

February 28, 2002

KorAm Bank (W 12,900) 3 - Market Perform

SOUTH KOREA
Banks

Asia Banks

Operating Results
Running to catch-up

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Investment conclusion

- A solid set of results marking a return to profitability, but the post Christmas run-up in price on merger speculation means that the stock is fully priced. Reduce rating to 3-Market Perform.

Summary

- KorAm announced FY2001 results of KRW195 billion representing a 21% ROE. Results were driven by sharply lower provisions and wider margins.
- The bank has restructured its balance sheet; growing credit cards 125% and consumer loans 51% overall. The loan book is now a 56:44 split between corporate and consumer. Loan growth was unexciting overall at 4%.
- Margins were 2.65%, up 86 basis points from FY2000 levels. NPLs fell to 8% of total lending on sales of non-performing loans and write-downs.
- On forward ROE of 24%, we are updating our price target to KRW12,000. Reduce to 3-Market Perform.

Rating

 New: 3 - Market Perform
 Old: 2 - Buy

Target

 New: 12,000
 Old: 7,800

Downside to Target %
-7

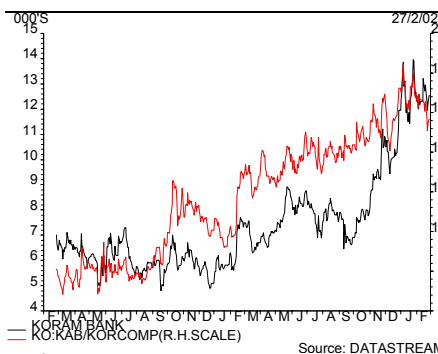
FY Dec Currency W	2000A Actual	2001E		2002E		2003E	
		Old	New	Old	New	Old	New
1Q EPS	502.78	-	275.87	-	570.39	-	616.24
2Q EPS	-298.05	-	590.06	-	502.06	-	521.41
3Q EPS	542.72	-	267.22	-	639.65	-	550.46
4Q EPS	-2,792.74	-	62.80	-	104.08	-	124.89
Full Year	-2,428.8	1,095.6	1,196.0	1,929.3	1,816.2	2,650.7	1,980.0
I/B/E/S	-	-	1,138.00	-	1,661.00	-	2,030.61
Net Profit (m)	-396,048	178,653	195,020	314,607	296,160	432,246	322,871
BVPS	4,898.44	5,794.78	6,076.92	7,148.49	8,554.42	9,243.43	11,203.3

Valuation

P/E (01;02)	10.5 : 6.9
P/BV (00;01)	2.6 : 2.1
ROE (00;01)	-52.5 : 20.9
ROA (00;01)	-1.5 : 0.7
Est. Dividend	35.9
Dividend Yield	0.30%

Financial Summary

Total Assets (WM)	29,178.1
Total Loans (WM)	18,208.7
Total Equity (WM)	990.9
NPL Ratio	8.0%
Total CAR	11.2%
Shares Outstanding (m)	163.1

Stock Overview

 Reuters 16830.KS
 Bloomberg 1683 KS
 ADR -

Performance	1M	3M	12M
Absolute %	-7.5	15.2	76.5
Rel. Market %	-12.9	-6.1	24.0

52 Week Range 13,950-6,300

Summary and Ratings Action:

KorAm Bank released FY2001 consolidated results after close on Friday of KRW195 billion (EPS KRW1,196, ROE 21%), beating estimates and marking a return to profitability. The stock has run-up in the past few months on merger expectations and is currently fully priced at 2.1x trailing book on forward ROE of 24%. We are updating our 12-month forward price target to W12,000 which represents 1.4x FY2002 book and 6.3x prospective earnings. Subsequently we reduce our rating to 3-Market Perform on valuation grounds alone. We continue however to like the fundamentals of the bank due to its SME focused loan book, high reserve levels and ex-Citibank management (with Carlyle/JPM in a strategic role).

Earnings Review:

KorAm Bank earned KRW195 billion on sharply reduced provisions, marking a return to profitability from last year's KRW396 billion loss. Pre-provision earnings were up 33% on improved margins and contribution from fees and

securities gains. ROE measured 21% for the year over an ROA of just 0.67%, an indication of the high leverage of the balance sheet.

Table 1: Key earnings components

<i>KRW million</i>	4Q00	1Q01	2Q01	3Q01	4Q01
Net interest income	125,939	164,909	173,123	179,529	198,923
Pre-provision profit	-98,101	171,730	95,488	191,049	89,095
Provisions	559,811	106,778	-43,380	125,555	51,106
Net income	-455,403	44,986	96,219	43,575	10,240
EPS (KRW)	-2,793	276	590	267	63

Source: Company reports; Lehman Brothers

Table 2: Key earnings ratios

	4Q00	1Q01	2Q01	3Q01	4Q01
NIM	1.99%	2.51%	2.66%	2.67%	2.91%
Asset yield	8.44%	8.37%	8.07%	7.87%	7.48%
Cost of funds	6.74%	6.07%	5.64%	5.47%	4.82%
Core ROAA	-6.33%	0.57%	1.18%	-0.19%	0.43%
Core ROAE	-117.96%	11.52%	20.95%	8.51%	1.22%
Overhead	4.82%	2.22%	0.77%	1.15%	2.64%
Efficiency	147.55%	45.92%	34.43%	28.85%	66.95%

Source: Company reports; Lehman Brothers

Rates and Margins:

Net interest margin picked up from FY2000 levels, expanding from 1.79% to 2.65% for the year—the only Korean bank in our universe to expand margins in FY2001. Margins also expanded on a quarterly basis, tracking movement of low-yielding assets from inter-bank and securities to the loan book over the last half of the year.

Table 3: Interest margin analysis

	4Q00	1Q01	2Q01	3Q01	4Q01
Change in asset yield	-0.03%	-0.08%	-0.29%	-0.21%	-0.39%
Change in cost of funds	-0.19%	-0.67%	-0.43%	-0.17%	-0.65%
Change in NIM	0.12%	0.51%	0.15%	0.01%	0.24%
Loan growth (QoQ)	15.44%	-11.97%	10.19%	8.43%	0.99%
Performing loan growth (QoQ)	24.03%	-14.02%	13.54%	9.61%	1.18%
Deposit growth (QoQ)	0.78%	0.78%	0.78%	0.78%	0.78%

Source: Company reports; Lehman Brothers

Quarter on quarter, asset yields dropped steadily from 8.44% in 4Q 2000 to 7.24% in 4Q 2001; a decline of 121 basis points. In a falling rate environment, yields at KorAm have remained more resilient than those of every other bank in our coverage except Kookmin. Breaking down the asset mix we can see the bank achieved this by moving KRW1,223 billion or 3.9% of total assets from inter-bank and trading securities into higher-yielding loans (approximately KRW1,000 billion into credit card loans alone).

Table 4: Margin comparison with other banks

LB covered banks	4Q01	4Q00	Change (YoY)
Asset yield			
Kookmin	8.51%	8.89%	-0.38
Shinhan	7.04%	8.56%	-1.51
Hana	7.01%	8.68%	-1.67
Koram	7.48%	8.44%	-0.97
Cost of funds			
Kookmin	5.25%	7.03%	-1.78
Shinhan	4.93%	7.03%	-2.10
Hana	5.77%	7.19%	-1.42
Koram	4.82%	6.74%	-1.92
NIM			
Kookmin	3.55%	2.17%	1.38
Shinhan	2.34%	2.02%	0.32
Hana	1.86%	2.00%	-0.14
Koram	2.91%	1.99%	0.92

Source: Company reports; Lehman Brothers

Falling cost of funds managed to out-pace the decline in yields, dropping by 194 basis points over the year as the bank moved high-cost borrowings into less expensive subordinated debt and structured instruments. Taking advantage of the market appetite for Korean debt, the bank issued KRW100 billion in five-year subordinated bonds, US\$160 million in 10-year subordinated debt and KRW262 billion in two-year termed CLOs. Pricing for these issues was in the 7.00-7.50% range.

Loan Growth:

Total loans grew just 4% YoY, constrained by the clearing of deadwood from the loan book—performing loans were up by 9% YoY. The bank reduced KRW1,038 billion of exposure to corporate and public enterprises over the year including KRW347 billion face value of corporate NPLs sold at a 33% haircut in 3Q01 and KRW122 billion of write-downs on Hynix exposure in 4Q01. The loan book now consists of a 56:44 breakdown between corporate and retail exposure—well on the way to the 50:50 balance targeted by management.

Table 5: Loan book breakdown

KRW billion	4Q00	1Q01	2Q01	3Q01	4Q01
Loans to Large corps	1,854.8	1,712.9	1,454.5	1,691.5	1,698.3
Loans to SME	5,648.2	5,684.7	5,681.7	5,950.0	5,869.1
Household loans	1,915.2	2,060.3	1,880.0	1,683.0	2,243.9
Public & others	1,085.2	186.4	176.6	225.3	203.4
Interbank loans	458.8	456.5	448.3	465.9	436.3
Credit cards	859.0	856.6	1,167.0	1,722.0	1,936.8

Source: Company reports; Lehman Brothers

Loan growth picked up steam only in the second half of the year following the appointment of new CEO Yung Ku Ha. The bank accelerated conversion of 1.8 million existing credit card accounts from the Shinsegae department store card acquisition in December 2000 into the more widely accepted Visa card network—approximately half of the growth in credit card outstandings can be attributed to increased usage from these accounts. The other half of the growth came from new card accounts and an increase in the ratio of cash advances from 20% to 35% of outstandings. Credit cards grew 125% YoY overall (off a small base) to KRW1,937 billion, adding KRW1,078 billion to the loan book. Non-credit card consumer loans grew by 17% to W2,244 billion. Overall consumer lending grew 51%.

We forecast loan growth of 11% for FY2002 on a consolidated basis, basically in line with our projected industry loan growth. This will be driven by continued increases in consumer lending as well as a recovery of corporate lending. As the bank is near to its 50-50 balanced corporate/consumer portfolio target, it will need to maintain or raise corporate loans going forward.

Asset Quality and Reserve Adequacy:

As with the entire sector over FY2001, KorAm made significant gains in this area. Reported NPLs dropped to 8% of total loans from the previous year's 11% mostly as a result of loan sales and write-downs of Hynix exposure. The bank made provisions of KRW240 billion for the year, a quarter of the size of the provisions that pushed the bank into loss in FY2000. These provisions leave the bank essentially fully-reserved against its NPLs with actual reserves at 96% of required and an insignificant shortfall-to-capital.

Table 6: Stated NPLs

	Gross Amount	Reserve Percentage	Required Reserve
Pass	17,201,158	1%	172,012
Special Mention	657,314	5%	32,866
Substandard	239,811	20%	47,962
Doubtful	475,289	50%	237,644
Loss	79,456	100%	79,456
ORE	-	20%	-
Excess AIR	59,343	20%	11,869
Total	18,712,371		581,808
Actual Reserves			557,578
Shortfall			24,230
Actual/Required			96%
Shortfall/Capital			4%

Source: Company reports; Lehman Brothers

Table 7: LB Adjusted NPLs

	Gross Amount	Reserve Percentage	Required Reserve
Pass	16,341,100	1%	163,411
Special Mention	958,655	5%	47,933
Substandard	702,604	20%	140,521
Doubtful	404,862	50%	202,431
Loss	245,807	100%	245,807
ORE	-	20%	-
Excess AIR	59,343	20%	11,869
Total	18,712,371		811,971
Actual Reserves			557,578
Shortfall			254,393
Actual/Required			69%
Shortfall/Capital			46%

Source: Company reports; Lehman Brothers

As with all Korean banks, we also stress test the balance sheet by adjusting KorAm's criticized assets upwards, increasing both the amount and the severity of NPLs. This adjustment lifts NPLs by approximately 50% above reported figures, leaving the bank with additional provisions of KRW254 billion to make before reaching our admittedly-conservative target. Another indication of the bank's narrow capital base is that this shortfall represents almost half of reported capital.

Capital Adequacy:

In the past year the bank raised upper-Tier 2 to bolster the capital base since FY2000 write-downs decimated Tier 1 levels. The bank issued Tier 2 capital in the form of US\$160 million of ten-year subordinated notes priced at 6.95% as well as KRW100 billion worth of five-year sub-ordinated debt at 7.65%. KorAm also issued (jointly with Hana Bank and Dongbu Insurance Co.) KRW229 billion of two-year collateralized loan obligations (CLOs) at 7.38%. CLOs also contribute to general capital efficiency through reduction in the risk-weighting of assets.

Table 8: Capital Adequacy Ratios

<i>KRW billion</i>	FY1999A	FY2000A	FY2001E	FY2002E
Tier 1 capital	934	726	991	1,395
Tier 2 capital	451	562	922	1,092.04
Risk-weighted assets	11,271	14,642	17,144	26,570
Tier 1 capital ratio	8.28%	4.96%	5.78%	5.25%
Total CAR	12.29%	8.80%	11.16%	9.36%

Source: Company reports; Lehman Brothers

These measures have helped tide the bank over while it earns its way back to a solid equity base—management indicated that it is not seeking to raise additional capital through a tier 1 issue. Based on the bank's ability to earn income going forward, we do believe that fresh Tier 1 is likely unnecessary. We project FY2002 net income of KRW296 billion which based on management projections of 5.25% FY2002 Tier 1 CAR indicate room for expansion in risk-weighted assets of KRW9,426 billion, or 55%. Proportionate growth of loans indicates support for up to 48% growth in total loans at these capital levels.

Note that KorAm has the slimmest capital base of our covered banks with equity to assets of 3.4% versus Shinhan on 5.5% and Kookmin on 4.3%. Normalizing ROE to the level of the average equity-to-asset ratio of our other covered banks, KorAm would have earned a ROE in FY2001 of 14.5% versus actual 19.9% and forward ROE of 19.4% versus expected 22.8%.

Table 9: Balance sheet leverage analysis

	KorAm		Kookmin		Shinhan		Hana	
	<i>FY2001A</i>	<i>FY2002E</i>	<i>FY2001A</i>	<i>FY2002E</i>	<i>FY2001A</i>	<i>FY2002E</i>	<i>FY2001A</i>	<i>FY2002E</i>
ROA	0.67%	0.94%	1.33%	1.44%	0.94%	1.05%	0.81%	1.07%
Core ROA	0.49%	0.94%	1.05%	1.44%	0.99%	1.05%	0.89%	1.07%
Equity-to-Assets	3.40%	4.11%	4.33%	4.77%	5.46%	5.70%	4.17%	4.02%
Calculated ROE	19.86%	22.83%	30.78%	30.17%	17.17%	18.41%	19.48%	26.58%
Calculated core ROE	14.40%	22.83%	24.21%	30.17%	18.12%	18.41%	21.37%	26.58%
Normalized equity-to-asset leve	4.65%	4.83%	4.65%	4.83%	4.65%	4.83%	4.65%	4.83%
Calculated ROE	14.49%	19.44%	28.62%	29.79%	20.14%	21.73%	17.47%	22.12%
Calculated core ROE	10.51%	19.44%	22.51%	29.79%	21.26%	21.73%	19.17%	22.12%

Source: Company reports; Lehman Brothers

Valuation:

KorAm currently trades at 2.1x trailing book on a ROE of 21% and 10.5x FY2001 earnings (6.9x forward earnings). At this level it trades at a higher valuation than Kookmin—a reflection of recent merger speculation.

On expected forward ROE of 24% and cost of capital of 15%; a book multiple of 1.6x trailing book is justified. We are updating our 12-month forward price target to KRW12,000 reflecting 4% downside from the current level. We are moving our rating down to 3-Market Perform.

Table 10: Valuation Summary

KRW	FY2001A	FY2002E	FY2003E
Current price	12,550		
EEPS	1,196	1,816	1,980
P/E	10.49 x	6.91 x	6.34 x
BVPS	6,077	8,554	11,203
P/BV	2.07 x	1.47 x	1.12 x
ROE	21%	24%	20%
ROE/(P/BV)	10%	16%	18%

Source: Company reports; Lehman Brothers

Company description

KorAm Bank was established in 1983 as a joint-venture between the Bank of America and a consortium of Korean companies including Samsung and Daewoo. Its operations are centered mainly around the Seoul area and have traditionally focused on SME lending. In November 2000, KorAm Bank increased its capital through an investment from a consortium led by the Carlyle Group and JP Morgan. The bank has over 220 branches and 3,800 employees.

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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, plus or minus 5 percentage points); 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).

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