932
Tax	1,789	2,038	2,238	1,988	1,315	1,097	2,412	2,433
Minorities and other	(464)	(536)	(909)	(1,020)	(462)	(409)	(871)	(907)
Net income	4,318	5,408	6,628	4,992	3,280	2,972	6,252	6,591
EPS (US$)	0.54	0.65	0.76	0.54	0.35	0.32	0.67	0.71

Source: Company data, ING estimates

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