Indonesian Banks: Accidental Stars

As Risk Spreads To All Markets, Indonesia Is Outperforming.

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- Raising to Neutral. We are raising our sector weighting on Indonesian banks to NEUTRAL from UNDERWEIGHT based on fundamental financial performance which is too good to ignore. The country risk remains high, but we have seen this year that sticking with large or politically stable markets is no insurance against volatility. Although our universe of traded banks in Indonesia is limited, we see opportunities for investors to reap outsized gains over the next twelve months.

- A Value Outperformer: Indonesia has been quietly outperforming larger Asian markets, and the bank sector has likewise outperformed the broader Indonesian market. Our covered universe of stocks has risen by an average of 23% YTD, and the sector does not yet look expensive—valuations have in some cases fallen, even as returns increase.

- Asset Quality is Receding as an Issue: Asset quality has been the driving focus of the sector—and a major negative—for three years, but recapitalized banks have maintained clean records on new lending and have the financial strength to write off their remaining problem loans, which they are doing aggressively.

- Consumer Banking is a Prime Target: Going forward, successful players are turning their retail deposit franchises into integrated consumer and SME banks, with plenty of room to grow in this business.

- Lending Set to Rise: Indonesia is well below regional averages in credit to GDP (only 21%) and consumer lending to GDP (6%), lagging substantially behind even Korea and Thailand. This bodes well for loan growth as economic activity picks up over the next several years—and the positive effects are already making themselves felt.

- We Like BCA: Our favorite bank in the sector remains BCA, the premier consumer bank and one with a very clean balance sheet now selling at 95% of book value and 4.3x trailing earnings. We also see potential value in Lippo Bank, a more distressed situation but one also offering the opportunity to own a top franchise at a bargain price.

September 27, 2001

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"…numerous indicators of fraud, noncompliance, irregularity, misappropriation, undue preferential treatment, concealment, bribery and corruption…"

—Bank Bali Audit Report, 2000

Investment Summary

Neutral on Indonesia

We are now NEUTRAL on Indonesian banks, up from UNDERWEIGHT at the beginning of the year. Although our universe of traded banks is small, fundamentals for the sector are good and the financial performance of our covered institutions has been strong.

As a consequence, even as Indonesia has been quietly outperforming other Asian markets, the bank sector has outperformed the broader Indonesian market. Our covered universe of stocks has risen by an average of 23% YTD, but the sector does not yet look expensive.

Our favorite bank in Indonesia remains BCA (BBCA, IDR1,325, 1-Strong Buy), with Lippo Bank (LPBN, IDR40, 2—Buy) also beginning to look attractive at these levels. Although the remaining bank we cover, Panin (PNBN, IDR240, 4—Market Underperform), is financially sound and will be a long-term survivor, we believe that shareholders will suffer further pain in the short run, as the bank works through its asset quality problems.

Key Points

- Interest Spreads Are Healthy: Indonesian banks are earning the highest interest margins of any group in our Asian banking universe, with average NIM of 5.19%. This robust underlying profitability has helped banks pull themselves out of difficulty—a feature still missing in markets like Thailand.

- Bad Loans Now Manageable: In part because banks have earned enough money to take write-offs, and in part due to IBRA's removal of bad loans, asset quality at those Indonesian banks we cover is recovering quickly, with some banks, like BCA , almost completely clean at this point.

- Commercial Bank Credit Has Room For Expansion: After write-offs and workouts, Indonesia has commercial bank credit outstanding amounting to only 21% of GDP, down from an average level of 45% between 1993 and 1997 and a peak of over 70% in 1998. In terms of leaving room for growth, the credit to GDP level in Indonesia compares quite favorably with 41% in the Philippines, 61% in Korea, and 91% in Thailand.

What Has Been Done

- Capacity Taken Out: Indonesia has closed or merged 87 banks, and is forcing many other financially sound but small institutions to seek merger partners or increase their capital.

- NPLs Removed: Indonesia's listed banks have been forced to recognize their bad assets, and the worst of these have been removed by the government, leaving the banks cleaner than those in Thailand or Korea.

- Remaining Banks Recapitalized: Of the remaining banks, the majority have been effectively recapitalized with government bonds, and IBRA has demonstrated a commitment to ensure that banks still under its charge are safe and sound before removing them from administration. This has eliminated a major source of systemic risk.

- Bank/Corporate Structures Broken: The cozy relationships between Indonesia's corporate groups and their bank affiliates have been largely broken through shareholder settlements and use of the 'fit and proper' test, although insidious influence has not vanished entirely from the market.

What Remains to be Done

- Continue Bank Privatization: IBRA has been slow to sell its stakes in banks, although poor market conditions have not helped any. Apart from the initiation of a tortuous sale process (in several tranches) for BCA, the government has yet to float or otherwise dispose of any banks. Bank Mandiri is scheduled to be listed next, but its cumbersome structure and recent integration of BII make this an uncertain prospect. IBRA should offer remaining banks (even at fire-sale prices) in order to put productive assets back to work in the private economy.

- Sell Remaining Assets: Although IBRA's recapitalization of banks and preservation of the banking system has been quite effective, its disposal of assets taken from liquidated and recapitalized banks has been far too slow. The longer these assets are held, the less value they have.

- Re-Think State Banks: It has been proven time and time again that governments should not be in the business of lending—and Indonesia is no exception. The former state banks were generally worse lenders than the private banks, and are significantly less efficient to boot. Indonesia's new administration needs to either devise a compelling rationale for keeping the government in the banking business, or find a clear and swift exit strategy.

- Effectively Regulate Going Forward: Bank Indonesia, the Central Bank, still needs to be recapitalized and cleaned up; this should be a priority of the new finance policy staff. In addition, an unambiguously professional supervisory staff must be institutionalized to ensure that banks stay on the straight and narrow. IBRA should also work to implement privately funded deposit insurance to replace the blanket government guarantee as soon as practicable.

The Indonesian Banking Scene

Indonesia has closed 87 commercial banks and consolidated the industry

Who's Left?

Indonesia's banking sector has consolidated quite significantly over the past two years, but remains more fragmented than in other Asian markets. However, the merger and liquidation process has reduced the number of banks by 37%, with some 87 commercial banks no longer in existence. Of these, 70 have been frozen or liquidated, with the remainder merged in an attempt to create viable institutions. In some cases, such as the eight-way merger which begot Bank Danamon, this strategy appears to have worked; in others such as the combination of four state banks (and now BII) into Bank Mandiri, the jury is still out.

Figure 1: Indonesia's Banks by Category: 1997–2000

	Oct-97	Dec-00	Change	%
State Banks	7	5	(2)	-29%
Private National Banks:				
Foreign Exchange Banks	115	67	(48)	-42%
Category A Banks		28		
Recapitalized Banks		6		
Taken Over (BTO) Banks		4		
JV Banks and Other		29		
Domestic Only Banks	79	43	(36)	-46%
Regional Development Banks	27	26	(1)	-4%
Foreign Banks	10	10	-	0%
Total Commercial Banks	238	151	(87)	-37%
Total Commercial Bank Branches	7,781	6,509	(1,272)	-16%

Source: Bank Indonesia

Although many of the liquidated banks were small (and indeed some banks like BCA were rescued only because they were "too big to fail"), the total number of bank branches has declined by 16%, and we expect a further fall as remaining large banks prune their low-performing branches.

Figure 2: Bank Market Share by Category: June 2001

		Deposits		
As of June, 2001	Assets	All	Demand	Time and Savings
State Banks	50.1%	46.6%	32.0%	49.5%
Private Banks	34.6%	43.5%	39.3%	44.3%
Foreign Banks	10.5%	3.6%	6.3%	3.1%
Joint Venture Banks	4.7%	1.0%	1.7%	0.9%
Regional Development Banks	3.4%	5.3%	20.7%	2.3%

Source: Bank Indonesia

Who's Better, Who's Best?

At this point there are only a handful of significant Indonesian banks remaining, although there is a possibility that IBRA may create several more through mergers of its remaining portfolio of banks.

Of the top ten banks in our estimation, six are full state banks, and the government owns a majority stake in two of the remaining four. We divide these banks into those concentrating on a mass retail and SME business (BCA, Danamon, Lippo, Panin, NISP), and those still operating in a traditional manner while waiting to be listed (Mandiri, BNI) or sold (Niaga, Universal, Bali). Only those in the first category can be of interest to investors in listed shares.

Figure 3: Major Indonesian Banks

	Total Assets	Status	Market Share	Branches
Mandiri	261,285	State Owned	24.7%	623
BNI	117,880	State Owned	11.1%	636
BCA	104,573	Public	9.9%	795
Danamon	56,093	State Owned	5.3%	497
Lippo	24,070	Public	2.3%	390
Niaga	18,699	State Owned	1.8%	95
Panin	15,881	Public	1.5%	113
Universal	11,320	State Owned	1.1%	69
NISP	5,686	Public	0.5%	73
Bali	5,652	State Owned	0.5%	265
Total	621,139		58.7%	3,556

Source: Bank Indonesia, company reports, Lehman Brothers estimates.

We believe that BCA, Lippo, and Danamon will survive as the major national retail banks, and also garner a fair share of the corporate business in the years ahead, as they begin with all of the advantages—clean balance sheets, large branch and ATM networks, good brand names, and voluminous existing customer bases on the deposit side. While no Indonesian bank has yet made a go of the consumer lending sector (pre-crisis this having been the purview of finance companies), it stands to reason that these banks will have the best ability to do so in the future.

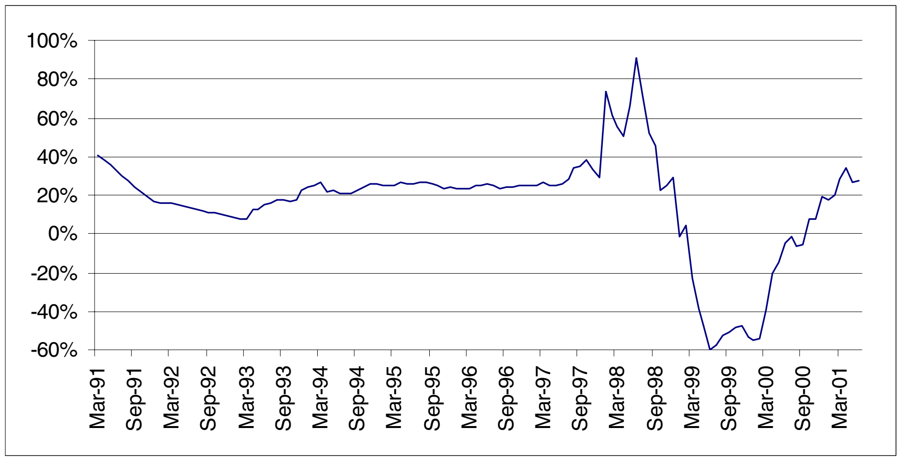
Panin and NISP have good potential futures as niche banks in high-margin sectors, and may be able to grow substantially over time as the top banks have less than 60% market share. The large state banks (BNI and Mandiri) will remain afloat as a matter of policy, but are long shots to generate value and return on invested capital over a full cycle, dependent as they are on high-cost liabilities and corporate/SOE lending. Universal and Bali have valuable, although tarnished, franchises, and may conceivably find new life under foreign bank purchasers; otherwise we look for them to be consolidated with other banks in the top ten within 12 months. Neither of the two appears to be viable as a stand-alone bank.

Industry Growth and Prospects

Loan Growth Has Begun To Recover…

Loan growth has returned to positive territory, although the banking system is considerably smaller in terms of total assets than it was pre-crisis. However, the listed private banks are moving ahead smartly with the business of extending credit. Importantly, we see no signs as yet that banks are lending imprudently or failing to properly classify new loans as necessary—although we advise continued vigilance as this is the major risk of investing in the financially strong Indonesian banks.

Figure 4: Indonesian Commercial Bank Loan Growth, YoY Change



Source: Bank Indonesia

Note that total or gross loans are not a good indicator of real growth, as they are subject to the distorting effects of loan write-offs—which we generally consider beneficial. Looking only at our statistic of performing (Category 1) loans, we see that growth at the more distressed banks in our coverage universe improves markedly.

Figure 5: Loan Growth: Lehman Brothers Covered Universe

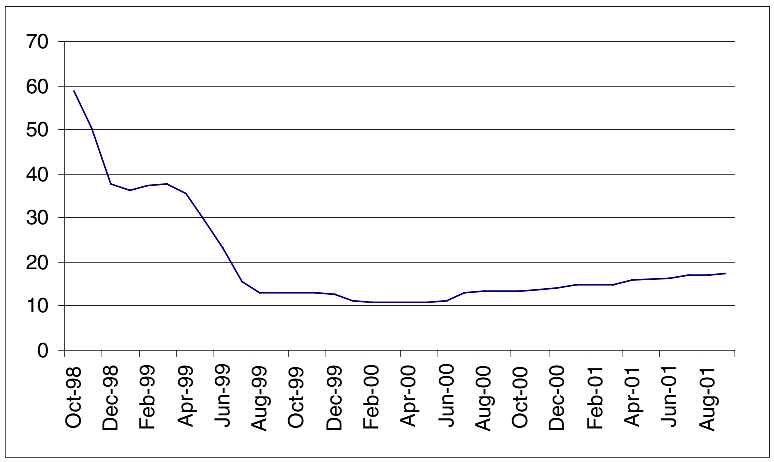
	BCA	Lippo	Panin	AVG
Loan Growth FY2000				
Total Loans	95%	-3%	15%	35%
Performing Loans	130%	-4%	145%	90%
Loan Growth 1Q01 (YoY)				
Total Loans	129%	-2%	8%	45%
Performing Loans	140%	18%	95%	84%
Loan Growth 2Q01 (YoY)				
Total Loans	105%	-7%	-29%	23%
Performing Loans	97%	20%	-26%	30%
Loan-to-deposit Ratio	12%	20%	53%	28%

Source:Company reports; Lehman Brothers estimates

...As Interest Rates Have Stabilized

Generally declining and stable interest rates over the past two years have contributed to the industry's increased vigor. Although rates have crept up over the past two quarters on political uncertainty, this issue appears to be resolved satisfactorily, at least for the moment. We project a decline in benchmark SBI rates of 500-600 bp by 2004, which should stimulate loan growth further.

Figure 6: 3-Month SBI Rate: 10/98—9/01



Source: Bloomberg

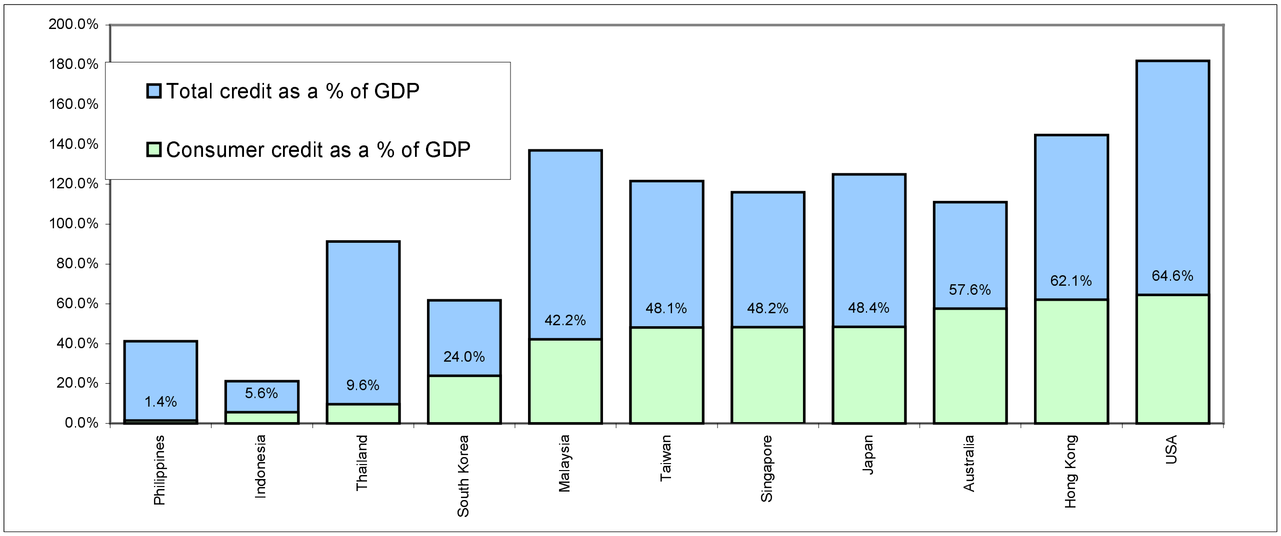
Figure 7: Aggregate Loan Growth and Loan to Deposit Ratio: 1991-2001

	Loan Growth		
	IDR Bil, YoY	**%, YoY**	**Loans to Deposits**
1991	15,847	16.34%	163%
1992	10,093	8.95%	145%
1993	27,353	22.25%	143%
1994	38,609	25.69%	151%
1995	45,731	24.21%	144%
1996	58,310	24.85%	136%
1997	85,213	29.09%	160%
1998	109,292	28.90%	117%
1999	(262,293)	-53.81%	48%
2000	43,867	19.48%	51%
Jun-01	66,198	27.57%	55%

Source: Bank Indonesia

We anticipate that loan growth will continue to be strong for our universe of banks, mainly due to them gaining market share and the normalization of the economy, rather than because of strong economic growth. After write-offs and workouts, Indonesia has commercial bank credit outstanding of only 21% of GDP, well below the average level in the region, leaving plenty of room for expansion, even despite low economic growth. We project average growth in performing loans of 33% in FY2001, 13% in FY2002, 20% in FY2003, and 18% in FY2004.

Figure 8: Total Commercial Bank Credit to GDP: Regional and Global Comparison



Source: Central banks; CEIC; Lehman Brothers estimates

Figure 9: Total Commercial Bank Credit to GDP: Regional and Global Comparison

	Total credit as a % of GDP	Consumer credit as a % of GDP	Consumer loans as a % of Total loans
Indonesia	21.2%	5.6%	26.2%
Philippines	41.2%	1.4%	3.2%
South Korea	61.8%	24.0%	38.8%
Thailand	91.4%	9.6%	10.5%
Australia	111.1%	57.6%	51.8%
Singapore	116.0%	48.2%	41.6%
Taiwan	121.7%	48.1%	39.5%
Japan	125.0%	48.4%	38.7%
Malaysia	137.1%	42.2%	30.8%
Hong Kong	144.8%	62.1%	42.9%
USA	182.0%	64.6%	35.5%

Source: Central banks; CEIC; Lehman Brothers estimates.

Financial Performance

Our Indonesian bank universe has largely returned to pre-crisis levels of profitability, due both to the removal of NPLs from banks' balance sheets and to consolidation, which has favored the best surviving institutions. Overall return on assets has increased from 0.96% in 1997 to a healthy 1.22%. Note that Panin bank skews the average in both periods, having reported high profits through 1997 but very depressed levels since. Panin did not receive government funds and was not able to take a one-time write-off, but is now spreading its pain over several years—a major reason to avoid its shares at the current time in favor of those of either of its competitors.

Figure 10: Coverage Universe ROA: 1996—2Q01

	1996	1997	1998	1999	2000	1Q01	2Q01
BCA	0.54%	0.34%	-49.59%	0.79%	1.87%	1.81%	2.59%
Lippo	1.31%	1.02%	-54.94%	-8.44%	1.06%	0.57%	0.97%
Panin	2.98%	1.53%	0.04%	0.33%	0.21%	0.15%	0.10%
Average	1.61%	0.96%	-34.83%	-2.44%	1.05%	0.84%	1.22%

Source:Company reports; Lehman Brothers estimates

Margins Have Recovered

Indonesian Banks' net interest margins are on average the highest in Asia—a positive signal for the underlying business

Interest margins are quite healthy across the board, and appear set to increase smartly in FY2001 compared with FY2000. Banks have been able to lag deposit rate rises or actually lower liability costs, even as SBI rates have risen in 1H01. Margins at those banks in our universe are wide, even though 58% of BCA's balance sheet and 24% of Lippo's are comprised of government bonds yielding SBI at best.

Figure 11: Coverage Universe Net Interest Margin: 1996—2Q01

	1996	1997	1998	1999	2000	1Q01	2Q01
BCA	2.20%	1.95%	-31.40%	-6.66%	2.51%	4.57%	4.94%
Lippo	4.96%	5.49%	-12.65%	-8.64%	3.97%	5.53%	5.75%
Panin	8.01%	6.66%	5.50%	5.35%	3.78%	4.06%	4.88%
Average	5.06%	4.70%	-12.85%	-3.32%	3.42%	4.72%	5.19%

Source: Company reports; Lehman Brothers estimates

Redeployment of these securities into loans at current rates would add an additional 400-500 bp to interest yields on this portion of these banks' assets. While we don't expect these banks to be loaned-up any time in the next three years, shifts to higher-margin assets could magnify the importance of the strong deposit franchises held by all three banks, and mitigate the impact of declining rates.

Margins will come off—but stability and falling rates will increase the value of deposit franchises nonetheless

We forecast that margins will decline throughout 4Q04 due to more normalized competition and a falling rate bias throughout the period. As the majority of banks' assets re-price quickly, while deposit rates are more sticky, this should have the effect of reducing spreads as SBI declines. However, with excess liquidity in the system and low loan growth, there is no reason why deposit margins should not recover as rates stabilize.

In truth, as we expect further consolidation, which will limit the number of convenient and safe banks, consumers may have fewer choices, and thus actually accept even lower deposit rates.

Figure 12: Key Earnings Ratios: FY2000

	NIM	ROA	ROE	NPLs/Assets
BCA	2.51%	1.87%	47.59%	0.6%
Lippo	3.97%	1.06%	29.39%	11.8%
Panin	3.78%	0.21%	1.26%	13.9%
Coverage Average	3.42%	1.05%	26.08%	8.76%

Source: Company reports; Lehman Brothers estimates

Increased Spreads + Lower Rates = Evidence of Deposit Pricing Power

Managements at Indonesian banks tell us that their customer surveys show retail depositors to be relatively rate insensitive. They first and foremost consider convenience when choosing where to bank. Financial data supports this view: even as rates have been lowered YTD, deposits have grown at the banks with large networks and good service, particularly in the more coveted demand and savings deposit categories.

Figure 13: Deposit Book Growth by Category: 2001YTD

	% of Total Deposits			YTD Growth		
	BCA	Lippo	Panin	BCA	Lippo	Panin
Rupiah-denominated:						
Demand	16.0%	22.0%	16.2%	+5.6%	+12.8%	-52.3%
Savings	51.9%	48.1%	23.1%	+1.7%	+9.2%	+20.0%
Time	32.1%	29.9%	60.7%	-2.3%	-15.9%	-24.8%
Subtotal	85.8%	76.7%	65.5%	+1.1%	+0.9%	-25.3%
Foreign Currency:						
Demand	44.9%	64.5%	51.6%	+28.7%	+58.0%	+7589.6%
Savings	0.1%	0.0%	0.0%	+16.7%	+0.0%	+0.0%
Time	55.0%	35.5%	48.4%	+53.7%	+22.3%	+14.6%
Subtotal	14.2%	23.3%	34.5%	+42.4%	+43.2%	+133.2%
Total Deposits	100.0%	100.0%	100.0%	+6.9%	+8.3%	-2.4%

Source: Company reports; Lehman Brothers estimate

Valuation

Banks have become religious about transparency—but are not yet getting credit.

Indonesian bank valuations are low across the board, in part due to an understandable reluctance on the part of investors to accept the reported figures at face value. Given the fraudulent accounting of the past, this is a reasonable "once bitten, twice shy" position—but we believe that standards and transparency have truly changed.

On a price-to-book basis, all banks in our universe trade below book value, despite an average sector ROE in the low to mid 20% range. Adjustments we make to our book value calculation to derive ABV include taking out property revaluation and capitalized tax loss carry-forwards. While these assets have real value, they don't fit our strict definition of ABV as a liquidation figure, and so we prefer to see their effects recognized through income. On this basis, the sector still trades at 1.1x.

Figure 14: Price to Book Valuations

	BCA	Lippo	Panin	Average
Book Value	1,395.2	67.2	446.3	
Price/Book	0.95	0.60	0.54	0.69
Adjusted Book Value	936.4	30.2	443.6	
Price/Adjusted Book	1.42	1.32	0.54	1.09
Trailing ROE	47.6%	29.4%	1.3%	26.1%
Forward ROE	42.5%	18.6%	4.8%	22.0%

Source: Company reports; Lehman Brothers estimate

Earnings valuations are likewise low: all banks have FY2002 P/E ratios in the low single digits, and the sector as a whole trades on 4.4x FY2002E EPS.

Figure 15: Price to Earnings Valuations

	BCA	Lippo	Panin	Average
EPS:				
2000A	306.2	3.1	2.4	
2001E	428.5	6.0	21.8	
2002E	406.9	6.4	66.3	
2003E	396.7	5.4	64.1	
2004E	400.2	6.0	63.1	
Price/EPS				
2000A	4.33	12.71	99.06	38.70
2001E	3.09	6.67	10.98	6.92
2002E	3.26	6.21	3.62	4.36
2003E	3.34	7.42	3.74	4.83
2004E	3.31	6.65	3.81	4.59

Source: Company reports; Lehman Brothers estimate

Our final valuation method for emerging market banks is a measure of the cost of the deposit franchise to an investor—particularly appropriate in the case of Indonesia as most banks are making returns on the liability front rather than on the asset side.

Under this methodology, we subtract adjusted book value from market capitalization to determine the value in excess of net assets that the market is placing on the bank's franchise. When expressed as a percentage of total deposits, this valuation methodology confirms our view that the Indonesian market is attractive, with an average deposit premium of –2.3%, the lowest in our universe.

Figure 16: Deposit Premium Valuations

	BCA	Lippo	Panin	Average
Market Capitalization	7,799.0	1,566.3	1,429.3	
Less: Adjusted Book Value	(5,511.5)	(1,183.0)	(2,642.2)	
Franchise Premium (FP)	2,287.5	383.3	(1,212.8)	
FP/Deposits	2.5%	1.9%	-11.4%	-2.3%
FP/Demand+Savings Deposits	3.8%	2.8%	-26.2%	-6.5%

Source: Company reports; Lehman Brothers estimate

Indonesia's Bank Restructuring—A Recap Review

The task of rebuilding the Indonesian banking system was entrusted to the Indonesian Bank Restructuring Agency (IBRA), established in January 1998. IBRA is an autonomous body invested with extraordinary powers to oversee the rehabilitation of the financial sector, including the right to seize and operate poorly run or insolvent banks, and to manage and dispose of assets and collateral. IBRA controls assets with a market value in excess of Rp200 trillion.

IBRA's restructuring strategy consists of implementing the government's guarantee program; managing the audit, assessment and triage program to identify viable institutions; recapitalizing and consolidating viable or strategically important banks; restructuring corporate debt and reviving the real economy; maximizing the recovery of government funds provided to banks by allocating losses to the banks' controlling shareholders, where possible; and recovering government funds through divestment and asset sales. This is clearly an ambitious, far-reaching, and politically sensitive project which has put IBRA in control of resources approximating Indonesia's entire GDP.

Classifying the Banks by Capital

To begin the restructuring process, the government in June 1998 hired auditors to determine the solvency of Indonesia's banks based on international standards. Indonesia's private banks were then placed in three different categories based on their capital adequacy ratios, as detailed below:

- Category A Banks. With CARs above 4%, these banks were considered sufficiently capitalized so as not to require additional funds from the government.

- Category B Banks. These banks, with CARs between negative 25% and positive 4%, were eligible for recapitalization, provided that they met certain criteria.

- Category C Banks. Banks with CARs of less than negative 25% were given 30 days to meet the capital requirements to become Category B (subject to the same criteria for recapitalization) or face closure.

Recapitalization Eligibility

The recapitalization program for private sector banks was carried out only on selected banks. This selection process consisted of first classifying the banks into A, B, and C categories and then conducting further appraisal on the Category B Banks. Eligible banks had to establish their viability by submitting a rehabilitation plan and subjecting management and owners to a "fit and proper test" by IBRA and Bank Indonesia, and by settling all intra-group loans exceeding the legal lending limit. Based on the results of this appraisal, bank selection was carried out as follows:

- Category B Banks that passed the further appraisals and whose controlling shareholders were willing to contribute a minimum of 20% of the total recapitalization cost as of December 31, 1998 were placed in the private sector bank restructuring and recapitalization program.

- Category B Banks that passed the further appraisal but whose shareholders were unwilling or unable to participate in the recapitalization were taken over by the government (banks taken over, or 'BTO').

- Category B Banks that failed to pass the appraisal had their operations frozen (BBKU), except for banks with more than 80,000 depositors (BCA and Bank Danamon), which were taken over by the government to preserve their payment and deposit systems.

Recapitalization Criteria

In undertaking a recapitalization, the government entered into an Investment Agreement with the bank concerned and its controlling shareholders. The principal provisions of this agreement were as follows:

- The controlling shareholders pledged their willingness to participate in the recapitalization, with a minimum investment of 20% of the recapitalization needs as of December 31, 1998.

- The government agreed to fund the remaining recapitalization needs as calculated by an independent public accountant, in cooperation with the bank's shareholders. Recapitalization funds would be injected primarily in the form of government bonds (*see below*).

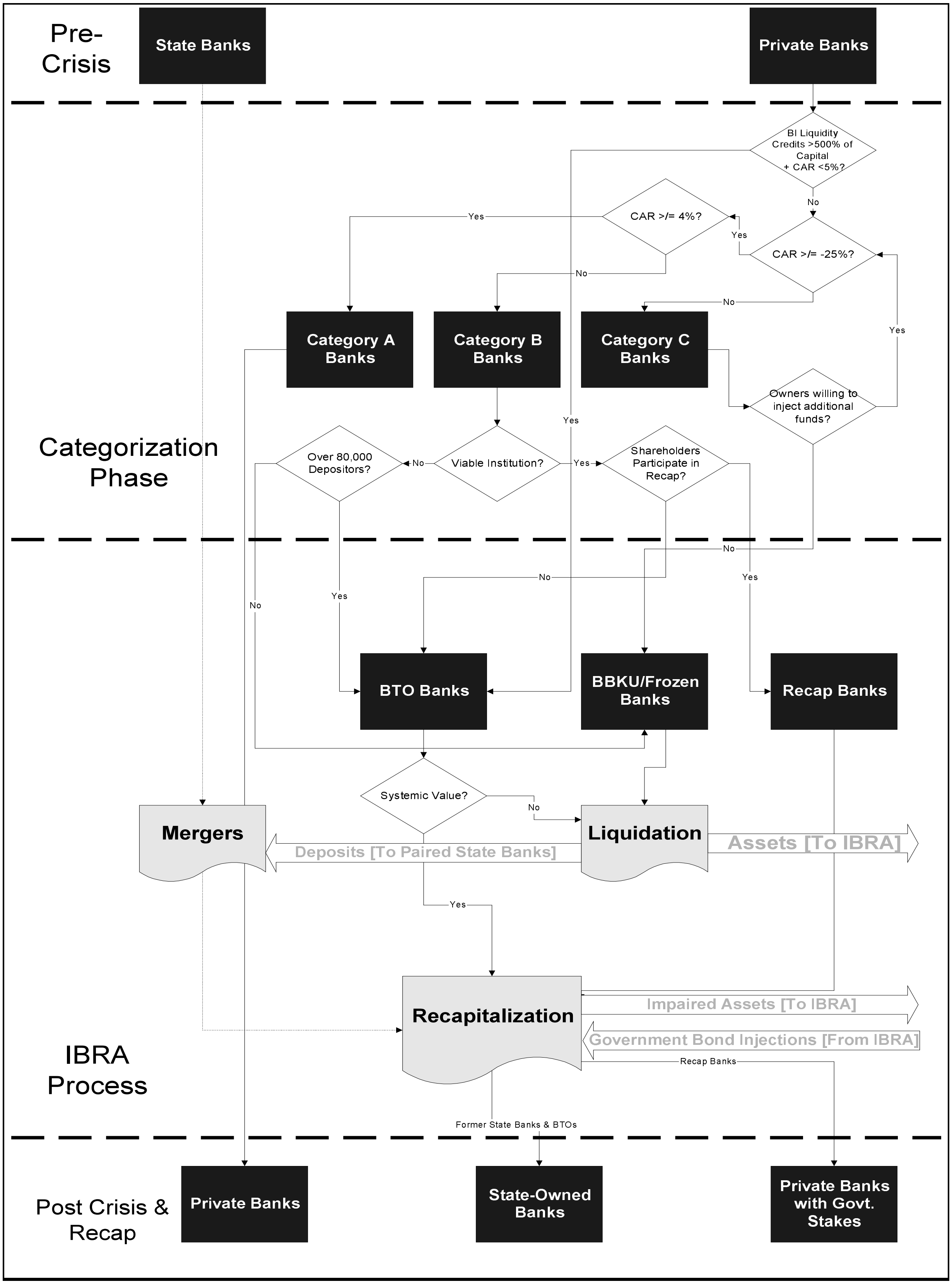
- The bank would transfer all Category 5 (Loss) loans to IBRA, with the exception of loans with principal balances of less than Rp5 billion.

- The bank would repay liquidity assistance and correct any legal lending limit violations within one year.

- The bank agreed to comply with financial and operational targets set out in the business plan, and to submit periodic progress reports.

- IBRA agreed not to participate in the day-to-day management of the bank.

Figure 17: Indonesian Bank Recapitalization Process



Source: IBRA; Lehman Brothers

All State Banks Were Recapitalized

The state-owned banks were deemed so important to national development that they were recapitalized, regardless of their capital ratios. The government plans to allow BNI, BRI, and BTN to continue operating as separate entities. The remaining four banks (Bank Bumi Daya, Bank Dagang Negara, Bank Exim and Bapindo) were merged into the newly established Bank Mandiri, which began operations in August 1999.

Liquidated Banks (BBO/BBKU)

In the case of banks whose operations were frozen (BBO and BBKU), IBRA has carried out the following actions:

- Payment of Bank Liabilities. In accordance with the government's guarantee program, IBRA will pay all the eligible liabilities of the BBO and BBKU banks.

- Transfer and Management of Bank Assets. All the assets of banks whose operations have been frozen were transferred to IBRA, which is servicing performing loans and restructuring NPLs.

- Shareholder Settlements. If there were any violations of banking regulations by a bank's controlling shareholders, IBRA is seeking to recover the liabilities from the controlling shareholder.

- Liquidation.

Recapitalization Bonds

Recapitalization bonds were used to raise the CAR of recap banks to the 4% minimum. These bonds were injected in exchange for non-performing loans, which were transferred to IBRA. In addition to removing NPLs from the books, the coupon payments from the bonds provide a steady income stream to the banks.

Recap bonds carry either a fixed coupon rate of 12% or 14%, paid semi-annually, or a variable rate equivalent to the average three-month SBI rate. The variable rate bonds have been much more desirable, as interest rates have risen since the original injections. Banks which received a greater proportion of variable-rate bonds (*e.g.*, BCA) are in much better condition than those which received mainly fixed-rate bonds (*e.g.*, Niaga). Fixed rate bonds trade at a discount of 10-12% to face, but the market is fairly illiquid.

Post-Recap Bank Share Classes

Bank shares in recap banks have been issued in three classes, although there is no practical distinction in listing or trading and all shares have the same rights. 'A' shares are the original, pre-recap, shares owned by private investors and/or the government. 'B' shares are shares purchased through the recap rights offerings, where existing shareholders were given the opportunity to participate in the recapitalization (and were required in aggregate to purchase shares totaling at least 20% of the cost of recapitalization). These shares were issued with special warrants and certificates of entitlement (COEs), described below, as an inducement to subscribe. Finally, the remaining recapitalization shares that were purchased by the government are 'C' shares. When called away by exercise of the warrants or independently sold by the government, the C shares become normal B shares.

Recap Warrants

Shareholders who participated in bank recaps by purchasing B shares also received warrants. The warrants have a three-year term and are exercisable every six months. They permit shareholders to buy out the government's share of the bank at the original rights offering price, plus a cost of carry charge based on the SBI rate. Warrant holders received these rights in amounts proportional to the government's percentage of participation in the recapitalization rights offering — in other words, if the rate of C shares issued to B shares issued was 4:1, each buyer of a B share would receive warrants for 4 C shares. These warrants are strippable and tradable, and some have already been exchange-listed.

Note that if there are independent sales or offerings of C shares by the government during the term of the warrants, there may not be enough remaining shares to cover warrant exercises. In this case, remaining warrants will be worthless. However, warrant holders have the right of first refusal on any share sales made during the life of their options.

Certificates of Entitlement (COEs)

In return for the Category 5 loans which were transferred to IBRA, shareholders in the recap banks received COEs which entitle them to the net recoveries on these assets through year-end 2002. Any recoveries will be paid in C shares if any are still held by the government; otherwise, settlement will be made in cash at the end of 2002. The COEs are tradable, but no organized market exists.

We believe that neither the warrants nor the COEs have any value.

Political Scene

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While Indonesia's recent political transition should result in better economic policy making, there are still numerous obstacles that could cause the Megawati administration to stumble.

A Peaceful Political Transition...

After months of destabilizing political brinkmanship, Indonesia's parliament moved swiftly to quell political uncertainty in August, impeaching President Wahid and replacing him with popular Vice President, Megawati Soekarnoputri. The final transition proved much smoother than many expected. Outbreaks of violence by pro-Wahid supporters failed to materialize and the new President received the emphatic backing of the military and the Supreme Court. This provided a boost to financial markets, and the currency rallied by more than 10% against the US dollar over the week.

Opens the Way for Stronger Government

We expect the new government to provide clearer political direction than the previous administration. Mrs Megawati's PDI-P party is the largest single parliamentary party, holding around a third of the seats. While her personal policy aptitude remains unproven, she has generally surrounded herself with credible economic advisors and reports suggest she actively prepared to assume office for several months leading up to Wahid's ouster, in order to hit the ground running.

As a result, relations between the IMF and the government have improved under President Megawati, after the prolonged breakdown in relations under the previous administration. A new IMF Letter of Intent has now been signed, which has allowed the stalled round of Paris-club debt rescheduling to proceed and opens the possibility of additional international financial assistance from external creditors in coming months.

But Huge Challenges Remain

While this is all good news for Indonesia, the effect of a change in leadership should not be overstated. The government still has numerous obstacles to overcome in trying to deal with Indonesia's deep-seated problems and the difficulty of these challenges has intensified in the current weak international environment.

It is now four years since the onset of the Asian crisis, and structural reforms in Indonesia remain in their infancy. The legal system remains open to abuse and corruption is rampant, frustrating even the best-intended efforts to accelerate meaningful financial sector and corporate debt restructuring.

In addition, Indonesia's fiscal situation remains a major concern and the government will be hard pushed to achieve this year's 3.7% of GDP budget deficit target. As a result of its large outstanding debt obligations, the government remains completely dependent on asset sales and foreign assistance to finance any revenue shortfalls. Despite the government's recent harsh budget cuts, the continued deterioration in economic conditions means that this year's deficit target will be difficult to achieve without additional international financial assistance. Even if this year's target is met, we doubt the ability of the Indonesian government to continue meeting its external debt obligations over the medium-term, particularly if there are any further disagreements with the IMF or international creditors.

We also have reservations about some aspects of the new President's policy agenda. As a staunch nationalist, Megawati will likely be reluctant to accelerate the privatization of state assets via sales to foreigners, even though this remains a key IMF policy requirement. President Megawati's well-known support for the military is also a potential source of concern as the new administration grapples with the vexed question of how to contain separatist movements and civil unrest. There are fears that Mrs Megawati may allow the military greater leeway in suppressing regional unrest, a move that may trigger an international backlash as it did in East Timor.

Finally, despite the unanimous endorsement of Mrs Megawati's presidency, Indonesia's political landscape remains fragmented. Despite the PDI-P's relative size, without a parliamentary majority, Mrs Megawati will likely confront political obstacles in pursuing her legislative agenda, particularly as opposition parties attempt to discredit the government ahead of the 2004 elections.

Political Outlook Remains Grim

In this environment the risk remains that the new administration may fail to succeed on all the fronts demanded by the IMF. At some point the new administration may fall behind the IMF's stipulated reform agenda, jeopardizing its access to continued international support and once again casting a cloud over the country's medium-term outlook.

Economic Outlook

Summary

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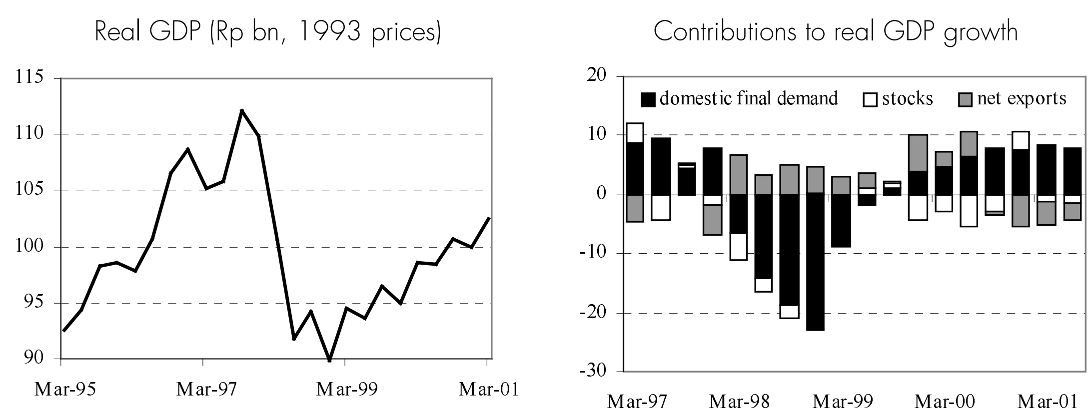
Despite the volatile political environment, Indonesia's recovery has continued to strengthen over the past year. Unfortunately, with global growth slowing and the government now tightening fiscal and monetary policy, growth this year is expected to slow to just 2.3%. Going forward, the economy's medium-term prospects remain highly dependent on the government's ability to control inflation and the budget deficit, while at the same time accelerating much needed structural reforms.

Economy is slowing

After suffering the greatest impact of the Asian crisis, Indonesia's economy continued to steadily recover over the past year. In 2000, the economy expanded by 4.8%, the fastest growth seen in 4 years, underpinned by strong export performance and robust domestic demand. Realistically, though, much of this acceleration still largely reflects "catch-up" from the Asian crisis and the volume of production remains a considerable 9.1% below its pre-crisis level.

More recently, growth appears to have peaked and is now slowing. In Q2, real GDP growth moderated to 3.5% y-o-y, from 5.2% in 4Q00 and the economy is set to slow further over the remainder of this year. In addition to slowing foreign demand and lower oil prices, the recovery will receive less support from accommodative fiscal and monetary policies. For the year as a whole, we expect the economy to expand by 3.0% y-o-y in 2001, rising to 4.5% in 2002.

Figure 18: Real GDP and Contributions to real GDP growth

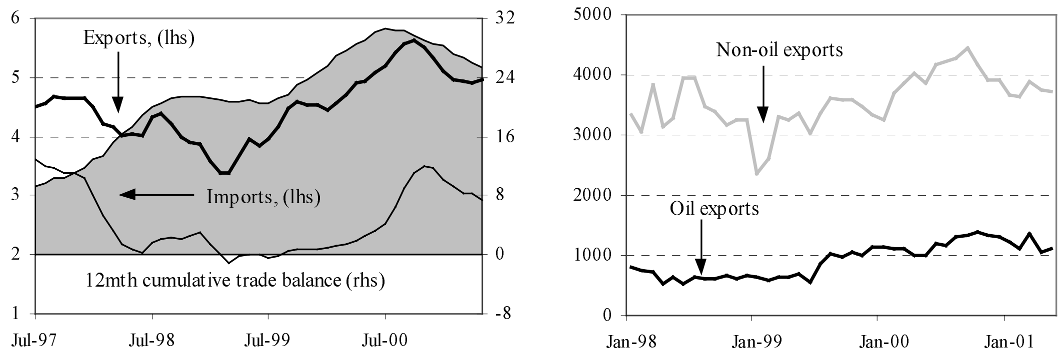


Source:Lehman Brothers Global Economics

External Demand Is Moderating

Figure 19: Trade balance and Exports

Trade balance US$bn　　　　Exports (US$m)



Source: Lehman Brothers Global Economics

- The main engine of Indonesian growth remains the export sector. With the currency still significantly undervalued, exports have performed strongly over the past year. In addition, as a significant oil producer, Indonesia has received a major windfall gain from higher global oil prices. As a result, Indonesia's trade surplus has swelled to one of the largest in the region, averaging close to US$2bn in recent months.

- Unfortunately, the economic slowdown in Indonesia's trading partners has seen the trade surplus edge lower in recent months and net exports actually detracted from growth in Q1 and Q2, as import demand outpaced export growth.

- More recently, however, imports appear to be slowing in line with weaker domestic fundamentals, while exports have stabilized. This suggests that net exports will make a small contribution to growth over the remainder of the year. In addition, tourism data has continued to trend higher, with the 12-month cumulative visitor arrivals figure, rising by 6.9% y-o-y in July.

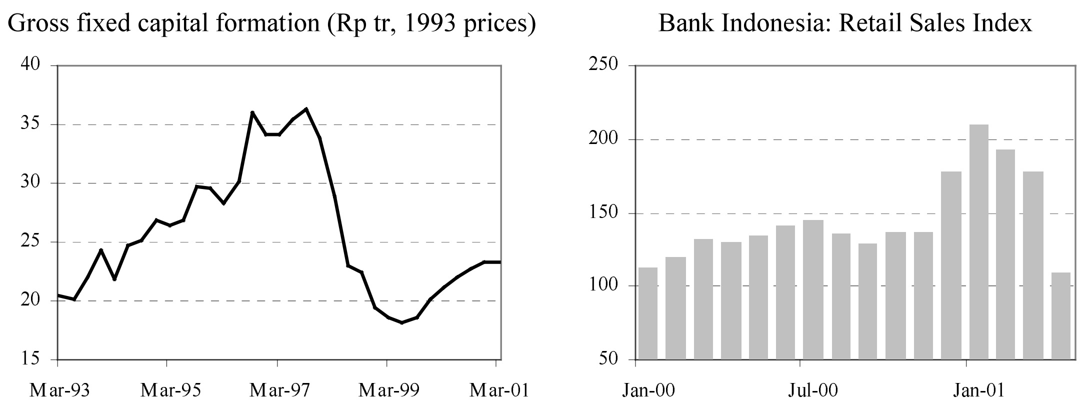
Domestic Demand Is Slowing

- The main source of weakness this year is likely to be domestic demand. Domestic final demand expansion slowed to 7.8% y-o-y in Q1, from 8.4% in the previous quarter, driven by a sharp slow down in new investment spending and weaker government consumption. Both of these factors are expected to continue to decline over the remainder of the year.

- The outlook for new investment spending remains particularly weak. Despite signs of renewed investment spending in export-oriented sectors last year, the economy is still running a sizeable output gap, and investment demand is likely to take some time to return to its pre-crisis level. With many corporations still operating well below their existing capacity, the most pressing concern is bringing idle capital back "online", rather than any need for spending on new investment in plant and equipment.

- Consumer spending is also likely to slow in coming months. While household consumption actually remained fairly resilient in Q2, rising by 4.8% y-o-y, recent indicators suggest consumption growth is likely to slow over the remainder of this year. Surging inflation from the removal of fuel and electricity subsidies, combined with higher interest rates and a weaker labor market has significantly reduced households' real disposable income. Already, Bank Indonesia's retail sales index has dropped sharply in recent months, after steadily improving in the second half of 2000.

Figure 20: Capital Formation and Retail Sales



Source: Lehman Brothers Global Economics

Tighter Fiscal and Monetary Policies

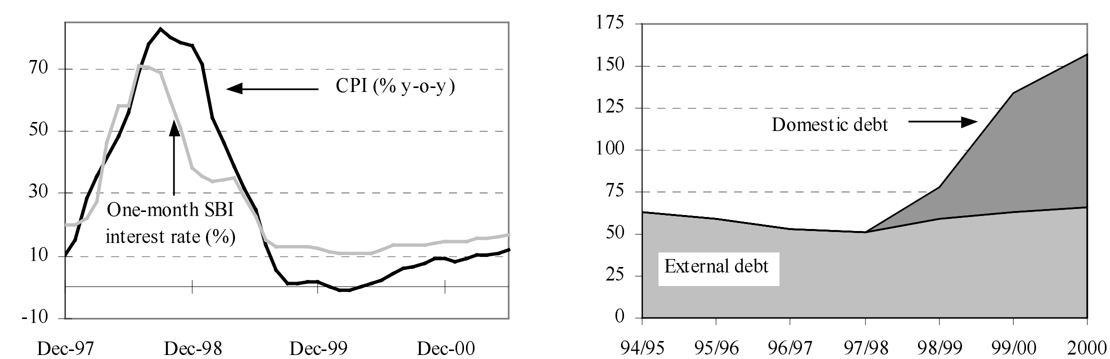
- The government's policy stance is also expected to have a more noticeable negative impact on growth in coming months, with both fiscal and monetary policies being tightened so far this year.

- On the fiscal front, with public debt close to 100% of GDP, the IMF has insisted that the government significantly tighten fiscal policy. The government has been forced to urgently remove fuel and electricity subsidies to make sure it meets this year's budget deficit target of 3.7% of GDP. Further cutbacks will be necessary if the government is to achieve its 2.2% of GDP budget deficit target in 2002.

- Meanwhile, rising inflationary pressures have forced the central bank to increase interest rates in recent months, even though economic growth remains weak. The inflation rate has accelerated to 12.2% y-o-y in August and Bank Indonesia is now firmly focused on slowing growth in the money base, to ensure inflationary pressures do not spiral out of control. As a result, the key 1-month SBI rate, has risen to around 17.6% at present, with further increases likely if the inflation rate does not begin to moderate.

Figure 21: Interest Rates, Inflation, and Government Debt

Interest rates and inflation (%) | Government Debt (US$bn)



Source: Lehman Brothers Global Economics

Structural issues

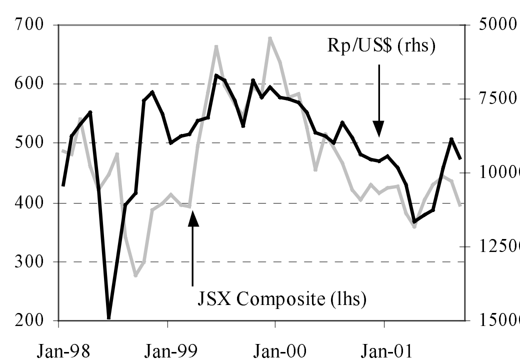
- The prospect of less supportive macro policies and a slowing world economy heightens the need for the Indonesian government to spur the private components of demand to sustain growth. This, in turn, will require further improvements in household and investor confidence. While the recent peaceful political transition has provided a boost to the currency and the equity markets, any sustained improvement in sentiment remains contingent on Indonesia's ability to complete the remaining necessary structural reforms. As such, there are still a multitude of risks that could derail the recovery and the outlook remains subject to considerable risk.

- One of the most delicate issues the government must confront is the vexed question of regional unrest. As a country of diverse geographical, religious and ethnic persuasions, Indonesia continues to be plagued by regional unrest. As the world's largest Muslim nation, civil unrest could intensify in coming months too if there is any US retaliation against other Muslim countries.

- On the economic reform front, relations with the IMF remain strained. The government has consistently struggled to pass the IMF's quarterly economic assessments, which are a prerequisite for continued foreign assistance. In addition, the banking sector remains weak and IBRA must continue to accelerate the corporate restructuring process and ensure the banking sector quickly resumes its essential lending function.

- China's entry into the WTO will only serve to intensify pressure on less developed countries like Indonesia to remain competitive or lose out on future FDI flows.

Figure 22: Financial market indicators



Source: Lehman Brothers Global Economics

Outlook

Overall, Indonesia's economic outlook remains highly uncertain given the number of political, social and structural problems that must be confronted. Support of international organizations such as the IMF and the World Bank remains crucial to rebuilding confidence. Going forward, if the new government can successfully overcome these many obstacles, the economy has the potential to return to its former high growth path that was sustained prior to the Asian crisis. However, if the country fails to meet these challenges, it could continue to underperform the region for several more years.

BANK CENTRAL ASIA

CROWN JEWEL IN MOTION

BANK CENTRAL ASIA	
Rating:	**1-Strong Buy**
Ticker:	BBCA.JK
Share Price:	IDR 1325
Market Cap:	IDR 7.8 Tr.

	Net Profit (IDR B)	EPS (IDR)	Change (%)	P/E (x)	P/BV (x)	DPS (IDR)	Yield (%)
1999A	641	217.90	NM	NA	NA	0.00	NA
2000A	1,802	612.30	181%	1.3	0.3	0.00	0.0%
2001E	2,522	428.49	-30%	3.1	0.8	60.24	4.5%
2002E	2,395	406.92	-5%	3.3	0.7	101.73	7.7%
2003E	2,335	396.69	-3%	3.3	0.6	138.84	10.5%

Shares Outstanding: 5.9 billion — Fiscal Year End: Dec

BCA shares have gained 89% since their IPO just over a year ago, but BCA's competitive position and financial performance continue to surprise on the upside. As a result the valuation has only grown more attractive.

We actually expect BCA's net income to decline through 2004, as interest rates fall, the company uses up its tax loss carry-forwards, and competition grows stronger, but the economic conditions and foreign entrants which will permit this scenario to unfold should raise BCA's valuation nonetheless.

We believe BCA is the most attractive way of taking emerging market exposure in Asian banks, and it has actually delivered so consistently that, in our opinion, it should be considered as an alternative investment to banks in many of the developed Asian markets.

2Q01 Earnings Highlights:

BCA reported a 2Q01 bottom-line profit of Rp 661 billion, or Rp112 per share, a 278% increase from the comparable period in FY2000 and 49% ahead of 1Q. Note that year-on-year gains were not at the expense of provisions, which actually rose from 2Q00. Earnings were equally impressive on a pre-tax, pre-provision basis, up 7% QoQ and 283% YoY.

Figure 23: BCA Key Earnings Components: 1999–2003

	FY1999	FY2000	2Q2001	FY2001E	FY2002E	FY2003E
Net Interest Income	(4,378.7)	2,131.7	1,113.9	4,214.5	4,198.4	4,136.8
Non-Interest Income	6,237.1	1,177.4	358.7	1,424.7	1,480.4	1,559.5
Non-Interest Expense	1,241.9	1,648.9	567.3	2,090.8	2,196.8	2,317.2
Provisions	382.2	55.6	155.2	547.1	300.0	300.0
Core Earnings	641.3	1,802.0	660.8	2,522.1	2,386.5	2,217.0
Net Income	641.3	1,802.0	660.8	2,522.1	2,386.5	2,217.0

Source: Company reports; Lehman Brothers estimates

Effect of Tax Loss Carry-Forwards

BCA's bottom-line income has been inflated by its use of tax loss carry-forwards, which contributed to a Rp -376 billion tax bill in 4Q and an overall -12% tax rate for the year. BCA has been striving to use these NOLs within the five-year period before expiration, but still carries an estimated Rp1.65 trillion in capitalized tax assets on its books (note that we deduct these assets from our adjusted book value calculation).

The declining tax effect is the major reason why our estimates show net income decreasing by 7% between FY2000 and FY2004; pre-tax income will rise by 9% over the same period.

Rates and Margins

BCA's net interest margin has been buoyed by rising benchmark rates and by the bank's shift of high-cost time deposits into transactions and savings accounts. NIM climbed to 4.94% in 2Q, up 37bp from 1Q and a whopping 68bp higher than in 4Q00.

Margins have been aided by a number of factors, including: 1) rising interest rates, which give BCA the ability to lag deposit rises on the upside; 2) better leverage, as BCA loans up its portfolio and purchases assets from IBRA; 3) improved spread from the foregoing—note that the spread has widened 43bp over the past two quarters; and 4) a more favorable deposit mix, as BCA has generally reduced its reliance on high-cost time deposits.

We forecast that margins will come down as rates return to somewhat more normal conditions and as competition increases, and project that BCA will give up 67bp of margin by YE2002. However, keep in mind that this trend could be mitigated by BCA's shift towards consumer lending, which has higher spreads. Also bear in mind that interest rate drops will produce gains in the fixed-rate portion of BCA's bond portfolio, which we do not include in our projections.

Figure 24: BCA Key Earnings Ratios

	FY1999	FY2000	2Q2001	FY2001E	FY2002E	FY2003E
Net Interest Margin	-6.66%	2.51%	4.94%	4.68%	4.35%	4.13%
ROA	0.79%	1.87%	2.59%	2.50%	2.24%	2.04%
Core ROA	0.79%	1.87%	2.59%	2.50%	2.24%	2.04%
ROE	-5.27%	47.59%	51.83%	42.50%	30.30%	22.34%
Core ROE	-5.27%	47.59%	51.83%	42.50%	30.30%	22.34%
Efficiency	66.83%	49.83%	38.52%	37.08%	38.68%	40.68%
Overhead	1.89%	1.95%	2.51%	2.32%	2.28%	2.32%
NPLs/Loans	23.10%	7.49%	14.47%	13.19%	12.58%	11.97%
NPL Coverage	33.74%	68.38%	69.20%	67.88%	75.26%	81.72%

Source: Company reports; Lehman Brothers estimates

Fee Income

Fees continue to be a strong source of growth for BCA. These fees primarily come from the retail deposit side, rather than from loans or treasury operations. Most fees are charged either on ATM/debit transactions or as account maintenance charges, and are hence relatively stable.

Figure 25: BCA Deposit Account Fees

IDR	Tahapan	Tapres	Current
Opening Deposit	500,000	500,000	500,000
Minimum Balance	10,000	500,000	-
Monthly Fee	2,000	5,000	26,000
Basic ATM Fee			
Issue of Card	10,000	15,000	10,000
Monthly Fee	2,500	-	2,500

Source: BCA

Liability Book

BCA's deposit book expanded by 5% QoQ, in what is largely a seasonal development. Deposits represent 98% of interest-bearing liabilities, broken down into foreign currency and rupiah-denominated demand, savings, and time categories.

Note that BCA is continuing to roll off its IDR time deposits while maintaining overall liquidity—this is contributing mightily as a shift from TDs into Tahapan savings increases the spread by 550bp and also generates fees. BCA is able to price deposits significantly lower than its major competitors, due to the convenience offered to customers by its large branch and ATM networks and its status as the de-facto national payments system. Indeed, Lippo Bank's experience under its more-aggressive pricing policies indicates that BCA has additional room to lower its cost of funds.

Any deterioration in confidence in the government should only strengthen BCA's hand relative to its state bank competitors, as a flight to quality similar to those experienced in 1998 and 1999 will lower comparative funding costs while raising income on floating-rate government bonds.

Asset Quality

Asset quality remains strong. NPLs to assets rose from 1.3% to 1.5% in the period, but management has signaled that this was due primarily to the purchase of a portfolio of restructured loans from IBRA. Even though these loans are performing, BI regulations mean that BCA must collect interest for at least three months before returning them to performing status. We should see these loans come out of NPL before year-end.

Reserve Adequacy

BCA is considerably over-reserved by our strict methodology, with a surplus of IDR513 billion or 87% over and above the required amount. Provisions of IDR291 billion in 1Q and IDR155 billion in 2Q are extremely conservative in our opinion, and we project them to drop off to IDR50 billion in each of the next two quarters.

Figure 26: BCA Reserve Adequacy

IDR, Bil	Gross Amount	Reserve Percentage	Required Reserve
Pass Loans	9,542.7	1%	95.4
Criticized Assets:			
Special Mention	863.6	5%	43.2
Substandard	339.3	20%	67.9
Doubtful	7.8	50%	3.9
Loss	380.6	100%	380.6
ORE	5.5	20%	1.1
Total Required Reserves			592.1
Actual Reserves			1,105.0
Actual/Required			186.6%
Shortfall (Surplus)			(513.0)
Shortfall/Capital			-6.2%

Source: Company reports; Lehman Brothers estimates

Loan Growth

BCA is delivering on its loan growth targets, with total credits rising 19% QoQ and 105% YoY in 2Q01, off an admittedly low base (the loan to deposit ratio is only 12%), even as management frets about poor utilization of approved lines. Growth has been accomplished in part by purchasing loans from IBRA: BCA won the bidding for two pools of loans during FY2000 and both have since been transferred.

The first pool of approximately $50 million in USD-denominated performing loans, which was purchased by the bank in part to further narrow its net open position, was bought at par and yields a floating rate of approximately 10%, well above BCA's USD fixed deposit rate of 5%.

The second pool, comprised of IDR235 billion in rupiah-denominated restructured performing loans, has an average floating coupon of 19%. However, BCA was able to purchase this pool at a discount of 25% to face value, so that its yield is approximately 24%. Both of these asset pools are an improvement over short-term interbank or recap bonds paying 16-17%.

While we are always concerned about Indonesian banks' ability to do due diligence on credit, given the excesses and mis-steps of the past, we do note that BCA's bid of a 25% discount was only marginally higher than the second place bid of a 27% discount, made by Goldman Sachs. Given BCA's superior ability to fund these assets with its abundance of cheap deposits, the convergence of the two bids implies an excellent projected return for BCA.

Branch Network

BCA has no plans to expand its current branch network of 795 branches, and in truth a smaller footprint of around 600 branches is probably more sustainable in the long run.

Management is instead focused on optimizing branch organization and floor planning for better service and higher capacity, with about 165 branches improved so far.

The bank currently plans to close another 40 branches, reflecting the high proportion of transactions that go through automated channels (currently 600 thousand daily ATM transactions versus 1.75 million non-ATM transactions). However, the bank does intend to keep expanding its ATM network, with plans to add 250 machines over the next two years to the existing base of 2,072. BCA will open up this proprietary network to selected small banks (with which it does not directly compete) such as NISP in return for transaction fees.

Acquisitions and Strategy

The bank is not actively searching for major acquisitions at this time, although management seems willing to consider purchasing small merchant banking operations to fill out its loan and bond syndication capacity.

Dividends

The company executed a two-for-one share split as of May 15th in order to increase liquidity, and has also undergone a capital restructuring to eliminate the bank's accumulated deficit. While not changing the overall level of capital, this technical change permits the bank to pay dividends under Indonesian securities regulations; however, any dividend payment has been postponed at IBRA's request pending the strategic stake sale.

We project that BCA will pay dividends of IDR60 in 2001 and IDR101 in FY2002, representing earnings pay outs of 14% and 25%, respectively.

IBRA Share Sale

Throughout 1H01, IBRA was operating under an IMF directive to sell its then-70% stake in BCA, and had been seeking a strategic foreign bank partner to purchase a 20-30% stake prior to a public offering of an additional 10-20% tranche.

After short-listing 16 bidders in May, IBRA disclosed that five qualified bidders were short-listed—they were reported at the time to be Keppel Capital, Newbridge Capital, Fubon Group, and two domestic investors related to PT Bhakti Investama. Clearly, soon-to-be-acquired Keppel was not a serious bidder, nor did the domestic bidders meet IBRA's goal of bringing in a strong foreign partner. Although IBRA did manage to sell the 10% public stake, the strategic tender was eventually cancelled.

Under the new administration, IBRA recently concluded an agreement with the IMF under which it plans to offer 51% of BCA to a strategic partner, a significantly more attractive offer as it comes with management control and the ability to financially consolidate results. Although elements of the Golkar and United Development parties have expressed their opposition to what they believe will be a sale to foreigners, the Megawati administration appears to be strongly in favor of the BCA sale as an easy way of raising cash and appeasing the IMF. Parliament has approved the majority sale, albeit in two tranches.

We suspect that bidders will be able to receive a commitment for a 51% purchase in two steps, with the pricing of the second tranche based on market value at a pre-determined forward date. Most banks with regional ambitions should be potential bidders for BCA, and we would look favorably on such an acquisition from both the perspective of the acquisitor and the remaining minority shareholders in BCA. In any event we believe that BCA will remain publicly listed for the foreseeable future.

Timing is, of course, uncertain— after all, it's still Indonesia.

Valuation

Shares of BCA are currently trading at 0.95x book value and 1.42x adjusted book value. Remember that we deduct all capitalized tax-loss carry forwards (currently IDR1.7 trillion) and real estate revaluation (IDR1.0 trillion) from adjusted book value—which is not to say that these accounts do not have value. On BCA's trailing and projected ROE of 48% and 43%, respectively, this is far too low a valuation in our view, even after assigning a hefty discount for country risk. Also bear in mind that BCA has a reserve surplus of approximately 10% of gross equity.

On an earnings basis, BCA shares trade at 4.3x trailing core EPS and 3.1x FY2001E core EEPS. This will widen slightly to 3.3x for FY2002, but still represents a bargain level.

Figure 27: BCA Summary Sheet

BCA

Share Price:	1,325.00	**Index:**	414.43	**Reuters Code:**	BBCA.JK	
52 Week Price Range:	727.50 - 1500.00	**Current Yield:**	0.0%	**Bloomberg Code:**	BBCA IJ	**Shares Outstanding** (B): 5.89

INCOME STATEMENT	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
(IDR bil) *year ending Dec*					
Interest income	13,933	10,431	12,821	13,379	13,635
Interest expense	18,311	8,299	8,606	9,169	9,334
Net interest income	**-4,379**	**2,132**	**4,214**	**4,210**	**4,301**
Ave. int. earnings assets	*65,760*	*84,765*	*90,040*	*96,493*	*100,065*
NIM (%)	**-6.66%**	**2.51%**	**4.68%**	**4.36%**	**4.30%**
Non-interest income	6,237	1,177	1,425	1,480	1,559
Total operating income	**1,858**	**3,309**	**5,639**	**5,690**	**5,860**
Non-interest expense	1,242	1,649	2,091	2,197	2,317
Pre provision profit	**616**	**1,660**	**3,548**	**3,494**	**3,543**
Loan loss provisions	382	56	547	300	300
Non-operating income	0	0	0	0	0
Pre tax profit	**234**	**1,605**	**3,001**	**3,194**	**3,243**
Tax	-407	-198	479	798	908
Net profit	**641**	**1,802**	**2,522**	**2,395**	**2,335**
Core earnings	**641**	**1,802**	**2,522**	**2,395**	**2,335**

PER SHARE DATA (IDR)	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
EPS	217.90	612.30	428.49	406.92	396.69
DPS	0.00	0.00	60.24	101.73	138.84
Effective payout ratio (%)	*0%*	*0%*	*14%*	*25%*	*35%*
BVPS	1,740.07	2,380.31	1,575.91	1,881.10	2,138.95
ABVPS	823.84	1,749.40	1,141.94	1,535.41	1,851.17

VALUATION	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
Price to book value (x)	NA	0.35	0.84	0.70	0.62
Price to adjusted book value (x)	NA	0.47	1.16	0.86	0.72
Price to earnings (x)	NA	1.35	3.09	3.26	3.34

PROFITABILITY RATIOS	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
(%)					
Net interest margin	-6.66%	2.51%	4.68%	4.36%	4.30%
Yield on interest earning assets	16.60%	12.18%	13.57%	13.58%	13.42%
Cost on interest bearing liabilities	20.37%	9.36%	9.06%	9.32%	9.30%
Net interest spread	-3.77%	2.82%	4.51%	4.26%	4.12%
Non-int. income (% Op income)	335.6%	35.6%	25.3%	26.0%	26.6%
Cost to income	66.8%	49.8%	37.1%	38.6%	39.5%
Overhead ratio	1.89%	1.95%	2.32%	2.28%	2.32%
Cost coverage	149.6%	200.7%	269.7%	259.0%	252.9%
ROA	0.79%	1.87%	2.50%	2.25%	2.15%
ROE	-5.3%	47.6%	42.5%	30.4%	23.4%

OROA ANALYSIS	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
Net interest margin	-6.66%	2.51%	4.68%	4.36%	4.30%
Non-interest inc./gross inc.	335.62%	35.58%	25.26%	26.02%	26.61%
Efficiency ratio	66.83%	49.83%	37.08%	38.61%	39.54%
Provision/assets	0.40%	0.06%	0.52%	0.28%	0.27%
Operating return on assets	**0.54%**	**1.90%**	**3.42%**	**3.34%**	**3.27%**
Equity/assets	5.31%	7.28%	8.78%	10.28%	11.45%
Operating return on equity	**10.19%**	**26.10%**	**38.98%**	**32.52%**	**28.53%**

BALANCE SHEET	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
(IDR bil) *year ending Dec*					
Gross loans	4,101	7,985	12,772	13,825	14,965
Loan loss reserves	*320*	*409*	*1,143*	*1,309*	*1,464*
Net loans	3,781	7,576	11,629	12,516	13,501
Total earning assets	83,915	85,616	94,464	98,523	101,607
Other assets	12,535	10,573	11,157	9,227	8,313
Total Assets	**96,450**	**96,188**	**105,621**	**107,749**	**109,920**
Deposits	86,803	86,869	93,143	96,445	98,388
Customer deposits					
Other deposits					
Other paying liabilities	3,080	1,797	1,863	1,929	1,967
Interest-bearing Liabilities	**91,329**	**89,183**	**96,345**	**96,677**	**97,331**
Gross Equity	**5,121**	**7,005**	**9,276**	**11,072**	**12,590**
Adjusted equity	**2,425**	**5,148**	**6,721**	**9,037**	**10,896**

BALANCE SHEET RATIOS	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
(%)					
Loan-to-deposit	4.7%	9.2%	13.7%	14.3%	15.2%
Equity to assets	5.3%	7.3%	8.8%	10.3%	11.5%
Total loan loss provisions	0.33%	0.43%	1.08%	1.22%	1.33%

ASSET QUALITY	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
Nonperforming assets	948	598	1,684	1,740	1,791
Special mention	460	88	881	877	877
Substandard	93	120	346	353	362
Doubtful	179	298	8	18	29
Loss	167	87	388	383	379
ORE	49	4	6	7	7
NPAs/total loans	23.1%	7.5%	13.2%	12.6%	12.0%
Reserve coverage of NPAs	33.7%	68.4%	67.9%	75.3%	81.7%
Required reserves	340	340	619	631	646
Actual reserves	320	409	1,143	1,309	1,464
Shortfall (surplus)	21	(69)	(524)	(678)	(818)
Actual to required reserves	94%	120%	185%	207%	227%
Shortfall to capital	0%	-1%	-6%	-6%	-6%

GROWTH RATES	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
(%)					
Income statement					
Net interest income	-71.0%	-148.7%	97.7%	-0.1%	2.2%
Non-interest income	-279.2%	-81.1%	21.0%	3.9%	5.3%
Total operating income	NM	78.1%	70.4%	0.9%	3.0%
Non-interest expenses	12.5%	32.8%	26.8%	5.1%	5.5%
Pre-provision earnings	NM	169.3%	113.7%	-1.5%	1.4%
Loan loss provisions	-96.2%	-85.4%	883.8%	-45.2%	0.0%
Core earnings	NM	181.0%	40.0%	-5.0%	-2.5%
Net profit	NM	**181.0%**	**40.0%**	**-5.0%**	**-2.5%**
Balance sheet					
Loan growth	-91.8%	94.7%	60.0%	8.2%	8.2%
Interest earning assets	76.3%	2.0%	10.3%	4.3%	3.1%
Asset growth	44.6%	-0.3%	9.8%	2.0%	2.0%
Deposit growth	50.7%	0.1%	7.2%	3.5%	2.0%
Shareholders funds	NM	36.8%	32.4%	19.4%	13.7%

Source: Company reports; Lehman Brothers estimates.

LIPPO BANK

RIADY FOR ACTION

Rating:	**2-Buy**
Ticker:	LPBN.JK
Share Price:	IDR 40
Market Cap:	IDR 1.6 Tril

	Net Profit (IDR B)	EPS (IDR)	Change (%)	P/E (x)	P/BV (x)	DPS (IDR)	Yield (%)
1999A	-1,640	-41.88	-98%	NA	NA	0.00	NA
2000A	246	6.29	-115%	8.7	0.9	0.00	0.0%
2001E	235	6.00	-5%	6.7	0.6	0.00	0.0%
2002E	252	6.45	7%	6.2	0.5	0.00	0.0%
2003E	211	5.39	-16%	7.4	0.5	0.81	2.0%

Shares Outstanding: 39.6 billion — Fiscal Year End: Dec

Lippo is a medium-sized but dynamic player with a strong brand name, well-positioned branch network and retail customer base, and experienced foreign management support. With much of Indonesia's banking sector tied up in the form of monolithic state banks (BNI, Mandiri, BRI) or troubled banks still under IBRA conservatorship (Bank Bali, Niaga), Lippo has had a relatively free hand to compete in and take a greater share of the consumer and SME markets. It has not wasted any time in doing so.

Customer Base

Lippo, although small compared to the pre-crisis state banks and BCA, has an enviable franchise base among both consumers and corporate borrowers. Like most other private conglomerate banks, Lippo Bank formerly had an extensive lending relationship with its group affiliates, such as Lippo Land. However, the bulk of these loans were repaid as a condition of the approval of the bank's recapitalization plan by the government.

Lippo has attracted new retail accounts by a combination of savvy marketing and comparatively nimble execution. Bank President-Director Ian Clyne reports that the bank's customer base has increased from 2 million when ING began management support in 1999 to 3.1 million currently, and is continuing to increase at approximately 80 thousand per month.

Consumer lending, given Lippo's brand image, customer base, and excellent marketing ability, is a natural goal, and the bank has been working to broaden its product line with innovative structures. Mortgages, still a fairly new product for Indonesian banks, offer tiered interest rates based on loan-to-value, exactly the type of explicit credit-risk pricing that Asia has been conspicuously lacking. Additionally, Lippo is willing to extend residential mortgages of up to 20 years, a longer term than any other bank now offers.

Credit and Debit Cards

Lippo was marginally active in credit cards prior to the crisis, although it wound up with Rp24 billion in write-offs as a result. The bank is now placing new emphasis on this area, having hired away Citibank's Indonesian card manager to lead the initiative.

In the interim, the real action is in debit cards, where Lippo has scaled up to over 1.5 million Visa debit cards through the Electron program. The attraction of this product from a customer's point ofview is that the Electron card is signature-based rather than PIN-based, and so it is easier for merchants to implement acceptance and more comfortable for consumers to carry and use. As approximately half of debit card accounts represent new customers, it is evident that Lippo's product differentiation in this area is paying dividends.

While we continue to prefer BCA as our top pick, any broad recovery in the Indonesian political and macroeconomic environment will affect Lippo's earnings more, due to its greater leverage. Naturally, the risk is symmetric on the downside—one reason to prefer BCA in these parlous times.

2Q01 Earnings and Financial Analysis

Lippo Bank's 2Q01 earnings showed a net profit of Rp57.2 million, or Rp1.46 per share, an increase of 76% over the prior year. Income for the half was Rp89.8 million, or Rp2.29 per share, 27% more than earnings of Rp70.5 million in the comparable period of 2000.

Lippo posted an ROE of 20% in Q2, up from 12% in the first quarter but down from the 29% posted for FY2000. In part this is due to seasonality; however, it is also a result of lower leverage, as evidenced by the ROA of only 0.97%. We expect Lippo to achieve better than a 20% return on capital for the year, but the bank will have to decide in 2002 how to keep its leverage high in order to avoid dilution.

We believe that this could happen, either through the resumption of dividend payments or through an acquisition. President-Director Ian Clyne highlighted to us during the 2001 Asian Bank Tour that Lippo was actively seeking acquisitions in the Rp8–10 trillion asset size range. This range would include such institutions as Bank Bali, Bank Universal, Bank NISP, and Bank Buana.

Rates & Margins

Lippo has continued to widen its margins, with NIM increasing by 22bp QoQ and 205bp YoY. Margins, at 5.75%, are now approximately 80bp higher than those of BCA, on a spread advantage of 196bp. Margin expansion is taking place on the liability side of the balance sheet, giving the bank a marked funding cost advantage.

Deposit Structure

We have discussed Lippo's deposit management strategy before (see our notes of April 26, 2001, and November 17, 2000); in summary, the bank is working to lower its cost of funds by reducing time deposits, aggressively targeting transaction and savings deposits, and attracting customers with fee-free accounts and low minimum balance requirements. This strategy appears to be working: deposits are increasing at approximately 12% per year, and funding costs are declining even as benchmark rates have risen.

Interestingly, Lippo has taken a very different tack from BCA on the deposit marketing side, despite a similar goal of rolling-off high-cost term funding into more profitable savings and checking accounts. While BCA has successfully raised its fees and hiked minimum balances to as much as Rp500 thousand, Lippo has elected to actually cut balance requirements to zero on savings accounts, and to waive ATM fees.

Figure 28: BCA and Lippo Account Fees

IDR	Tahapan Savings		Current	
	BCA	Lippo	BCA	Lippo
Opening Deposit	500,000	-	500,000	500,000
Minimum Balance	10,000	-	-	500,000
Monthly Fee	2,000	-	26,000	20,000
Basic ATM Fee				
Issue of Card	10,000	-	10,000	-
Monthly Fee	2,500	-	2,500	-

Source: Company reports; Lehman Brothers estimates

Note that the lack of fees has allowed Lippo to undercut BCA by as much as 400bp on Tahapan and savings products. Although Lippo's tiered interest rates mean that depositors are frequently paid very low rates, customers are so fed up with spiraling bank charges that Lippo picked up 200 thousand accounts in the first month of this new policy, while maintaining a spread averaging 4%. Management believes that savings deposits can be sustainably grown at 4–7% per year over the next few years.

Figure 29: BCA and Lippo Account Rates

Account Balance	Tahapan Lippo	Tahapan BCA	Super Savings Lippo	Tapres BCA	Demand Lippo	Demand BCA
0-249,999	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
250,000-499,999	2.0%	0.0%	0.0%	0.0%	0.0%	0.0%
500,000-999,999	4.0%	8.0%	0.0%	9.0%	0.0%	0.0%
1,000,000-1,499,999	4.0%	8.0%	5.0%	9.0%	0.0%	0.0%
1,500,000 - 5,000,000	7.5%	8.0%	5.0%	9.0%	0.0%	0.0%
5,000,000 - 24,999,999	7.5%	8.0%	8.0%	9.0%	0.5%	0.0%
24,999,999 - 99,000,000	7.5%	8.0%	8.0%	9.0%	2.0%	0.0%
100,000,000 - 499,999,999	7.5%	8.0%	10.0%	10.0%	2.0%	0.0%
500,000,000 +	7.5%	8.0%	10.0%	10.0%	3.0%	0.0%

Source: Company reports; Lehman Brothers estimates

Reported figures show that the rate differential has not kept Lippo from posting better growth in rupiah savings and demand deposit accounts so far this year, confirming that customers feel Lippo has a convenient network and are willing to switch from BCA and other banks to avoid fees. It also implies that BCA has not been as aggressive as it could be in cutting rates.

Provisions

Provisions have totaled only Rp13.5 billion in the first half, down from Rp38.7 billion in 1H00. We believe that this is low, particularly after what we consider an unwarranted write-back of Rp247 billion from reserves in 4Q00. Going forward, we believe that Lippo will have to increase its provisioning level, and we are estimating provisions of Rp25 billion in 2H01, Rp50 billion in FY2002, and Rp33 billion in FY2003.

Figure 30: Lippo Bank Provisions and Reserves

IDR Bil.	1997	1998	1999	2000	2001	2002	2003	2004
Provisions	134.1	6,800.8	114.3	(181.9)	38.5	50.0	33.0	26.0
% of Assets	1.03%	45.10%	0.48%	-0.80%	0.15%	0.18%	0.11%	0.08%
% of Loans	1.29%	71.99%	2.80%	-4.59%	0.96%	1.18%	0.71%	0.50%
% of Rev	18.46%	-1009.70%	-12.52%	-22.70%	3.06%	3.86%	2.50%	1.91%
Reserves	249.1	4,930.2	1,068.2	706.9	802.4	831.6	842.2	843.4
% of Assets	1.92%	32.69%	4.49%	3.12%	3.18%	3.06%	2.82%	2.57%
% of Loans	2.39%	52.19%	26.14%	17.84%	19.99%	19.67%	18.13%	16.37%
NPL Coverage	NA	NA	19.59%	26.52%	19.70%	21.13%	25.24%	31.37%

Source: Company reports; Lehman Brothers estimates

Asset Quality and Reserves

Asset quality remains poor by any standard, in particular owing to the loan book. Criticized assets amount to some 96% of gross loans—but note that this figure is misleading due to the low level of loan assets. The loan to deposit ratio stands at only 20%.

After the write-back of reserves in 4Q00, we now once again consider Lippo under-reserved, with a required loss allowance of Rp1,049 billion under our methodology only 75% met. The shortfall amounts to some 10% of total equity, not an egregious figure but one that bears watching—hence our expectation of higher provisions to come.

Figure 31: Lippo Bank Reserve Adequacy

IDR, Bil	Gross Amount	Reserve Percentage	Required Reserve
Pass Loans	1,840.4	1%	18.4
Criticized Assets:			
Special Mention	1,032.9	5%	51.6
Substandard	663.8	20%	132.8
Doubtful	107.7	50%	53.8
Loss	489.6	100%	489.6
ORE	1,513.4	20%	302.7
Total Required Reserves			1,048.9
Actual Reserves			787.4
Actual/Required			75.1%
Shortfall (Surplus)			261.5
Shortfall/Capital			9.9%

Source: Company reports; Lehman Brothers estimates

Lending

Loan growth has weakened in the first half, with 2Q01 showing a 7% drop in gross loans. However, some of this is due to write-offs of NPLs, with Pass loans actually rising year on year. Lippo is looking mainly to SMEs in the retail, tobacco, and pharmaceuticals industries for future growth.

Capital

Lippo has a very high CAR of 22.67%, primarily due to the large amount (Rp5.8 trillion, or 24% of assets) of zero-weighted government bonds on the books. We estimate that the bank could add an additional Rp10 trillion in fully weighted loans while maintaining a CAR of over 12%, well within the realm of safety. For this reason, we do not believe that Lippo will have to come to market for equity in the next 12 months, although an abundance of caution or an acquisition opportunity could bring an offering if the market is favorable.

Ownership

Lippo's major shareholders include IBRA, which owns 59% of the company, and Lippo E-Net (the former Lippo Life Insurance), which remains controlled by the Riady family and owns 7.2% of the bank. The public float is approximately 33%.

Valuation

Lippo currently trades at 0.60x stated book value and 1.32x adjusted book value, based on 2Q01 results. Our book value adjustments include subtracting real estate revaluation of Rp633 billion and capitalized tax loss carry-forwards of Rp815 billion (both figures estimated).

On an earnings basis, Lippo trades at 6.4x trailing EPS, and at 6.7x our FY2001 estimates. While this is a fairly low level for the region as a whole, BCA, with a clean boo,k and considerably higher safety margin is still less expensive.

Figure 32: Lippo Bank Summary Sheet

Lippo Bank

Share Price:	40.00	**Index:**	414.43	**Reuters Code:**	LPBN.JK		
52 Week Price Range:	30.00 - 80.00	**Current Yield:**	0.0%	**Bloomberg Code:**	LPBN IJ	**Shares Outstanding** (B):	39.16

INCOME STATEMENT	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
(IDR bil) *year ending Dec*					
Interest income	2,481	2,022	2,393	2,597	2,790
Interest expense	3,589	1,392	1,460	1,631	1,809
Net interest income	**-1,108**	**630**	**933**	**966**	**981**
Ave. int. earnings assets	*12,828*	*15,877*	*16,380*	*18,570*	*20,243*
NIM (%)	**-8.64%**	**3.97%**	**5.69%**	**5.20%**	**4.84%**
Non-interest income	196	171	326	330	338
Total operating income	**-913**	**802**	**1,258**	**1,295**	**1,319**
Non-interest expense	801	771	909	948	992
Pre provision profit	**-1,713**	**31**	**350**	**347**	**326**
Loan loss provisions	114	-182	38	50	33
Non-operating income	0	0	0	0	0
Pre tax profit	**-1,827**	**212**	**311**	**297**	**293**
Tax	-187	-34	76	45	82
Net profit	**-1,640**	**246**	**235**	**252**	**211**
Core earnings	**-1,640**	**246**	**235**	**252**	**211**

PER SHARE DATA (IDR)	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
EPS	(41.88)	6.29	6.00	6.45	5.39
DPS	0.00	0.00	0.00	0.00	0.81
Effective payout ratio (%)	*0%*	*0%*	*0%*	*0%*	*15%*
BVPS	59.08	64.69	70.90	77.35	82.74
ABVPS	13.19	29.63	34.72	42.69	49.49

VALUATION	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
Price to book value (x)	4.2	0.85	0.56	0.52	0.48
Price to adjusted book value (x)	19.0	1.86	1.15	0.94	0.81
Price to earnings (x)	NM	8.74	6.67	6.21	7.42

PROFITABILITY RATIOS	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
(%)					
Net interest margin	-8.64%	3.97%	5.69%	5.20%	4.84%
Yield on interest earning assets	14.72%	13.56%	13.40%	13.47%	13.16%
Cost on interest bearing liabilities	19.25%	7.33%	6.88%	7.21%	7.35%
Net interest spread	-4.52%	6.23%	6.52%	6.26%	5.81%
Non-int. income (% Op income)	-21.5%	21.4%	25.9%	25.4%	25.6%
Cost to income	-87.7%	96.2%	72.2%	73.2%	75.3%
Overhead ratio	6.24%	4.86%	5.55%	5.11%	4.90%
Cost coverage	-114.0%	104.0%	138.5%	136.6%	132.9%
ROA	-8.44%	1.06%	0.98%	0.96%	0.74%
ROE	56.5%	29.4%	18.6%	16.7%	11.7%

OROA ANALYSIS	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
Net interest margin	-8.64%	3.97%	5.69%	5.20%	4.84%
Non-interest inc./gross inc.	-21.47%	21.37%	25.88%	25.44%	25.64%
Efficiency ratio	-87.74%	96.19%	72.21%	73.21%	75.26%
Provision/assets	0.48%	-0.80%	0.15%	0.18%	0.11%
Operating return on assets	**-13.84%**	**1.00%**	**1.98%**	**1.68%**	**1.50%**
Equity/assets	9.73%	11.19%	11.02%	11.13%	10.83%
Operating return on equity	**-142.2%**	**8.90%**	**17.98%**	**15.14%**	**13.86%**

BALANCE SHEET	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
(IDR bil) *year ending Dec*					
Gross loans	4,086	3,963	4,013	4,228	4,644
Loan loss reserves	*1,068*	*707*	*802*	*832*	*842*
Net loans	3,018	3,256	3,211	3,397	3,802
Total earning assets	16,847	14,907	17,854	19,286	21,199
Other assets	6,932	7,720	7,341	7,931	8,717
Total Assets	**23,779**	**22,627**	**25,195**	**27,217**	**29,916**
Deposits	18,066	18,692	21,067	22,470	24,442
Customer deposits					
Other deposits					
Other paying liabilities	(18,066)	(18,692)	(21,067)	(22,470)	(24,442)
Interest-bearing Liabilities	**21,466**	**20,094**	**22,419**	**24,188**	**26,676**
Gross Equity	**2,313**	**2,533**	**2,776**	**3,029**	**3,240**
Adjusted equity	**517**	**1,160**	**1,360**	**1,672**	**1,938**

BALANCE SHEET RATIOS	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
(%)					
Loan-to-deposit	22.6%	21.2%	19.1%	18.8%	19.0%
Equity to assets	9.7%	11.2%	11.0%	11.1%	10.8%
Total loan loss provisions	4.49%	3.12%	3.18%	3.06%	2.82%

ASSET QUALITY	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
Nonperforming assets	5,453	2,665	4,073	3,935	3,337
Special mention	856	1,385	1,139	1,093	988
Substandard	647	644	651	600	489
Doubtful	1,147	229	106	97	79
Loss	99	407	509	484	429
ORE	2,704	1,552	1,669	1,660	1,352
NPAs/total loans	133.5%	67.3%	101.5%	93.1%	71.9%
Reserve coverage of NPAs	19.6%	26.5%	19.7%	21.1%	25.2%
Required reserves	1,400	1,044	1,101	1,061	914
Actual reserves	1,068	707	802	832	842
Shortfall (surplus)	332	338	298	229	72
Actual to required reserves	76%	68%	73%	78%	92%
Shortfall to capital	14%	13%	11%	8%	2%

GROWTH RATES	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
(%)					
Income statement					
Net interest income	-12.6%	-156.9%	48.0%	3.6%	1.5%
Non-interest income	-67.1%	-12.6%	90.1%	1.2%	2.6%
Total operating income	NM	-187.8%	57.0%	2.9%	1.8%
Non-interest expenses	-9.0%	-3.7%	17.8%	4.4%	4.7%
Pre-provision earnings	NM	-101.8%	1043.7%	-0.8%	-6.0%
Loan loss provisions	-98.3%	-259.2%	-121.2%	29.9%	-34.0%
Core earnings	NM	-115.0%	-4.7%	7.5%	-16.3%
Net profit	NM	**-115.0%**	**-4.7%**	**7.5%**	**-16.3%**
Balance sheet					
Loan growth	-56.7%	-3.0%	1.3%	5.4%	9.8%
Interest earning assets	91.2%	-11.5%	19.8%	8.0%	9.9%
Asset growth	57.7%	-4.8%	11.3%	8.0%	9.9%
Deposit growth	-2.6%	3.5%	12.7%	6.7%	8.8%
Shareholders funds	NM	9.5%	9.6%	9.1%	7.0%

Source: Company reports; Lehman Brothers estimates.

PANIN BANK

SELF-RELIANCE AND SELECTIVITY

PANIN BANK	
Rating:	**4-Market Underperform**
Ticker:	PNBN.JK
Share Price:	IDR 240
Market Cap:	IDR 1.4 Tril

	Net Profit (IDR B)	EPS (IDR)	Change (%)	P/E (x)	P/BV (x)	DPS (IDR)	Yield (%)
1999A	35	5.93	132%	113.8	1.4	0.00	0.0%
2000A	29	4.85	-18%	35.1	0.4	0.00	0.0%
2001E	130	21.85	351%	11.0	0.5	0.00	0.0%
2002E	395	66.33	204%	3.6	0.5	0.00	0.0%
2003E	382	64.13	-3%	3.7	0.4	0.00	0.0%

Shares Outstanding: 5.96 billion — Fiscal Year End: Dec

Panin was the only significant bank in Indonesia to be rated a Category A bank under the bank recapitalization program implemented by IBRA, and as such received no government funds. Ironically, while Panin's less-prudent competitors, such as BCA and Lippo, are now relatively healthy due to infusions of recap bonds and the removal of their category 5 (Loss) loans, Panin remains beset by asset quality difficulties.

In addition, we have doubts about the bank's strategic plan, which calls for turning what was a small corporate lender into one of the top five or six retail banks. Although we agree that the consumer lending space is an attractive one, we note that Panin has little experience in the sector, which is becoming more competitive by the day. On the positive side, Panin does have a strong foreign partner and beefy capital base, and trades at a fairly cheap valuation.

We continue to believe that Panin will be a prominent survivor (and perhaps consolidator), but feel that better investment options in the sector exist at this time, with our top pick remaining BCA.

Asset Quality Still Lags

Panin is executing well in certain areas of its recovery plan, but remains behind its government-assisted competitors as it did not receive any bail-out funds and was not able to transfer NPLs to the government. This has led to a balance sheet which is significantly more stressed than that of its competitors.

The bank is still in restructuring mode, with the primary method for cleaning up the balance sheet (39% NPLs/loans) being write-offs. Most of Panin's NPLs are syndicated loans, so that IBRA and the lead banks are driving the workout process.

Figure 33: Asset Quality Comparison: BCA, Lippo, and Panin

	BCA	Lippo	Panin
NPLs/Assets	1.5%	15.8%	13.8%
NPLs/Loans	14.5%	96.3%	39.1%
NPL Coverage	69.2%	20.7%	41.8%
Reserve Shortfall	(830.4)	261.5	413.5
% of Capital	-10.1%	9.9%	15.6%

Source: Company reports; Lehman Brothers estimates

As you can see from the table, above, Panin has significantly worse asset quality than does BCA, and is similar to Lippo in terms of NPLs/Assets, although its reserve coverage is considerably better. What this masks is that the severity of Lippo's NPLs is not as great, so that it is able to come closer to our required reserve calculation. We estimate that Panin is under-reserved by 16% of capital, versus 10% for Lippo.

Panin's NPLs are more severe than those of the other extant Indonesian banks as its Category 5 (Loss) loans have not been removed by IBRA. Given that the oversight and due diligence on the portfolio has been at a lower level, and that the bank has had no incentive to disclose NPLs (whereas Category B and C banks had incentive to show as many NPLs as possible in order to have them removed and increase their recapitalization funds), we believe that there may still be a wide margin for error in the reported numbers.

Figure 34: Panin Reserve Adequacy

IDR, Bil	Gross Amount	Reserve Percentage	Required Reserve
Pass Loans	3,886.2	1%	38.9
Criticized Assets:			
Special Mention	238.0	5%	11.9
Substandard	480.9	20%	96.2
Doubtful	199.5	50%	99.8
Loss	1,036.3	100%	1,036.3
ORE	242.3	20%	48.5
Total Required Reserves			1,331.5
Actual Reserves			918.0
Actual/Required			68.9%
Shortfall (Surplus)			413.5
Shortfall/Capital			15.6%

Source: Company reports; Lehman Brothers estimates

In addition, we are extremely concerned by the excessive amount of accrued interest receivable on Panin's balance sheet, although the level has come down markedly over the past quarter. AIR of 3.97% of total loans has been as high as 9.76% in 1Q01, a potential sign that the bank is booking income which has not been received and a harbinger of asset quality problems in the future. We believe that a more appropriate level would be well below 2%, even making allowances for the high interest rate level in Indonesia.

Rates and Margins

Panin Bank did extremely well with margins in the second quarter, expanding NIM by 82bp in a relatively even split between the funding and asset sides. The bank has done some very shrewd work here, including using its recap bonds (purchased in the market at a discount) to create an off-balance-sheet money market product for customers thus removing excess deposits from its balance sheet while preserving a 3-4% spread.

We project that spreads will come down, however, as stable or falling interest rates make it more difficult for Panin to maintain margins against a loan and securities book which will adjust downward quickly. Potential reversals of AIR through the net interest income line may also have a distorting effect on reported margins.

Loan Growth

Loan growth has been uneven, with growth in performing assets coming down rapidly over the past four quarters. Although the environment is becoming more conducive to lending—with rates falling and economic activity surprisingly strong—we expect Panin to have difficulty continuing to outpace its competition.

Distribution Network

Panin management is concentrating on the bank's distribution channels, which they see as the bank's weakness. According to their market survey data, 68% of Indonesian retail customers choose a bank because of the convenience of distribution channels (branches).

Panin's branch network is currently small at 113, and still primarily oriented towards larger business customers on the asset side. Hence, Panin's strategy is to extend organically from its 113 branch network, at the rate of approximately 10 or 15 branches per year. In addition, management is repositioning the branches to move into areas around the Stock Exchange, the new business districts, and high-net-worth areas—all new to Panin.

The bank has been steadily adding ATMs as well, going from 62 pre-crisis to 140 currently. In addition, management has focused on improving its operations with the launch of new phone banking services and a call center.

Products

Panin is aiming at the mid-to-upper net worth consumer with both deposit-like and loan products. Panin's customer demographics are skewed toward older people, which benefits the bank as these customers are more loyal and tend to keep higher balances. But it still lags on the measure of customers per branch.

One successful product has been a recently introduced investment fund which effectively securitizes recap bonds. Panin is able to take a spread of 3-4%, pay no deposit insurance, and avoid taxes on interest, while minimizing risk-weighted assets. The bank took in Rp2 trillion in funds over the first 30 days it was offering this fund—with 50% of customers signing up new to the bank. Note that Panin was able to do this at an attractive rate because it purchased the recap bonds in the market at a discount (market rates are around 88-91% of face); other banks which were given recap bonds by the government and are holding them at par would have a difficult time offering this type of product without first recognizing a capital loss.

Management is focused on expanding the retail and services portion of the loan portfolio, and expects to double the percentage of these loans to 40% within three years. However, the bank is still limiting its consumer loans to secured products (i.e. mortgages and auto finance, which carry collateral), in order to limit the credit downside.

ANZ Partnership

Panin has a fairly deep relationship with Australia's ANZ Bank, which encompasses an equity stake, joint venture, and management support. ANZ now owns approximately 10% of Panin, with options to purchase 18% more from the controlling family interests.

In addition, Panin and ANZ are partners in an Indonesian joint venture bank, PT ANZ Panin Bank, of which ANZ owns 85%. ANZ Panin has a deposit taking and lending operation, and also purchased the credit card operations of the former Bank Papan Sejahtera from IBRA in mid-1998. From a base of 47 thousand cards, this operation has now grown to 70 thousand.

Capital

Panin has a high CAR of 40% due to its relatively unlevered balance sheet and high book equity of 17% of assets. We note that book value no longer includes any material asset revaluation; the revaluation on computer equipment which was taken in 1999 has been reversed, and there are no capitalized tax loss carry-forwards on the balance sheet either. Therefore, our major adjustment to book value is for reserve underfunding.

Foreign Borrowings

Panin still has offshore (dollar) borrowings, as it was not recapitalized through a government program which would have removed them. Management reports that this does not represent an unhedged exposure, as they have purchased exchange bonds which mature at the same time as their liabilities, and are fully prepared to repay borrowings.

Valuation

Panin is relatively cheap on a price-to-book basis, trading at only 0.54x 2Q01 BV. The adjusted book multiple is almost the same, although including reserve underfunding would raise the P/ABV to 0.64x. However, Panin has a fairly low ROE (projected to peak in 2003 at 13.3%), and trades at 28.5x FY2000 core EPS (49.5x actual EPS). On a forward basis, the bank trades at 11.0x core FY2001 EEPS and 3.6x core FY2002E EPS, somewhat expensive compared with its peers.

Figure 35: Panin Bank Summary Sheet

Panin Bank

Share Price:	240.00	**Index:**	414.43
52 Week Price Range:	90.00 - 275.00	**Current Yield:**	0.0%

Reuters Code:	PNBN.JK		
Bloomberg Code:	PNBNIJ	**Shares Outstanding (B):**	5.96

INCOME STATEMENT	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
(IDR bil) *year ending Dec*					
Interest income	1,652	1,450	2,157	2,265	2,386
Interest expense	1,130	969	1,458	1,568	1,697
Net interest income	**522**	**481**	**698**	**697**	**690**
Ave. int. earnings assets	*9,755*	*12,720*	*15,209*	*15,801*	*17,101*
NIM (%)	**5.35%**	**3.78%**	**4.59%**	**4.41%**	**4.03%**
Non-interest income	154	95	339	327	331
Total operating income	**676**	**576**	**1,037**	**1,024**	**1,020**
Non-interest expense	188	215	284	297	311
Pre provision profit	**488**	**361**	**753**	**727**	**709**
Loan loss provisions	451	341	600	200	200
Non-operating income	1	0	0	0	0
Pre tax profit	**38**	**20**	**153**	**527**	**509**
Tax	2	-9	23	132	127
Net profit	**35**	**29**	**130**	**395**	**382**
Core earnings	**-43**	**50**	**130**	**395**	**382**

PER SHARE DATA (IDR)	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
EPS	5.93	4.85	21.85	66.33	64.13
DPS	0.00	0.00	0.00	0.00	0.00
Effective payout ratio (%)	*0%*	*0%*	*0%*	*0%*	*0%*
BVPS	482.45	447.79	466.35	532.68	596.80
ABVPS	325.44	444.83	463.82	530.32	594.61

VALUATION	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
Price to book value (x)	1.3991124	0.38	0.51	0.45	0.40
Price to adjusted book value (x)	2.0741147	0.38	0.52	0.45	0.40
Price to earnings (x)	113.75187	35.08	10.98	3.62	3.74

PROFITABILITY RATIOS	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
(%)					
Net interest margin	5.35%	3.78%	4.59%	4.41%	4.03%
Yield on interest earning assets	16.23%	9.50%	14.23%	13.77%	13.44%
Cost on interest bearing liabilities	13.61%	7.33%	10.92%	11.00%	11.22%
Net interest spread	2.62%	2.18%	3.32%	2.77%	2.22%
Non-int. income (% Op income)	22.8%	16.5%	32.7%	31.9%	32.4%
Cost to income	27.8%	37.3%	27.4%	29.0%	30.5%
Overhead ratio	1.93%	1.69%	1.87%	1.88%	1.82%
Cost coverage	359.3%	267.8%	364.7%	344.6%	328.0%
ROA	0.33%	0.21%	0.79%	2.29%	2.05%
ROE	2.1%	1.3%	4.8%	13.3%	11.4%

OROA ANALYSIS	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
Net interest margin	5.35%	3.78%	4.59%	4.41%	4.03%
Non-interest inc./gross inc.	22.75%	16.51%	32.67%	31.89%	32.40%
Efficiency ratio	27.84%	37.34%	27.42%	29.02%	30.49%
Provision/assets	3.98%	2.06%	3.63%	1.11%	1.03%
Operating return on assets	**1.02%**	**0.78%**	**1.32%**	**3.48%**	**3.11%**
Equity/assets	25.35%	16.08%	16.81%	17.68%	18.36%
Operating return on equity	**4.0%**	**4.88%**	**7.87%**	**19.70%**	**16.96%**

BALANCE SHEET	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
(IDR bil) *year ending Dec*					
Gross loans	4,278	4,912	5,702	5,993	6,455
Loan loss reserves	*848*	*620*	*1,084*	*1,213*	*1,338*
Net loans	3,430	4,292	4,619	4,780	5,117
Total earning assets	10,175	15,264	15,153	16,449	17,753
Other assets	1,160	1,324	1,372	1,490	1,608
Total Assets	**11,335**	**16,588**	**16,525**	**17,939**	**19,360**
Deposits	6,578	10,894	11,065	11,802	12,526
Customer deposits					
Other deposits					
Other paying liabilities	1,722	2,333	2,294	2,447	2,597
Interest-bearing Liabilities	**8,461**	**13,921**	**13,748**	**14,766**	**15,806**
Gross Equity	**2,873**	**2,667**	**2,777**	**3,172**	**3,554**
Adjusted equity	**1,938**	**2,649**	**2,762**	**3,158**	**3,541**

BALANCE SHEET RATIOS	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
(%)					
Loan-to-deposit	65.0%	45.1%	51.5%	50.8%	51.5%
Equity to assets	25.3%	16.1%	16.8%	17.7%	18.4%
Total loan loss provisions	7.48%	3.74%	6.56%	6.76%	6.91%

ASSET QUALITY	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
Nonperforming assets	3,329	2,304	2,144	1,957	1,645
Special mention	814	304	229	202	165
Substandard	487	677	462	409	333
Doubtful	515	180	192	170	138
Loss	1,338	916	995	899	764
ORE	175	227	267	277	245
NPAs/total loans	77.8%	46.9%	37.6%	32.7%	25.5%
Reserve coverage of NPAs	25.5%	26.9%	50.5%	62.0%	81.3%
Required reserves	1,782	1,234	1,289	1,177	1,009
Actual reserves	848	620	1,084	1,213	1,338
Shortfall (surplus)	933	614	205	(37)	(329)
Actual to required reserves	48%	50%	84%	103%	133%
Shortfall to capital	32%	23%	7%	-1%	-9%

GROWTH RATES	**1999A**	**2000A**	**2001E**	**2002E**	**2003E**
(%)					
Income statement					
Net interest income	13.7%	-7.8%	45.1%	-0.2%	-1.1%
Non-interest income	-12.4%	-38.1%	256.1%	-3.7%	1.2%
Total operating income	NM	-14.7%	80.0%	-1.3%	-0.3%
Non-interest expenses	4.5%	14.5%	32.1%	4.5%	4.7%
Pre-provision earnings	NM	-25.9%	108.5%	-3.5%	-2.4%
Loan loss provisions	1.1%	-24.4%	75.9%	-66.6%	0.0%
Core earnings	NM	-217.6%	159.8%	203.6%	-3.3%
Net profit	NM	**-18.3%**	**350.9%**	**203.6%**	**-3.3%**
Balance sheet					
Loan growth	-15.5%	14.8%	16.1%	5.1%	7.7%
Interest earning assets	9.0%	50.0%	-0.7%	8.6%	7.9%
Asset growth	8.9%	46.4%	-0.4%	8.6%	7.9%
Deposit growth	3.6%	65.6%	1.6%	6.7%	6.1%
Shareholders funds	NM	-7.2%	4.1%	14.2%	12.0%

Source: Company reports; Lehman Brothers estimates.

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Key to Investment Rankings: This is a guide to expected total return (price performance plus dividend) relative to the total return of the stock's local market over the next 12 months. 1 = **Strong Buy** (expected to outperform the market by 15 or more percentage points); 2 = **Buy** (expected to outperform the market by 5-15 percentage points); 3 = **Market Perform** (expected to perform in line with the market); 4 = **Market Underperform** (expected to underperform the market by 5-15 percentage points); 5 = **Sell** (expected to underperform the market by 15 or more percentage points); V = **Venture** (return over multiyear time frame consistent with venture capital; should only be held in a well-diversified portfolio).