

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

Sector	: Banking	Vice-Chairman & Chief Executive	: Mr. Raymond C. F. Or
HKSE Code	: 0011		
Market Price	: HK\$112.90 (30/07/2007)	Managing Director & Deputy Chief Executive	: Mr. Joseph C. Y. Poon
Shares Issued	: 1,911.843 million		
Mkt. Cap.	: HK\$215,847.0 million		
52 weeks Hi/ Lo	: HK\$114.60 / HK\$96.90		
HSI	: 22,739.90 (30/07/2007)		
Main Business	: Banking and related financial services		

**SUMMARY OF THE INTERIM RESULTS FOR THE SIX MONTHS ENDED 30<sup>TH</sup> JUNE 2007**
**Interim Results Highlights**

	HK\$ million	Vs 1H2006 (%)	Vs 31/12/2006 (%)
• Net interest income	6,696	+20.8%	
• Non-interest income	4,271	+34.1%	
• Total operating income	10,967	+25.7%	
• Operating expenses	(2,914)	+24.6%	
• Operating profit before impairment losses	8,053	+26.1%	
• Impairment losses on loans and other credit provisions	(280)	+723.5%	
• Gain on dilution of an associate - Industrial Bank	1,465	N/A	
• Profit before taxation	10,218	+36.0%	
• Taxation	(1,150)	-4.3%	
• <b>Profit attributable to shareholders</b>	<b>8,867</b>	<b>+43.2%</b>	
• Total loans	311,952	+16.7%	+11.3%
• Total deposits	558,419	+10.6%	+3.4%
• Total assets	741,322	+18.0%	+10.8%
• Basic EPS (HK\$)	4.64	+43.2%	
• 1 <sup>st</sup> & 2 <sup>nd</sup> interim DPS (HK\$)	2.20	unchanged	

Selected Ratios	1H2007	1H2006	FY2006
• Net interest margin	2.11%	2.01%	2.02%
• Cost-income ratio	26.6%	26.8%	29.0%
• Return on average assets	2.5%	2.1%	1.9%
• Return on average equity (#)	36.6%	29.0%	27.4%
• Impaired loan ratio	0.46%	0.45%	0.49%
• Impaired advances coverage	68.4%	73.4%	66.6%
• Loan-deposit ratio	55.9%	53.0%	51.9%
• Capital adequacy ratio	12.3%	14.2%	13.6%
• Average liquidity ratio	52.9%	50.9%	51.9%

# Excluding the dilution gain, return on average equity would have been 30.5% for 1H2007.

- **1H2007 results beat market expectations** Hang Seng reported a 43.2% y-o-y increase in net profit to a record HK\$8,867 million for 1H2007, which was stronger than market expectations ranging between HK\$7.6 billion and HK\$8.35 billion. This was mainly due to strong net interest income on widening NIM, fee income growth, a one-off dilution gain resulting from the listing of Industrial Bank as well as a lower effective tax rate of 11.3% (1H2006: 16.0%).
- **One-off dilution gain** Hang Seng booked a gain on dilution of investment in associate of HK\$1,465 million on the RMB16-billion A-share IPO of Industrial Bank in Feb 07 that diluted Hang Seng's effective interest in the Mainland bank from 15.98% to 12.78%. Excluding the dilution gain, pre-tax profit would have risen by 16.5%.

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- **Widened NIM** Net interest income jumped 20.8% y-o-y on a 15.1% increase in average interest-bearing assets. Meanwhile, net interest margin widened by 10 bps y-o-y to 2.11% for 1H2007, reflecting a 5-bps rise in contribution from net free funds and a 5-bps increase in net interest spread amid improvement in deposit spreads and re-pricing of the fixed-rate bonds in its treasury book at a higher yield.
- **Loan growth driven by IPO-related financing** Total loans grew 11.3% (or HK\$31.7 billion) h-o-h during 1H2007, mainly driven by IPO-related financing that accounted for 85% (or HK\$26.9 billion) of the growth. Loans for use outside Hong Kong grew by 14.1%, mainly driven by a 21.3% in lending by its Mainland branches. With a mild 3.4% h-o-h growth in total deposits, the bank's loan-to-deposit ratio rose to 55.9% as of 30/06/2007 from 51.9% as of 31/12/2006.
- **Continued strong momentum in non-interest income** Hang Seng's non-interest income soared by 34.1% y-o-y in 1H2007, attributable to a 60.6% surge in net fee income. The strong fee income growth was mainly attributable to the strong momentum of its wealth management business (HK\$3,429m, +58.2% y-o-y), with stock-broking fees (HK\$738m, +85.4%), sale of retail investment funds (HK\$728 million, +50.4%) and structured investment products (HK\$511m, +117.4%) being the key drivers.
- **Cost efficiency maintained** Operating expenses rose 24.6% y-o-y, due largely to the investment in its Mainland operations (including Mainland-incorporation expenses, branch network expansion and headcount increase) as well as increase in performance-related pay. Excluding these two factors, operating expenses would have risen by 8.9% y-o-y on new hires in Hong Kong and increase in marketing costs. With increase in total operating income (+25.7% y-o-y) outpaced that of operating expenses, the bank's cost-to-income ratio edged down to 26.6% from 26.8% a year earlier.
- **Benign credit quality** Loan impairment charges and other credit risk provisions jumped to HK\$280m in 1H2007 from HK\$34m a year ago while gross impaired loans increased from HK\$1,209m as of 30/06/2006 to HK\$1,432m as of 30/06/2007, due to some problem corporate loans in the Mainland. Nevertheless, impaired loan ratio was 0.46% as of 30/06/2007, little changed from 0.49% as of 31/12/2006. Impaired loan coverage was 68.4%, up from 66.6% as of 31/12/2006.
- **Mainland operations** Despite an 86% y-o-y jump in total operating income to HK\$225m, Hang Seng's Mainland operations (ex-Industrial Bank) saw a HK\$40m decline in pre-tax profit, due to the costs of establishing its Mainland subsidiary, exchange loss on USD capital funds amid RMB appreciation and an increase in loan impairment charges. Total loans at its Mainland branches rose by 21.3% h-o-h while deposits increased 42.7%. During 1H2007, Hang Seng opened 1 sub-branch in Guangzhou and another 2 sub-branches in Shanghai, boosting the total number of outlets to 19. Including contribution from Industrial Bank (but excluding the dilution gain), Mainland businesses accounted for 5.9% of the bank's total pre-tax profit for 1H2007 (FY2006: 6.1%; 1H2006: 4.3%).
- **Solid profitability** Hang Seng's profitability remained solid, with ROAE of 36.6% (or 30.5% excluding the dilution gains) in 1H2007. Meanwhile, the bank's CAR stood at 12.3% as of 30/06/2007.

**Outlook & Prospects**

- **Steady NIM expected** While further re-pricing of the fixed-rate bonds in Hang Seng's treasury book would be beneficial to the bank's NIM in 2H2007, narrowing Prime-HIBOR spread will exert an offsetting impact. These should lead to a stable NIM going forward.
- **Acquisition of remaining stake in Hang Seng Life** Hang Seng announced in late June 07 the proposed acquisition of the remaining 50% stake from HSBC for a consideration of HK\$2.4 billion. Given Hang Seng's 50% stake, contribution from the life arm, which recorded a profit after tax of HK\$316 million last year, accounted for just 1.3% of the bank's FY2006 earnings. Although near-term incremental earnings contribution may not be significant, management indicated the increase in stake would help extend the product offering and hence boost proposition for its wealth-management business. Nonetheless, the strengthening of insurance operation should help diversify the fee-income source from the market-driven investment services income.
- **Private Banking target to be achieved earlier than originally planned** Hang Seng's Private Banking division achieved a pre-tax profit of HK\$459m in 1H2007, up 62.4% y-o-y. The bank now expects to achieve its 5-year goal of doubling the division's 2005 pre-tax profit by the end of this year, three years ahead of schedule.
- **Local incorporation in the Mainland** Hang Seng has received the approval for local incorporation in China in May. Hang Seng Bank (China) currently has over 800 staff, with a plan to expand the team to more than 2,000 who will serve customers through a network of over 50 outlets by 2010 (from the current 19 outlets). Branch network build-out could hamper earnings growth for its Mainland operations in the next couple of years although its 10% China pre-tax profit contribution target by 2010 should be on track amid continued strong volume growth.
- **Hold for yield** Hang Seng's 4.4x FY2007E P/B and 16.2x FY2007E P/E is justified by an ROE of mid-high twenties with dividend payout of above 80%. Meanwhile, the stock has underperformed the HSI by 22.2% in the past 12 months that may partly reflect the market perception of a tepid growth story. This set of buoyant interim results should serve as a near-term positive catalyst while the bank's solid fundamentals and the 4.6% yield should well cushion any downside for its share price. However, we are neutral on the counter as we see its rich valuation metrics remains one of the key hurdles for investors to turn really positive on the counter.

**Recommendation: *Neutral***

**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
<b>As of 30/06/2007</b>	0.13%	0.18%	0.46%	0.37%
<b>As of 31/12/2006</b>	0.14%	0.18%	0.49%	0.46%
<b>As of 30/06/2006</b>	0.14%	0.19%	0.45%	0.51%

**II. Comparison of Hang Seng Bank's loan book: 30/06/2007 vs 31/12/2006**

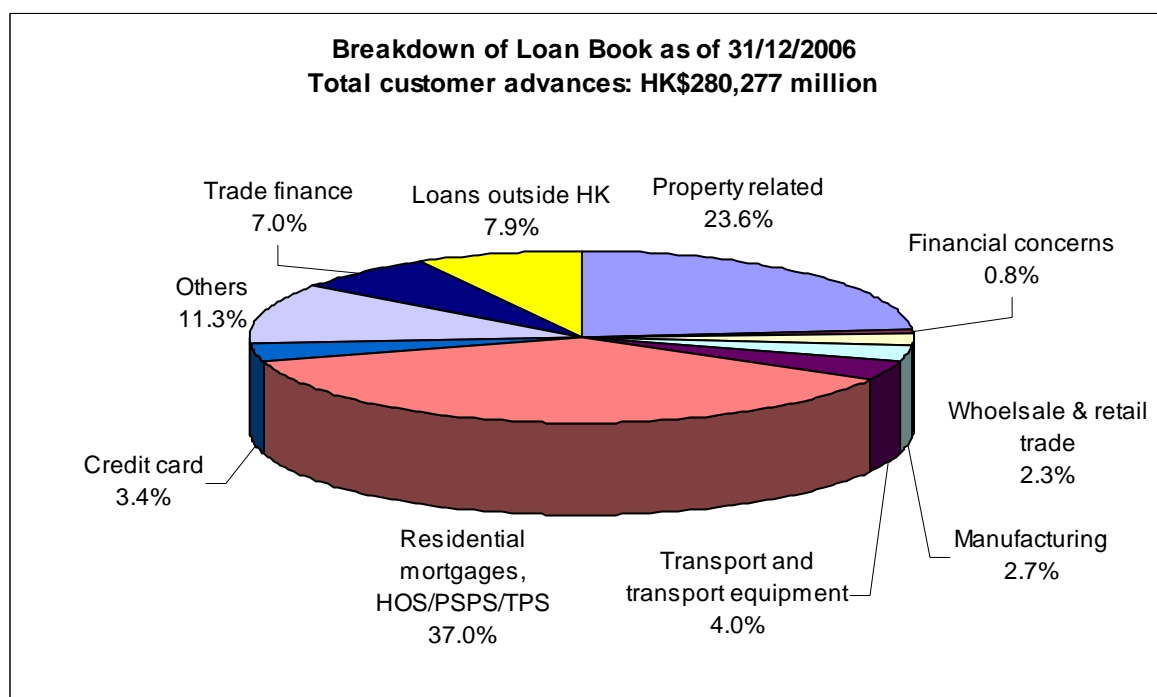
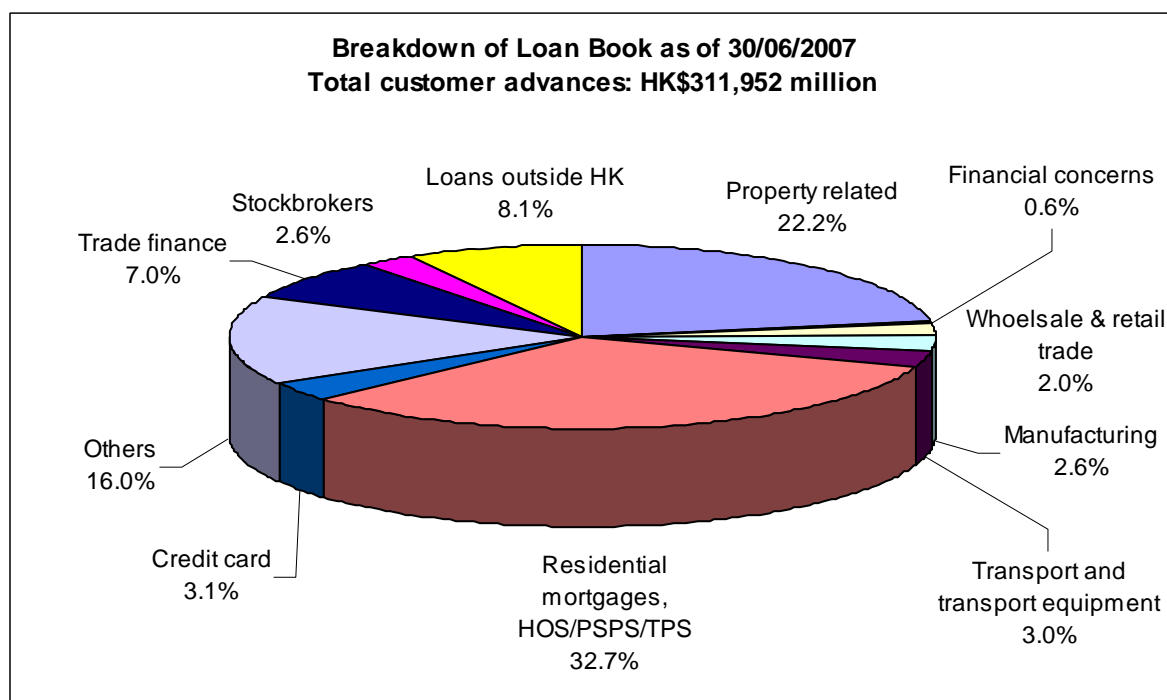
Loans-by industry	30 <sup>th</sup> Jun, 2007 HK\$ million	Up/(down)	31 <sup>st</sup> Dec, 2006 HK\$ million
Property related	69,316	+4.8%	66,147
Financial concerns	1,917	-8.8%	2,103
Wholesale & retail trade	6,084	-4.3%	6,360
Manufacturing	8,098	+5.6%	7,670
Transport & transport equipment	9,431	-15.4%	11,145
Residential mortgages, HOS/PSPS	102,109	-1.5%	103,694
Credit card	9,804	+3.8%	9,448
Others	49,914	+58.0%	31,600
Trade finance	21,988	+11.7%	19,684
Stockbrokers	7,976	+3308.5%	234
Loans outside HK	25,315	+14.1%	22,192
	<u>311,952</u>	<u>+11.3%</u>	<u>280,277</u>

**III. Comparison of Hang Seng Bank's loan book: 30/06/2007 vs 30/06/2006**

Loans-by industry	30 <sup>th</sup> Jun, 2007 HK\$ million	Up/(down)	30 <sup>th</sup> June, 2006 HK\$ million
Property related	69,316	+9.4%	63,345
Financial concerns	1,917	-9.1%	2,108
Wholesale & retail trade	6,084	+1.9%	5,972
Manufacturing	8,098	+17.5%	6,894
Transport & transport equipment	9,431	-18.5%	11,578
Residential mortgages, HOS/PSPS	102,109	-2.0%	104,155
Credit card	9,804	+29.3%	7,585
Others	49,914	+74.1%	28,673
Trade finance	21,988	+15.9%	18,968
Stockbrokers	7,976	+2669.4%	288
Loans outside HK	25,315	+42.0%	17,827
	<u>311,952</u>	<u>+16.7%</u>	<u>267,393</u>



**Breakdown of loan book of Hang Seng Bank**



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