

**BEA securities**

EAST ASIA SECURITIES COMPANY LIMITED

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HONG KONG RESEARCH**4th August 2005****THE BANK OF EAST ASIA, LIMITED (東亞銀行)**

Sector	: Banking
HKSE Code	: 0023
Market Price	: HK\$24.00 (03/08/2005)
Shares Issued	: 1,503.021 million
Mkt. Cap.	: HK\$36,072.50 million
52 weeks Hi/Lo	: HK\$24.70 / HK\$20.35
HSI	: 15,118.50 (03/08/2005)
Main Business	: Banking and related financial services

Chairman & Chief Executive : Dr. David Li Kwok-po

Executive Directors &
Deputy Chief Executives : Mr. Joseph Pang Yuk-wing
Mr. Chan Kay-cheung**SUMMARY OF THE INTERIM RESULTS FOR THE SIX MONTHS ENDED 30TH JUNE 2005****Interim Results Highlights**

	HK\$ million	Vs 1H2004 (%)	Vs 31/12/2004 (%)
• Net interest income	1,715.6	-4.8%	
• Non-interest income	1,037.8	+26.4%	
• Total operating income	2,753.4	+4.9%	
• Operating expenses	(1,410.5)	+7.3%	
• Operating profit before impairment allowance / provisions	1,342.9	+2.6%	
• Release of impairment losses and impairment allowances for impaired assets (ex the impairment allowances on held-to-maturity and available-for-sale securities)	24.3	N/A	
• Attributable profit	1,183.0	+20.0%	
• Total loans	128,418	+21.5%	+9.5%
• Total deposits	166,980	+7.0%	-0.6%
• Total assets	212,291	+9.3%	+0.9%
• Basic EPS (HK\$)	HK\$0.79	+17.9%	
• Interim DPS (HK\$)	HK\$0.33	+17.9%	

Selected Ratios	1H2005	1H2004	Year ended 31/12/2004
• Net interest margin	1.76%	1.94%	1.96 ^(^)
• Impaired loan ratio (<i>NPL ratio</i> *)	1.17%	2.07 ^(*)	1.35 ^(*)
• Impaired advances coverage (<i>NPL coverage</i> *)	46.9%	81.9 ^(*)	113.3 ^(*)
• Return on average assets	1.14%	1.00%	1.38 ^(^)
• Return on average equity	10.91%	9.82%	13.15 ^(^)
• Loan-deposit ratio	76.9%	67.7%	69.8%
• Cost-income ratio	51.2%	50.1%	50.3%
• Capital adequacy ratio	15.6%	17.7%	16.2%
• Average liquidity ratio	39.5%	43.9%	44.4%

Remarks: ^(^) – Figures for 2H2004 only

- **1H2005 results in line with forecast** Bank of East Asia ("BEA") reported a 20.0% y-o-y surge in net profit to HK\$1,183 million for six months ended 30/06/2005, largely in line with consensus forecast. The bottom line growth in the first half was mainly driven by a jump in trading gains and a release of impairment losses and allowances on impaired assets.
- **Steady dividend payout at 42%** Basic earnings per share for 1H2005 was HK\$0.79, while the Bank proposed to an interim dividend of HK\$0.33 per share. It represented a payout ratio of 41.8%, which was unchanged from a year earlier.

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- **Net interest margin dropped** Net interest income slipped 4.8% y-o-y to HK\$1,715.6 million in 1H2005, mainly due to a sharp 90.5% y-o-y jump in interest expense. As a result, BEA's net interest margin narrowed by 18bps y-o-y and 20bps h-o-h to 1.94% in 1H2005. The Bank's interest margins were under serious pressure during the first half, as interbank rates stood exceptionally low amid liquidity flood. Nonetheless, BEA management said that margin squeeze eased significantly during 2Q2005, after Hong Kong Monetary Authority refined the linked exchange rate system. Besides, several rates hikes in 1H2005 also helped improve interest margins.
- **Robust loan growth in the Mainland** As of 30/06/2005, BEA's loan portfolio stood at HK\$128.4 billion, up 9.5% h-o-h from HK\$117.3 billion as of 31/12/2004, driven by strong loan demand in China and solid growth in HK and other overseas markets. China business continued to grow well, with its loan book (after transfer of risk) expanded by 39.8% h-o-h and was more than double from a year earlier. In HK, a property boom helped boost related loan demand. Residential mortgages HOS/PSPS, which represented 30.7% of BEA's loan book as of 30/06/2005, grew 8.1% h-o-h. Other property related loans jumped a solid 12.0% during the first half to HK\$21.213 billion, representing 16.5% of the Bank's total loans (31/12/2004: 16.1%). With total deposits down 0.6% h-o-h in 1H2005, loan-to-deposit ratio surged to 76.9% as of 30/06/2005 from 69.8% as of 31/12/2004.
- **Non-interest business continued to outshine** Non-interest income jumped 26.4% y-o-y in 1H2005 to HK\$1,037.8 million. The rise was mainly driven by a 104.6% y-o-y surge in net trading gain from Treasury operations, despite a drop in fee and commission income. For the six months ended 30/06/2005, fee and commission income slipped 0.6% y-o-y to HK\$771.0 million, seeing a fall in income from loans, overdrafts & guarantees and securities & asset management but a rise in fee income from corporate services. Higher fee income from corporate services was attributable to strong performance of Tricor Holdings – a key player in the region's corporate and investor services. Meanwhile, Blue Cross Insurance reported a 35% rise in gross premium income in 1H2005, while Bancassurance recorded a 25% increase in premiums during the first half. Overall, non-interest income accounted for 37.7% of total operating income in 1H2005, up from 31.3% in a year earlier.
- **Cost-to-income ratio increased** Operating expenses increased by 7.3% y-o-y in 1H2005, due to a 10.0% rise in total staff costs and a 16.3% increase in rental expenses. A reviving labour market, keen rivalry in the financial sector as well as business development in the Mainland and overseas were the reasons behind rising salary expenses during the first half. Coupled with a milder growth in operating income (+4.9% y-o-y), the Bank's cost-to-income ratio rose to 51.2% in 1H2005 from 50.1% in 1H2004.
- **Gain on properties disposal** BEA recorded a HK\$35.3 million disposal gain of fixed assets in 1H2005. BEA disposed of a vacant bank premise in Kennedy Town during the first half, after its relocation of certain Departments to Millennium City 5 in Kwun Tong. The Bank said it may book further disposal gains in the second half, as it continues to unload redundant office spaces.
- **Accounting changes lowered loan impairment charges** BEA reported a release of impairment losses and impairment allowances for impair assets totalling HK\$24.3 million in 1H2005 when compared with a HK\$143.1 million charge for bad and doubtful debts a year earlier. It was mainly due to better credit quality and the adoption of new accounting standard HKAS 39. As a result, the impaired loan ratio fell to 1.17% as of 30/06/2005 (31/12/2004: 1.35%), while the impaired advances coverage tumbled to 46.9% as of 30/06/2004 from 113.3% as of 31/12/2004, due to a one-off write-back of general provisions of previous years.
- **Healthy financial position and improved profitability** BEA's financial position stayed healthy, with its CAR stood above sector average at 15.6% as of 30/06/2004 and an average liquidity ratio of 39.5% in 1H2005. The Bank's profitability also improved with ROAA and ROAE for 1H2005 stood at 1.14% and 10.91% respectively, when compared with 1.00% and 9.82% for 1H2004.



Outlook & Prospects

- **HK economic outlook continues to improve** The local jobs market continues to revive, with jobless rate stood at 5.7% – the lowest level since 2001. Better employment and economic sentiment should help boost consumer spending and the demand for home purchase, so as to boost consumer lending and mortgage businesses.
- **Cost-income ratio seen falling in 2H2005** BEA's cost-to-income ratio further rose to 51.2% in 1H2004 amid rising salary. Nonetheless, the increase in staff costs has started stabilizing during the first half. Besides, property maintenance costs are expected to fall, as the Bank continues to unload redundant office premises. Accordingly, the Bank's management is optimistic that the ratio would come down to below 50% in the second half and for the full year. One point worth looking at is the Bank did not report any goodwill amortization in 1H2005, due to the change in accounting policy. Goodwill amortization accounted for more than 5% of total operating expenses in FY2004.
- **NIM outlook improves** Aggressive rate hikes during the second quarter helped ease margin pressure among banks in HK. Besides, the introduction of two-way trading bands for HK dollar against the greenback by the HKMA to fine tune the linked exchange rate system also helped normalize interbank rates and make asset-liability management easier and more predictable. The outlook for interest margins should keep improving in the second half, as it is expected to have two to three more 25-bps hike in the US and local banks are expected to follow. Nonetheless, one should note that an accelerating funds flow from savings to term deposits for higher return may increase banks' funding costs in due course.
- **Corporate services to boost Non-interest business** Tricor Holdings, the corporate and investor services arm of the Bank, maintained healthy growth during the first half. The acquisition of the company secretarial business of Ernst & Young in BVI in May and the corporate services business of PricewaterhouseCoopers in Thailand last month should provide the segment with full strength to grow and become a leading market player in the future.
- **China business grows healthily** Leveraging on its business network of 23 outlets in the Mainland, including branches, sub-branches and representative offices, BEA's China business continued to perform well during the first half. Credit quality in the mainland has been improving gradually, as the economy stays robust with a 9.5% GDP growth in 2Q2005. With the most extensive network among local peers, BEA is well positioned to explore business opportunities in the mainland China.
- **Accounting change leads to reporting volatility** BEA adopted new accounting standards in 1H2005, which would create significant changes in financial reporting and bring extra volatility to the bottom line of the income statement.
- **Fair valuation with pleasant outlook** Trading at 15.0x FY2005E P/E and 1.6x FY2005E P/B, shares of BEA are valued at a slight premium to its local banking peers. However, we see such valuations not demanding, given the Bank's prime positioning in the mainland China and a pleasant outlook for both its interest- and non-interest businesses. With some 4.7% dividend yield, we recommend a HOLD rating on the banking counter.

Recommendation: Hold

I. Allowances, impaired advances, overdue and rescheduled advances of the Bank of East Asia

As % of total customer advances	Individual impairment loss allowances	Collective impairment loss allowances	Impaired advances	Overdue and rescheduled advances
As of 30/06/05	0.28%	0.36%	1.17%	0.91%
	Specific provisions	General provisions	NPLs	Overdue and rescheduled advances
As of 31/12/04	0.29%	1.14%	1.16%	1.12%
As of 30/06/04	0.37%	1.24%	1.78%	2.01%

II. Comparison of the Bank of East Asia's loan book : 30/06/2005 Vs 31/12/2004

Loans-by industry	30 th Jun, 2005 HK\$ million	Up/(down)	31 st Dec, 2004 HK\$ million
Property related	21,213	+12.0%	18,935
Financial concerns	1,486	-1.4%	1,507
Wholesale & retail trade	1,684	+7.3%	1,570
Manufacturing	1,860	+2.0%	1,823
Transport & transport equipment	4,198	-6.9%	4,507
Residential mortgages, HOS/PSPS	39,414	+8.1%	36,450
Credit card	1,371	-16.9%	1,649
Others	9,343	+0.9%	9,263
Trade finance	4,175	+2.0%	4,092
Stockbrokers	177	-36.4%	278
Loans outside HK	43,497	+17.0%	37,184
	128,418	+9.5%	117,259
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III. Comparison of the Bank of East Asia's loan book : 30/06/2005 Vs 30/06/2004

Loans-by industry	30 th Jun, 2005 HK\$ million	Up/(down)	30 th Jun, 2004 HK\$ million
Property related	21,213	+24.3%	17,068
Financial concerns	1,486	+17.6%	1,264
Wholesale & retail trade	1,684	+3.4%	1,628
Manufacturing	1,860	+43.4%	1,297
Transport & transport equipment	4,198	-12.0%	4,771
Residential mortgages, HOS/PSPS	39,414	+12.2%	35,122
Credit card	1,371	+9.3%	1,255
Others	9,343	+18.3%	7,895
Trade finance	4,175	+13.2%	3,689
Stockbrokers	177	-25.3%	237
Loans outside HK	43,497	+38.2%	31,467
	128,418	+21.5%	105,693
	=====		=====



Breakdown of loan book of the Bank of East Asia

