

Analyst: Vincent Leung
HANG SENG BANK LIMITED (恒生銀行)

Sector	: Banking	Chairman	: Mr. Michael R. P. Smith
HKSE Code	: 0011		
Market Price	: HK\$105.90 (05/03/2007)	Vice-Chairman & Chief Executive	: Mr. Raymond C. F. Or
Shares Issued	: 1,911.843 million		
Mkt. Cap.	: HK\$202,464.1 million	Managing Director & Deputy Chief Executive	: Mr. Joseph C. Y. Poon
52 weeks Hi/ Lo	: HK\$113.60 / HK\$94.00		
HSI	: 18,664.88 (05/03/2007)		
Main Business	: Banking and related financial services		

SUMMARY OF THE FINAL RESULTS FOR THE YEAR ENDED 31ST DECEMBER 2006
Final Results Highlights

	HK\$ million	Vs FY2005 (%)	Vs 30/06/2006 (%)
• Net interest income	11,694	+8.3%	
• Non-interest income	6,387	+17.5%	
• Total operating income	18,081	+11.4%	
• Operating expenses	(5,241)	+15.3%	
• Operating profit before impairment losses	12,840	+9.9%	
• Impairment losses on loans and other credit provisions	(264)	-57.3%	
• Net surplus on property revaluation	321	-75.6%	
• Profit on disposal of fixed assets	505	+2,557.9%	
• Profit before taxation	14,395	+7.8%	
• Taxation	(2,049)	+14.2%	
• Attributable profit to shareholders	12,038	+6.1%	
• Total loans	280,277	+7.1%	+4.8%
• Total deposits	540,303	+12.8%	+7.0%
• Total assets	669,064	+15.2%	+6.5%
• Basic EPS (HK\$)	6.30	+6.2%	
• 3 rd & 4 th interim DPS (HK\$)	3.00	Unchanged	
• Total DPS (HK\$)	5.20	Unchanged	

Selected Ratios	FY2006	FY2005	1H2006
• Net interest margin	2.02%	2.06%	2.01%
• Cost-income ratio	29.0%	28.0%	26.8%
• Return on average assets	1.9%	2.0%	2.1%
• Return on average equity	27.4%	27.5%	29.0%
• Impaired loan ratio	0.49%	0.55%	0.45%
• Impaired advances coverage	66.6%	72.2%	73.4%
• Loan-deposit ratio	51.9%	54.6%	53.0%
• Capital adequacy ratio	13.6%	12.8%	14.2%
• Average liquidity ratio	51.9%	45.1%	50.9%

- **FY2006 results within market expectations** Hang Seng Bank reported a 6.1% increase in net profit to HK\$12,038 million for FY2006, which was in line with market expectations (HK\$11,499 million-HK\$12,802 million). Stripping out the exceptional items, including net surplus on property revaluation of HK\$321 million (FY2005: HK\$1,313 million) and a profit on disposal of fixed assets of HK\$505 million (FY2005: HK\$19 million), pre-tax profit would have risen by 12.8%, driven by higher net interest income (+8.3%) and better net fee income (+18.3%) as well as lower loan impairment charges (-57.3%).

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- **Higher net interest income despite slightly lower NIM** Net interest income rose 8.3% on a 10.6% increase in average interest-bearing assets. The non-treasury portfolios performed well amid a wider Prime/HIBOR gap while rise in both interest rate and funds balance also buoyed contribution from net free funds. However, yields in treasury balance sheet management portfolios were further compressed by rising interest rates and flat yield curves. Meanwhile, net interest margin narrowed slightly by 4 bps to 2.02%, reflecting a 15-bps rise in contribution from net free funds and a 19-bps fall in net interest spread.
- **Moderate loan growth** Total loans grew 7.1% during FY2006, fuelled by property-related corporate lending (+6.0%) as well as loans to wholesale & retail (+14.3%) and manufacturing (+18.4%) sectors. Higher yielding card advances (+22.1%), personal loans (+16.5%), trade finance (+24.0%) and Mainland loans (+50.9%) also saw notable growths during FY2006. However, on the back of a 12.8% growth in total deposits, the bank's loan-to-deposit ratio declined to 51.9% as of 31/12/2006 from 54.6% a year earlier.
- **Solid non-interest income growth** Hang Seng's non-interest income rose 17.5% in FY2006. This was mainly attributable the strong momentum of its wealth management business (+22.7%), with stock-broking and related services up 63.3% on a strong equity market in 2006, private-banking business (+83.5%) and structured investment products (+48.1%) being the key drivers. Fee income from credit cards rose 22%, thanks to a 10.5% rise in the number of cards in issue to some 1.4 million and an 11.7% increase in cardholder spending to HK\$37,178 million. In addition, trading income surged 50.3% on a 50.1% jump in FX income. However, the growth of non-interest income was trimmed by an underwriting loss of HK\$231 million in FY2006, against a gain of HK\$769 million in FY2005. Management said the higher growth in claims (15.2%) than the increase in net earned premiums (+0.8%) was due to higher insurance investment income, which has to be credited back to the customers.
- **Cost efficiency maintained** Operating expenses rose 15.3%, as an increase in overall staff headcount (8,464, +7.8%) and pay rise drove up salaries by 19.1% and the bank increased its Mainland outlets to 15 from 12 a year earlier. With an 11.4% increase in total operating income, the bank's cost-to-income ratio edged up to 29% from 28% a year earlier.
- **Stable credit quality** Loan impairment charges and other credit risk provisions were down 57.3% on benign credit environment. During the year, the bank recorded substantially lower new & additional charges (HK\$423 million, -60.5%) on reduction in those for commercial banking customers, while releases (HK\$106 million, -69.8%) was dragged by mortgages & personal lending. Impaired loan ratio was 0.49% as of 31/12/2006, down from 0.55% as of 31/12/2005. Impaired loan coverage was 66.6%, down from 72.2% as of 31/12/2005.
- **Mainland operations** Its 13%-held Fujian-based Industrial Bank contributed HK\$763 million in net profit to Hang Seng, up 113.1%. Meanwhile, Hang Seng's mainland operations (ex-Industrial Bank) registered a 94.2% increase in pre-tax profit to HK\$134 million while both deposits and loans rose by 51%. Including contribution from Industrial Bank, Mainland business accounted for 6.1% of the bank's total pre-tax profit (FY2005: 4.5%).
- **Solid profitability** Hang Seng's profitability remained solid, with ROAE and ROAA maintained at 27.4% and 1.9% in FY2006 respectively. Meanwhile, the bank's CAR stood at 13.6% as of 31/12/2006.

Outlook & Prospects

- **NIM is a key for local business** The earnings-dragging treasury book has been running off, so as its negative impact on NIM. However, China loans, which commands a higher NIM, is still a small portion of Hang Seng's overall loan portfolio and local loan growth (FY2006: +3.7%) is unexciting. We see limited improvement in the bank's overall NIM in 2007. Looking ahead, commercial banking (especially SME) and private banking is expected to be the bank's focus for its local business.
- **Cost discipline has been the key** Hang Seng has been consistently showing cost discipline with its cost-to-income ratio always among the lowest in the Hong Kong banking industry. However, this may be under pressure with the bank's commitment on aggressively expanding its Mainland operations.
- **Fruitful results from organic growth on the Mainland yet to come** While Hang Seng has an aggressive mainland expansion plan, a meaningful impact to the bank's overall bottom line could be difficult to achieve in the near term, given its large Hong Kong operations and the medium-term earnings drag from the significant capital commitment in China at the outset. Hang Seng currently operates 7 branches, 8 sub-branches and 1 representative office in eight Mainland cities and targeted to boost the total outlets to over 50 by 2010 while it will increase its number of staff on the Mainland from 661 to more than 2,000.
- **Possible acquisition to drive Mainland growth** Despite a high tier-1 CAR of 10.7%, full-year DPS was kept unchanged at HK\$5.20, translating to a lower payout ratio of 82.5% (FY2005: 87.7%). While additional capital is much needed for organic expansion in China, we would not be surprised to see another acquisition or a stake increase in Industrial Bank by Hang Seng to drive Mainland pre-tax earnings to its target of 10% by 2010.
- **Rich valuation with downside cushioned by attractive yield** While Hang Seng's 4.41x FY2007E P/B and 16.4x FY2007E P/E looks rich, an ROE of high twenties with dividend payout of above 80% should justify this premium valuation. Nevertheless, in the absence of any near-term positive catalyst, Hang Seng Bank will remain a dividend yield play (4.9% yield) for now and is premised a Hold rating.

Recommendation: *Hold*

I. Impairment allowances, overdue and rescheduled advances of Hang Seng Bank

As % of total customer advances	Individual allowance	Collective allowance	Impaired advances	Overdue and rescheduled advances
As of 31/12/2006	0.14%	0.18%	0.49%	0.46%
As of 30/06/2006	0.14%	0.19%	0.45%	0.51%
As of 31/12/2005	0.20%	0.19%	0.55%	0.47%

II. Comparison of Hang Seng Bank's loan book: 31/12/2006 vs 31/12/2005

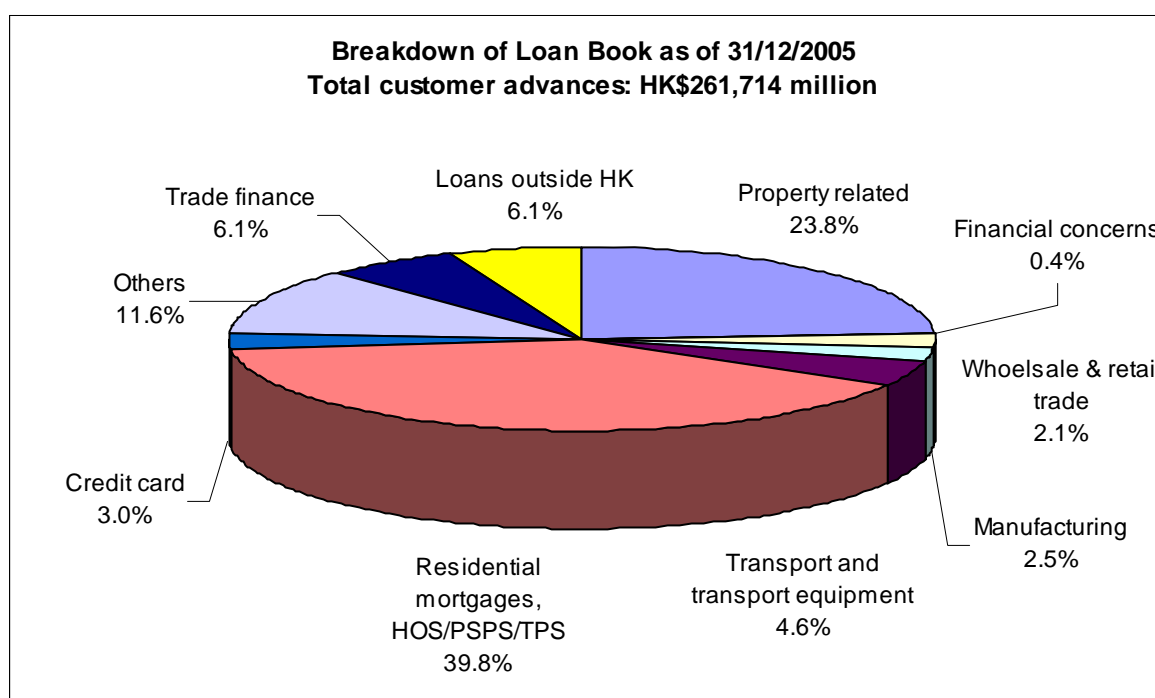
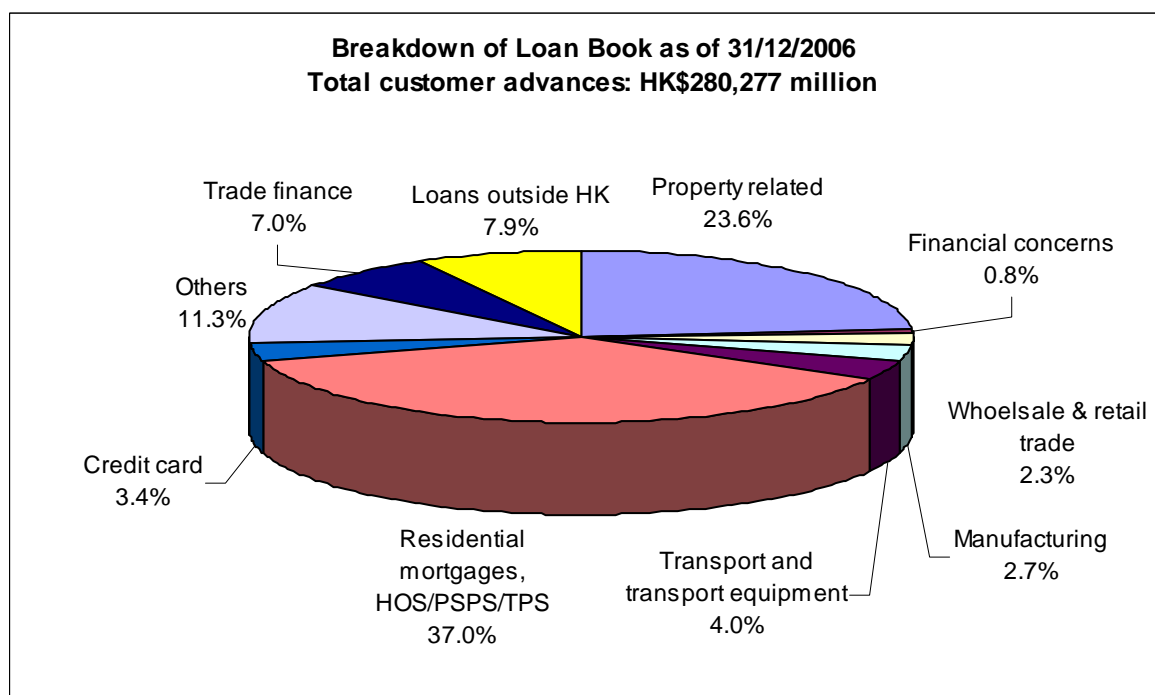
Loans-by industry	31 st Dec, 2006 HK\$ million	Up/(down)	31 st Dec, 2005 HK\$ million
Property related	66,147	+6.0%	62,410
Financial concerns	2,103	+117.3%	968
Wholesale & retail trade	6,360	+14.3%	5,562
Manufacturing	7,670	+18.4%	6,477
Transport & transport equipment	11,145	-6.5%	11,919
Residential mortgages, HOS/PSPS	103,694	-0.5%	104,197
Credit card	9,448	+22.1%	7,735
Others	31,600	+3.7%	30,475
Trade finance	19,684	+24.0%	15,874
Stockbrokers	234	+5.9%	221
Loans outside HK	22,192	+39.8%	15,876
	<u>280,277</u>	<u>+7.1%</u>	<u>261,714</u>

III. Comparison of Hang Seng Bank's loan book: 31/12/2006 vs 30/06/2006

Loans-by industry	31 st Dec, 2006 HK\$ million	Up/(down)	30 th June, 2006 HK\$ million
Property related	66,147	+4.4%	63,345
Financial concerns	2,103	-0.2%	2,108
Wholesale & retail trade	6,360	+6.5%	5,972
Manufacturing	7,670	+11.3%	6,894
Transport & transport equipment	11,145	-3.7%	11,578
Residential mortgages, HOS/PSPS	103,694	-0.4%	104,155
Credit card	9,448	+24.6%	7,585
Others	31,600	+10.2%	28,673
Trade finance	19,684	+3.8%	18,968
Stockbrokers	234	-18.8%	288
Loans outside HK	22,192	+24.5%	17,827
	<u>280,277</u>	<u>+4.8%</u>	<u>267,393</u>



Breakdown of loan book of Hang Seng Bank



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