Equity Markets

Company results

ING FINANCIAL MARKETS

Hong Kong

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Hang Seng Bank

Results review: Reaching the limit

Maintained

Sell

1 March 2004

Banks

1/3/04
HK$110.50

Target price: 12 months
HK$90 (-19%)

Bloomberg
11 HK

Hang Seng disappointed with another sequential earnings decline for both 2H03 and the full year. We think that the bank is poorly positioned to benefit from renewed loan growth in HK until interest rates turn decisively. SELL.

What's not to love? For any other bank, Hang Seng's results would be a dream come true: a 23% ROE, well-controlled costs, and strong and improving asset quality. However, a jaded market has already priced in HSB's incredible performance, and we believe as investors focus on growth HSB will continue to lag the market.

Not geared to asset improvement. Major earnings increases during the current reporting season in Hong Kong have come largely from a run-off in high provisions – which Hang Seng has never had in the first place. The P&L charge for bad debts actually increased by 39% in FY03, but with little impact on bottom-line earnings.

Capital constraints. HSB paid out 98% of FY03's earnings, and after charges taken directly to the balance sheet, book value is actually declining, as are the equity/assets and CAR ratios. The lack of retained earnings will hamper HSB's ability to loan-up its book as and when the market recovers.

Forecasts and ratings

	2001	2002	2003	2004F	2005F
Net int income (HK$m)	11,660	10,805	10,179	10,593	11,889
Core earnings (HK$m)	9,783	9,588	9,311	10,446	11,443
Net profit (HK$m)	10,114	9,961	9,539	10,383	11,324
EPS (HK$)	5.29	5.21	4.99	5.43	5.92
Ch to previous EPS (%)	n/a	n/a	n/a	4.2	1.6
Core EPS (HK$)	5.12	5.02	4.87	5.46	5.99
EPS growth (%)	1.3	-1.5	-4.2	8.9	9.1
PER (x)	20.9	21.2	22.1	20.3	18.7
DPS (HK$)	4.90	5.40	4.90	4.90	5.14
Yield (%)	4.4	4.9	4.4	4.4	4.7

Source: Company data, ING estimates

Financial data

	2002	2003	2004F
ROE (%)	22.48	22.93	25.86
Core ROE (%)	21.64	22.38	26.02
ROA (%)	2.10	1.95	2.05
Core ROA (%)	2.02	1.90	2.07
NIM (%)	2.41	2.22	2.22
Cost/Income (%)	24.44	24.60	23.85
Overhead (%)	0.85	0.85	0.82
NPLs/Tot loans (%)	3.46	2.96	2.43
BVPS (HK$)	22.79	20.73	21.27
Price/book (x)	4.8	5.3	5.2

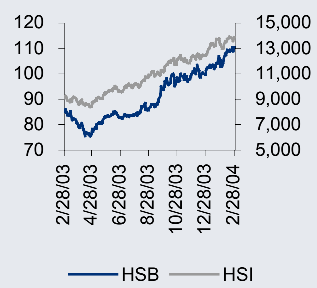
Share data

Market cap (US$m)	27,084
Number of shares (m)	1,912
Daily turnover (US$m)	22
Free float (%)	36.0
52-week hi/lo	75.50 - 110.50

Performance (%)

	1m	3m	12m
Absolute	7.3	9.4	29.6
Relative to HSI	0.3	-2.2	-22.8

Share price performance



Source: Datastream

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Summary

Earnings down.

Hang Seng reported a bottom line of HK$9.5bn for the full year and HK$4.5bn for the second half, in line with our estimates but a disappointment to the Street. Earnings were down 4% for the year and 10% for 2H03 on a consecutive-half basis.

Banking on non-banking products.

Non-interest income continues to carry the load, with fund products and insurance both very strong for the year, and broking making a comeback in 2H03 as well. However, sales of fund products did fall off sharply in 2H versus the first period of 2003.

Not positioned for growth.

Loan growth at Hang Seng was slack but still ahead of the market. However, HSB's worry seems to be shifting to how the bank can expand in an up market given its falling capital ratios and 98% dividend payout rate.

Benefits of volatility could be short lived.

Hang Seng booked forex trading profit of HK$764m for 2003, above the consistent range of HK$500-600m over the past ten years. A reversion could cost the bank another 1.5% of pre-tax profits.

Waiting for Alan...

Hang Seng's margins are squeezed due both to excess liquidity and to the bank's huge free funds position. Until the rate environment turns around in Hong Kong, management has few options other than to keep piling up money in the investment portfolio, keeping duration short but interest income low.

Dividend yield maintained.

Hang Seng's dividend of HK$4.90 per share remains solid, with management indicating its maintenance as one of their top priorities. With a current yield of 4.4%, the dividend does support the stock to some extent.

Priced for perfection.

Hang Seng has long been the most expensive stock in our universe on a P/BV basis, and now at 5.3x YE03 book it has widened its lead over challengers. Although the bank's returns are excellent, its price of over 22x earnings with limited growth is too high for us. We have raised our earnings marginally for 2004-05 to reflect better non-interest income, and boosted our target price from HK$78 to HK$90, but maintain our SELL rating on Hang Seng shares.

Results and returns

Hang Seng Bank reported 2003 results in Hong Kong, posting a net profit of HK$9.54bn, or HK$4.99 per share. This result was in line with our relatively bearish estimates but well below consensus of HK$10bn.

For the second year in a row, HSB's net profit and core earnings both declined in absolute terms, down 4% and 3%, respectively, although ROE has continued to advance as the bank pays out more than 100% of its capital accretion.

Fig 1 Key earnings components: 1997-2005F

(HK$m)	1997	1998	1999	2000	2001	2002	2003	2004F	2005F
Net interest income	11,157	11,355	11,667	11,691	11,660	10,805	10,179	10,593	11,889
Non-interest income	4,025	3,280	3,310	3,879	4,391	4,875	5,686	5,765	6,262
Non-interest expenses	3,730	3,865	3,743	3,725	4,104	3,832	3,902	3,901	4,028
Loan loss provisions	635	2,476	1,419	196	424	571	792	450	500
Core income	8,873	7,051	8,231	9,778	9,783	9,588	9,311	10,446	11,443
Net income	9,363	6,788	8,307	10,014	10,114	9,961	9,539	10,383	11,324
EPS	4.89	3.55	4.35	5.24	5.29	5.21	4.99	5.43	5.92

Source: Company data, ING estimates

Fig 2 Key earnings components: 2H99-2H03

(HK$m)	2H99	1H00	2H00	1H01	2H01	1H02	2H02	1H03	2H03
Net interest income	5,773	5,883	5,808	5,902	5,758	5,453	5,352	5,220	4,959
Non-interest income	1,625	2,045	1,834	2,169	2,222	2,622	2,253	3,026	2,660
Non-interest expenses	2,002	1,739	1,986	1,866	2,238	1,816	2,016	1,821	2,081
Loan loss provisions	630	83	113	21	403	281	290	456	336
Core income	4,078	5,026	4,753	5,191	4,592	4,912	4,680	4,829	4,485
Net income	4,046	5,195	4,819	5,375	4,739	5,220	4,741	5,022	4,517
EPS	2.12	2.72	2.52	2.81	2.48	2.73	2.48	2.63	2.36

Source: Company data, ING estimates

Hang Seng continues to undergo an ROA squeeze, with that key measure falling from 2.10% in FY02 to 1.95% in FY03. ROA is mainly hurt by weak top-line growth in the interest income book – all the more so due to HSB's large free funds position, which has less and less value in a low-interest and excess-liquidity market.

The bank has maintained its ROE by increasing gearing, with equity/assets falling from 9.5% at YE01 to 7.9% currently. The bank's CAR has likewise fallen, with Tier 1 capital declining from 12.3% to 11.3% and total CAR dropping from 15.3% to 13.2% over the same period.

This is in many ways a salutary example of managing for shareholder value, and one reason why we hold the HSB management team in such high esteem. However, we are bound to point out that such a strategy has a built-in end to it, as equity can not go below the regulatory minimum (very hazy here for a bank like HSB but probably around 12% for total CAR).

Other indicators of profitability were as usual stellar: ROE reached 22.9%, cost-to-income stayed below 25% (although up just a shade from 2002), and overhead was a rock-solid 0.85% of average assets.

Fig 3 Key earnings ratios: 1997-2005

(%)	1997	1998	1999	2000	2001	2002	2003	2004F	2005F
ROA	2.38	1.66	1.92	2.12	2.07	2.10	1.95	2.05	2.20
Core ROA	2.26	1.72	1.90	2.07	2.01	2.02	1.90	2.07	2.22
ROE	19.10	14.25	19.53	23.42	22.23	22.48	22.93	25.86	27.35
Core ROE	18.10	14.80	19.35	22.87	21.50	21.64	22.38	26.02	27.64
NIM	3.11	2.97	2.87	2.64	2.53	2.41	2.22	2.22	2.43
Cost/income	24.57	26.41	24.99	23.92	25.57	24.44	24.60	23.85	22.19
Overhead	1.04	1.01	0.92	0.84	0.89	0.85	0.85	0.82	0.82
Effective tax rate	13.57	14.32	15.05	14.26	12.15	11.23	12.74	13.00	16.00

Source: Company data, ING estimates

Fig 4 Key earnings ratios: 2H99-2H03

(%)	2H99	1H00	2H00	1H01	2H01	1H02	2H02	1H03	2H03
ROA	1.84	2.26	1.97	2.19	1.98	2.21	2.01	2.10	1.83
Core ROA	1.86	2.19	1.94	2.11	1.92	2.08	1.98	2.02	1.82
ROE	18.61	26.15	20.98	23.60	21.00	23.37	21.59	23.83	22.48
Core ROE	18.76	25.30	20.69	22.79	20.35	21.99	21.31	22.91	22.32
NIM	2.79	2.71	2.51	2.55	2.55	2.43	2.40	2.31	2.14
Cost/income	27.06	21.93	25.99	23.12	28.05	22.49	26.51	22.08	27.31
Overhead	0.97	0.80	0.86	0.81	0.99	0.81	0.90	0.81	0.90
Effective tax rate	14.56	14.89	13.57	13.07	11.09	12.68	9.59	14.17	11.09

Source: Company data, ING estimates

Strong fee income

The bright spot in Hang Seng's results continues to be fee income. Total fee income rose by 25% YoY on robust performances in sales of insurance and wealth management products. In addition, broking revenues – decimated over the past few years despite an increasing market share – rose by 48% YoY. These strong performances offset declines in account fees, credit card charges and other lending fees.

Fig 5 Fee income breakdown: 2001-2003

	2003		2002		2001
	HK$m	% YoY	HK$m	%YoY	HK$m
Securities/stockbroking	361	48	244	11	220
Retail investment fund sales	921	32	700	89	370
Insurance	1,226	81	676	59	424
Account services	211	-17	255	-9	280
Remittance	132	3	128	4	123
Credit card fees	551	-8	598	-6	633
Credit facilities	231	-14	270	-11	305
Import/export	223	3	217	1	214
Other	192	31	147	16	127
Total	4,048	25	3,235	20	2,696

Source: Company data, ING estimates

Most of the gain in broking came in the second half, with revenues 91% above those of 1H03. Somewhat more sedately but quite steadily, insurance income maintained its advance in 2H03, with a 10% rise. Even credit cards show signs of recovery, with management disclosing an aggressive marketing plan to take share and regain balances.

A potential area of concern is that fund sales trailed off abruptly in the second half, falling by 66% from their red-hot pace of early 2003. Management's argument that the decline is seasonal is supported by a similar 52% decline from 1H02 to 2H02; however, we can't help but think that a decline in investment sales and a rise in broking leaves HSB with somewhat less attractive earnings quality.

Fig 6 Fee income breakdown: 1H03-2H03

(HK$m)	1H03	2H03	%HoH
Securities / stockbroking	124	237	91
Retail investment fund sales	685	236	-66
Insurance	583	643	10
Account services	111	100	-10
Remittance	63	69	10
Credit card fees	258	293	14
Credit facilities	113	118	4
Import/export	105	118	12
Other	96	96	0
Total	2,138	1,910	-11

Source: Company data, ING estimates

Rates and margins

Hang Seng's Achilles' heel is its inability to maintain asset yield in a low rate environment with excess liquidity. At a 53% loan-to-deposit ratio, HSB is scrapping for every loan it can get – but almost 60% of the bank's net loan growth comes from low-rate mortgages.

Not able to source enough of even these slim-spread loans, HSB management is forced to bulk up the bank's bond portfolio, although they must be careful not to take on too much duration at the bottom of the rate cycle.

Fig 7 Key net interest margin components: 1998-2003

(%)	1998	1999	2000	2001	2002	2003
Yield on earning assets	8.09	6.77	6.77	5.45	3.34	2.73
Cost of interest-bearing liabilities	6.03	4.40	5.11	3.25	1.09	0.69
Interest spread	2.06	2.36	1.65	2.20	2.25	2.04
Net interest margin	2.97	2.87	2.64	2.53	2.41	2.22

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	7.15	6.35	4.48	3.42	3.28	2.93	2.63
Cost of interest-bearing liabilities	5.37	4.27	2.23	1.14	1.05	0.76	0.63
Interest spread	1.79	2.08	2.25	2.28	2.23	2.17	1.99
Net interest margin	2.51	2.55	2.55	2.43	2.40	2.31	2.14

Source: Company data, ING estimates

With asset income contracting, HSB is simply not able to drop its cost of funds quickly or far enough to maintain spreads. The bank is now paying customers only 1/10 of a basis point on most savings deposits, with benchmark time deposit rates ranging only up to 3.75bp at the one-year mark – there is simply no more room to cut.

Net interest margins fell by 17bp in 2H03 to 2.14%, still above average for the industry but a far cry from the 3%+ spreads earned in 1998 and before. For the full year, NIM dropped 19bp from 2.41% to 2.22%, with interest spread slightly more negative.

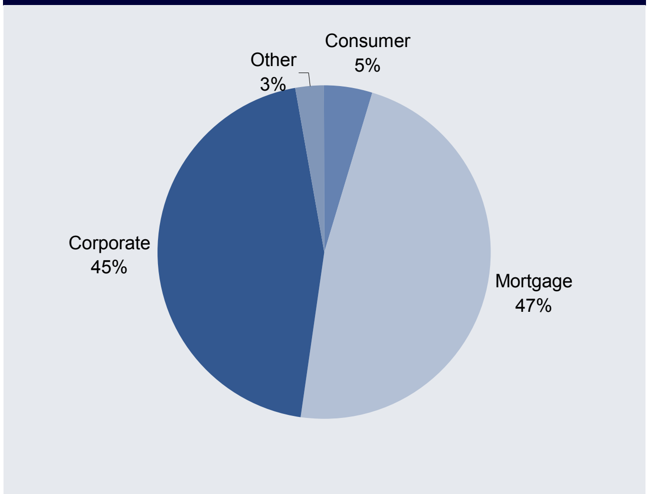
We expect a maintenance of the FY03 NIM level for 2004, which implies a modest rise in spreads from the second half as the US curve steepens. However, any sizeable benefit from higher rates will likely not be felt until 2005.

Loan portfolio

Hang Seng's loan portfolio remains dominated by mortgages, although the proportion has slipped slightly since 2001 mainly due to the demise of the government HOS program. Non-mortgage consumer lending takes up only a small piece of the book, with credit cards at only 2% of loans and other retail lending only slightly larger.

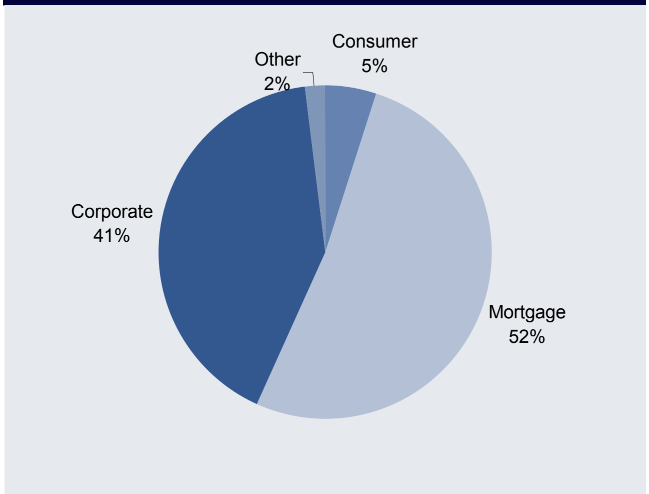
Management noted that they have off-loaded some of the highest-yielding – but also riskiest – assets by pruning their unsecured product offerings.

Fig 9 Loan portfolio distribution: YE 2003



Source: Company data, ING estimates

Fig 10 Loan portfolio distribution: YE 2001



Source: Company data, ING estimates

Fig 11 Loan portfolio breakdown: 2H02-2H03

	2H03		1H03		2H02	
	HK$m	% total	HK$m	% total	HK$m	% total
Total loans:	231,999	100	228,840	100	227,475	100
Corporate	110,529	48	106,559	47	102,078	45
For use in Hong Kong	103,838	45	101,278	44	97,585	43
Property development	16,828	7	17,910	8	19,300	8
Property investment	34,555	15	33,268	15	31,507	14
Financial concerns	6,109	3	3,681	2	2,071	1
Stockbrokerage	226	0	154	0	219	0
Wholesale and retail trade	4,376	2	4,097	2	3,941	2
Manufacturing	2,556	1	2,096	1	2,037	1
Transport and transport equipment	10,139	4	8,885	4	9,238	4
Others (agri, hotels, utilities)	17,727	8	20,158	9	19,521	9
Trade finance	11,322	5	11,029	5	9,751	4
For use outside Hong Kong	6,691	3	5,281	2	4,493	2
Retail	121,470	52	122,281	53	125,397	55
Home-ownership scheme loans	30,431	13	32,840	14	35,050	15
Home mortgage loans	79,830	34	77,972	34	78,518	35
Credit card	5,430	2	5,186	2	5,578	2
Other retail (tax loan, personal etc)	5,779	2	6,283	3	6,251	3

Source: Company data, ING estimates

Loan growth

HSB grew total loans by 2% YoY and 1.4% HoH. Although this is a low showing, it is still better than the market performance, which was slightly down. Note that most of Hang Seng's portfolio increase comes from commercial loans and mortgages, with trade finance slowing notably in 2H03. Credit cards did record a HoH gain, reversing losses from charge-offs and bankruptcies.

Fig 12 Loan growth: 1H03-2H03 (%)

	2H03		1H03
	%YoY	**%HoH**	**%HoH**
Total loans:	2.0	1.4	0.6
Corporate	8.3	3.7	4.4
For use in Hong Kong	6.4	2.5	3.8
Property development	-12.8	-6.0	-7.2
Property investment	9.7	3.9	5.6
Financial concerns	195.0	66.0	77.7
Stockbrokerage	3.2	46.8	-29.7
Wholesale and retail trade	11.0	6.8	4.0
Manufacturing	25.5	21.9	2.9
Transport and transport equipment	9.8	14.1	-3.8
Others (agri, hotels, utilities)	-9.2	-12.1	3.3
Trade finance	16.1	2.7	13.1
For use outside Hong Kong	48.9	26.7	17.5
Retail	-3.1	-0.7	-2.5
Home-ownership scheme loans	-13.2	-7.3	-6.3
Home mortgage loans	1.7	2.4	-0.7
Credit card	-2.7	4.7	-7.0
Other retail (tax loan, personal etc)	-7.6	-8.0	0.5

Source: Company data, ING estimates

Asset quality

HSB's asset quality remains strong. Criticised loans plus ORE on the balance sheet amount to only 3% of total loans, down from 3.5% at YE02. The severity of the criticisms has also declined; on a weighted basis bad assets total only 1.83% of loans, down from 2.55% at YE2002.

Net charge-offs for the year came in at 51bp, slightly over the 2002 level, with the worst seen in 1H03. Although charge-offs continue to out run provisions as they have since 1999, with improving asset quality and positive macro indicators we are less concerned about balance sheet risk – although we would not like to see reserve levels of 110bp on average loans get any slimmer.

Fig 13 Charge-off summary: 1998-2003

(bp on average loans)	1998	1999	2000	2001	2002	2003
Provisions	121.00	70.10	9.24	18.93	25.19	34.47
Net charge-offs	28.88	49.01	33.19	62.02	50.64	51.01
Provisions less charge-offs	92.11	21.09	(23.95)	(43.09)	(25.45)	(16.54)
Accumulated reserves	221.66	245.18	210.03	155.84	128.50	110.26

Source: Company data, ING estimates

Fig 14 Charge-off summary: 2H00-2H03

(bp on average loans)	2H00	1H01	2H01	1H02	2H02	1H03	2H03
Provisions	10.18	1.88	35.68	24.55	12.71	19.99	14.58
Net charge-offs	39.28	43.35	80.03	54.52	22.96	30.68	20.48
Provisions less charge-offs	(29.10)	(41.48)	(44.35)	(29.97)	(10.25)	(10.69)	(5.90)
Accumulated reserves	401.40	356.75	308.95	274.98	127.66	116.98	109.93

Source: Company data, ING estimates

Reserve adequacy

Hang Seng's reserve remains inadequate by our standards, although the bank is moving closer to compliance. Currently, HSB maintains a reserve of only 58% of our required level – barely sufficient to absorb our standard 1% reserve against the performing portfolio.

However material the difference may be from an earnings timing perspective, it is not relevant when compared to capital; the entire shortfall amounts to only 5% of HSB's total equity.

Fig 15 Reserve adequacy: YE2003

(HK$m)	Gross amount	Reserve percentage (%)	Required reserve
Pass	225,648	1	2,256
Special Mention	3,044	5	152
Substandard	1,297	20	259
Doubtful	858	50	429
Loss	1,152	100	1,152
ORE	506	20	101
Excess AIR	-	20	-
Total	232,505		4,350
Actual reserves			2,533
Shortfall			1,817
Actual/required (%)			58
Shortfall/capital (%)			5

Source: Company data, ING estimates

Valuation

Hang Seng is priced like a rare jewel; while we agree that the bank deserves a premium rating for its management and safety, current valuations are far too rich for us. Since we last looked at Hang Seng, the price has moved up by approximately 27%, slightly below the rise in the overall market. On a one-year basis, HSB has underperformed by 23% versus the HSI, but has risen by almost 30% in absolute terms – the basis for our ratings

While we can't be overly upset about selling something which underperforms the market by 23%, it nevertheless behooves us to look for absolute downside in the stock in order to maintain our rating. We believe that this is at hand.

HSB is caught between its desire to maintain a constant and growing dividend (which right now consumes 98% of earnings) and its need to demonstrate growth prospects. Having managed capital effectively in a down market, HSB finds itself with shrinking book value and falling CAR, which will limit the bank's ability to take advantage of any growth in its home market.

Note, however, that management has disclosed a substantial (HK$1bn+) gain on equities which is not yet reflected in either the P&L or the balance sheet. In addition, we would not be surprised if HSB joins its parent in offering holders dividends either in cash or in stock. Given the substantial retail holdings of HSB, we suspect that many shareholders would opt for scrip, thus providing a new source of capital reinvestment for HSB.

A potential stumbling block is that HSBC is probably disinclined to either participate in such a program or to have its stake in Hang Seng diluted.

Fig 16 Valuation at current price

	2002	2003	2004F	2005F
Share price (HK$)	110.50			
PER (x)	21.21	22.15	20.35	18.66
Core PER (x)	22.03	22.69	20.22	18.46
PUP (x)	17.83	17.66	16.96	14.96
P/BV (x)	4.85	5.33	5.20	5.01
P/ABV (x)	6.00	6.45	6.22	5.93

Source: Company data, ING estimates

Fig 17 Valuation at target price

	2002	2003	2004F	2005F
Share price (HK$)	90.00			
PER (x)	17.27	18.04	16.57	15.19
Core PER (x)	17.95	18.48	16.47	15.04
PUP (x)	14.52	14.38	13.81	12.18
P/BV (x)	3.95	4.34	4.23	4.08
P/ABV (x)	4.89	5.25	5.06	4.83

Source: Company data, ING estimates

HSB is currently valued at 22x 2003 EPS and at 20.4x our forecast for 2004 earnings, falling to 18.7x 2005F profit. On a price-to-book basis, HSB is clearly the most expensive bank in our universe, at a robust 5.3x YE03 book value per share and just over 5x YE05 BVPS.

We have set a new target price of 15x 2005F EPS, commensurate with the bank's anticipated single-digit growth over the 2003-2005 period. At our target price of HK$90, HSB would be trading at a multiple of 4.3x YE03 BVPS and at 4.1x YE05F BVPS – still very generous, in our view.

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				Taipei
				Tel: 886 2 2734 7500

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.

Important Company Disclosures

The following designations [a-i] next to a company covered in this publication highlight that one or more members of ING Group:

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