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DBS Bank (S$ 14.90) 3 - Market Perform

SINGAPORE
Banks
Asia Banks

Operating Results

2H01 Earnings Review: No Lai See

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Investment conclusion

- DBS earnings continue to be lackluster. We maintain our 3-Market Perform rating and S$12.50 price target.

Summary

- DBS Group reported 2H01 and FY2001 earnings after the close last night, posting a 2H net profit of S$370 million and full-year earnings of S$999 million.
- While margins were a bright spot, expanding on falling interest rates and savvy asset/liability management, overall results were poor with an ROE of only 7%.
- Asset quality has continued to deteriorate since the 3Q01 earnings release, requiring additional provisions.
- Loan growth was slack in both Singapore and Hong Kong, with customer loans down 2% in the half and up less than 1% (pro-forma) on the year.

FY Dec	2000A	2001E		2002E		2003E	
Currency S$	Actual	Old	New	Old	New	Old	New
1Q EPS	0.60	-	-	0.57	0.57	0.45	0.45
2Q EPS	-	-	-	-	-	-	-
3Q EPS	-	-	-	-	-	-	-
4Q EPS	-	-	-	-	-	-	-
Full Year	1.14	0.80E	0.70A	1.15	1.15	1.08	1.08
I/B/E/S	-	-	-	-	-	-	-
Net Profit (m)	-	-	-	-	-	-	-
BVPS	-	-	-	-	-	-	-

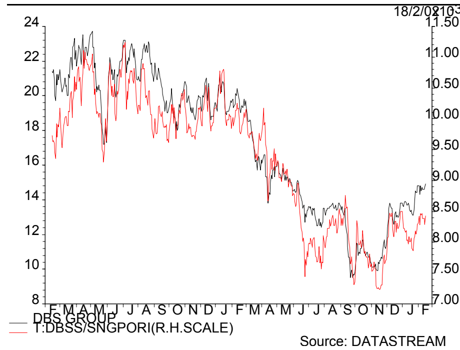
Valuation

P/E (01;02)	
P/BV (00;01)	- : -
ROE (00;01)	- : -
ROA (00;01)	- : -
Est. Dividend	-
Dividend Yield	-

Financial Summary

Total Assets (S$M)	-
Total Loans (S$M)	-
Total Equity (S$M)	-
NPL Ratio	-
Total CAR	-
Shares Outstanding (m)	1,446.9

Stock Overview



Source: DATASTREAM

Reuters	DBSM.SI		
Bloomberg	DBS SP		
ADR	-		
Performance	**1M**	**3M**	**12M**
Absolute %	11.2	44.7	-22.8
Rel. Market %	4.5	16.4	-13.9
52 Week Range	19.80-9.50		

Rating	Target
New: 3 - Market Perform	New: 12.50
Old: 3 - Market Perform	Old: 12.50
Downside to Target %	**-16**

Summary and Comments:

Singapore's DBS Bank Group reported its 2H01 results after the close last night, posting a poor showing, as expected, and undershooting our estimates. While some areas, such as resilient margins, were a positive surprise, the overall tone of the results was negative insofar as prospects for future growth remain weak.

We are maintaining our 3–Market Perform rating and S$12.50 price target on DBS, and will adjust our earnings estimates for the bank and its peers after the end of Singapore's reporting period next week.

Earnings Review:

DBS reported a consolidated 2H01 profit of S$370 million, representing only a 0.48% ROA and 4.8% return on economic equity. There are several schools of thought on the proper way to present and compare these results, given the significant inclusion of non-cash charges stemming from the goodwill incurred in the DHB acquisition, as well as

DBS' odd prior reporting: 1H01 financial statements consolidated the balance sheet of DHB but not its income statement, making ratio analysis difficult.

While still relying on reported figures for our analysis, we believe that pro-forma figures for 1H01 and earlier offer the best basis for understanding the operations of DBS and its subsidiaries, and we will also present these throughout.

As for the goodwill issue, we are in agreement with management that this non-cash item does not represent the operational dimension of the bank, and are thus placing more emphasis on our measure of core earnings going forward, which does not include the goodwill adjustment. Core earnings also deduct extraordinaries and tax-adjusted securities gains, but not dealing or trading revenues—a key line item for DBS.

Table 1: Key Earnings Components—Reported

S$, MM as Reported	2000	1H01	2H01	2001	2002E
Net Interest Income	2,039.4	961.5	1,295.0	2,256.5	2,626.3
Non-Interest Income	932.0	574.4	763.6	1,338.0	1,522.0
Non-Interest Expense	1,246.0	748.9	993.0	1,741.9	1,924.5
Provisions	54.3	46.5	333.0	379.5	50.0
Core Earnings	1,347.8	508.3	411.7	920.0	1,634.2
Net Income	1,389.1	629.5	370.2	999.7	1,303.3

Source: Company reports; Lehman Brothers estimates.

On a consecutive half basis, reported earnings in 2H01 were down by 41%, mainly due to higher provisions and goodwill charges (-19% on a core basis). While reported pre-provision earnings and net interest income were seemingly robust, both up 35% from the prior period, this is due entirely to the consolidation of DHB in 2H01 reporting for the first time.

FY2001 net income fell by 28% from last year's S$1.39 billion profit. Bear in mind that earnings per share were down 39% YoY, due to the additional dilution caused by November's capital-raising.

Table 2: Key Earnings Components—Pro-Forma

S$, MM Pro-Forma	2000	1H01	2H01	2001	2002E
Net Interest Income	2,763.0	1,204.0	1,295.0	2,499.0	2,626.3
Non-Interest Income	1,162.0	731.8	763.6	1,495.4	1,522.0
Non-Interest Expense	1,626.4	971.5	993.0	1,964.5	1,924.5
Provisions	133.1	127.2	333.0	460.2	50.0
Core Earnings	1,745.7	610.0	411.7	1,021.7	1,634.2
Net Income	1,822.2	718.0	370.2	1,088.2	1,303.3

Source: Company reports; Lehman Brothers estimates.

On a pro-forma basis 2H earnings declined by 48% half-on-half and by 62% year-on-year—somewhat more bleak when the DHB figures are included for prior periods. Net interest income fell 9% YoY (+8% HoH) and pre-provision profit was off by 10% (+11% HoH).

Table 3: Key Earnings Ratios—Reported

As Reported	1999	2000	1H01	2H01	2001	2002E
Net Interest Margin	2.35%	2.09%	1.57%	1.86%	1.92%	1.92%
ROA	1.04%	1.28%	0.94%	0.48%	0.76%	1.12%
Core ROA	0.95%	1.24%	0.76%	0.54%	0.70%	1.41%
ROE	9.54%	11.59%	9.56%	4.75%	7.10%	8.68%
Core ROE	8.70%	11.25%	7.72%	5.28%	6.53%	10.88%
Efficiency	33.96%	41.93%	48.76%	48.24%	48.46%	46.39%
Overhead	1.23%	1.28%	1.22%	1.42%	1.48%	1.41%
NPLs / Assets	7.65%	3.97%	3.09%	2.98%	2.98%	2.82%
NPL Coverage	49.93%	51.82%	50.90%	54.10%	54.10%	68.52%

Source: Company reports; Lehman Brothers estimates.

Table 4: Key Earnings Ratios—Pro-Forma

Pro-Forma	1999	2000	1H01	2H01	2001	2002E
Net Interest Margin	2.40%	2.21%	1.77%	1.86%	1.92%	1.92%
ROA	1.05%	1.28%	0.95%	0.48%	0.76%	1.12%
Core ROA	0.95%	1.23%	0.81%	0.54%	0.70%	1.41%
ROE	9.95%	12.20%	9.76%	4.75%	7.10%	8.68%
Core ROE	9.05%	11.69%	8.29%	5.28%	6.53%	10.88%
Efficiency	35.46%	41.44%	50.19%	48.24%	48.46%	46.39%
Overhead	1.26%	1.30%	1.43%	1.42%	1.48%	1.41%
NPLs / Assets	6.36%	3.42%	3.09%	2.98%	2.98%	2.82%
NPL Coverage	50.04%	52.92%	50.90%	54.10%	54.10%	68.52%

Source: Company reports; Lehman Brothers estimates.

Rates and Margins:

A strong point for DBS was its increased net interest margin during the period: based on our pro-forma model, consolidated NIM rose by 9bp to 1.86%, although it remains 40bp below the year-earlier figure. On a full-year basis NIM of 1.91% was 30bp below that of FY2000.

Management attributes the increased spreads to three main factors:

- The falling rate environment coupled with DBS' naturally liability-sensitive balance sheet—a rarity among Asian banks.
- An active program to roll-off high-cost deposits at both DBS Bank and Dao Heng, shrinking the low-spread portion of the balance sheet.
- Better asset/liability management and a decision to lock-in some fixed-yield assets.

It is impressive that DBS was able to lower its cost of funds (by 72bp in the half and 104bp during the year, to 2.47%) even while increasing the bank's dependence on higher-cost funding sources such as subordinated debt. We do not expect to see this trend replicated at the other Singaporean banks.

Provisions and Asset Quality:

Asset quality, as signalled by management in the 3Q results, is a problem area—and one we *do* expect to see this carried over into peer results. Gross NPLs of S$4.5 billion declined by 7% from mid-year, but only at a cost of S$333 million in second half provisions and an additional S$19 million drop in the reserve. Although the gross amount of criticized loans fell, their severity increased, so that our required reserve estimate remained almost unchanged.

Additionally, management disclosed that as part of the acquisition of DHB, certain loans were re-valued based on the more stringent criteria applied by DBS in Singapore, and the incremental write-down of S$112 million was taken through an increase in goodwill. This charge could well be considered a provision, which did not run through the P&L account, but which would raise credit costs in 2H to $464 million, or an annualized rate of 130bp on customer loans.

Reserve Adequacy:

DBS has maintained its reserves almost exactly in line with our required reserve model in 1H01 and 2H01, and we consider the bank fully-reserved. However, the bank has swung from a S$356 million reserve surplus at YE2000 to a S$10 million deficit today—a material change.

Table 5: Reserve Adequacy

2H01 S$, MM	Gross Amount	Reserve Percentage	Required Reserve
Pass	66,808	1%	668
Special Mention		5%	-
Substandard	3,085	20%	617
Doubtful	521	50%	261
Loss	906	100%	906
ORE		20%	-
Excess AIR	-	20%	-
Total	71,320		2,452
Actual Reserves			2,441
Shortfall			11
Actual/Required			100%
Shortfall/Capital			0%

Source: Company reports; Lehman Brothers estimates.

Expenses:

Non-interest expense at DBS rose by 33% HoH and 52% YoY on a reported basis—note that this is the only area in which management is disinclined to make an apples-to-oranges comparison, instead noting that DBS ex-DHB expenses rose by less than their commitment of 17%. On our pro-forma numbers we see 2H01 expenses up 17% YoY and 2% HoH, with full year expenses rising by 21%. Given a revenue increase of only 2% this is not stellar.

Note that management cites (and excludes from its analysis) restructuring charges of $40.4 million for the full year.

Other Special Items:

Included in 2H01 securities gains are profits from the sale of Insurance Corporation of Singapore in the amount of S$120.1 million and DBS' stake in Keppel Capital Holdings in the amount of S$60.6 million.

Valuation:

DBS is currently trading at 1.3x its BVPS of S$11.48, based on a gross book value which includes both goodwill of S$5.1 billion and off-balance-sheet re-valuations of S$893 million. Given an ROE of 7.1% for FY2001 and prospective ROEs which do not exceed 10% (even after excluding goodwill), we think this is a generous valuation. On an earnings basis, DBS is trading at 19.6x pro-forma 2001 EPS and at 16.3x our FY2002 net EEPS (13.0x cash EEPS). However, based on these results the bias for near-term adjustment of forward estimates will clearly be down, so that this multiple is likely to rise.

As stated in our previous notes, our S$12.50 price target for DBS is more dependent on a sum-of-parts analysis, as we believe that this methodology yields the highest value. We maintain our 3–Market Perform rating on the shares of DBS.

Company description

DBS Bank is the largest bank headquartered in Singapore, with major banking units including DBS Bank Singapore, Hong Kong's Dao Heng Bank, and Thai Danu Bank.

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