

First Read

Hang Seng Bank

Sale of 5% of Industrial Bank a good move

A good disposal

The sale of 5% of HSB's 10.87% holding in Industrial Bank looks like a good transaction for shareholders. The stake we believe has been for sale for some time now (it was reclassified as "available for sale" some time ago). Given Industrial Bank's strong recent share price performance, we believe the sale, at a 7% discount to the closing price on the day of transfer, is good news. The disposal proceeds will be HK\$15.79 (5.8% of Hang Seng's market cap) and result in a HK\$2.8bn gain booked in the 2015 P&L. Over time we would expect the group to look to dispose of the remaining stake.

A big boost to capital ratios

Prior to the sale we believe Hang Seng's fully loaded Basel III capital ratio was too low at c9.4% (end H1 14). Under regulatory capital rules we believe the Industrial Bank stake will have been deducted from CET1. The removal of this drag and the inclusion of the net gain on sale proceeds is said to add 4.1% to the group's "fully loaded" Basel III capital ratios. We estimate that post sale the CET1 ratio will be c13.5-13.8%. This will leave the group's capital position unquestionably strong.

Too soon to talk of special dividends?

We think it is premature to think of a special dividend at this stage. The group's capital ratios have received a large boost, however, we believe it should look to run with a CET1 ratio of over 12%. Indeed the HKMA recently announced a counter-cyclical capital buffer of 2.5% and Hang Seng is likely to be classified as a domestically systemically important financial institution pushing capital requirements even higher. We also see scope for more risk-weighted asset inflation in coming years. As such we think it is too soon to talk of large special dividends (this would require a sale of the remaining stake). With the drag of Industrial Bank on capital to an extent removed, it does however give scope for a more progressive ordinary dividend in future.

Valuation: We think the stock is fully valued

Our DCF-derived target price for Hang Seng Bank uses a 15.5% sustainable RoE and 10% cost of equity. We believe the stock looks fully valued, hence our Sell rating.

Equities

Hong Kong
Banks, Ex-S&L

12-month rating

Sell

12m price target

HK\$120.00

Price

HK\$142.80
RIC: 0011.HK **BBG:** 11 HK

Trading data and key metrics

52-wk range	HK\$144.90-118.30
Market cap.	HK\$273bn/US\$35.5bn
Shares o/s	1,913m (ORD)
Free float	38%
Avg. daily volume ('000)	1,515
Avg. daily value (m)	HK\$200.2
Common s/h equity (12/14E)	HK\$114bn
P/BV (12/14E)	2.4x
Tier 1 ratio	12%

EPS (UBS, diluted) (HK\$)

	UBS	Cons.
12/14E	8.73	8.74
12/15E	9.39	9.82
12/16E	10.12	10.64

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Highlights (HK\$m)	12/11	12/12	12/13	12/14E	12/15E	12/16E	12/17E	12/18E
Revenues	22,597	24,381	28,062	29,301	31,663	34,339	37,277	40,479
Profit before tax	19,255	21,994	28,496	19,623	20,769	22,567	24,617	27,031
Net earnings (local GAAP)	16,885	19,327	26,678	16,778	17,758	19,295	21,047	23,112
Net earnings (UBS)	16,144	18,439	16,424	16,688	17,946	19,355	21,107	23,172
Tier 1 ratio %	11.6	12.2	13.8	11.9	12.3	12.8	13.4	14.0
EPS (UBS, diluted) (HK\$)	8.44	9.64	8.59	8.73	9.39	10.12	11.04	12.12
Profitability/valuation	12/11	12/12	12/13	12/14E	12/15E	12/16E	12/17E	12/18E
ROE (UBS) %	21.6	21.4	16.4	15.1	15.3	15.4	15.7	15.9
P/POP (diluted)	14.8	13.0	12.4	13.7	12.6	11.5	10.5	9.6
P/BV x	2.7	2.2	2.2	2.4	2.3	2.1	2.0	1.8
P/BV (UBS) x	3.0	2.4	2.4	2.6	2.5	2.3	2.1	2.0
P/E (UBS, diluted)	13.5	11.2	14.4	16.4	15.2	14.1	12.9	11.8
Net dividend yield %	4.5	4.9	4.4	3.9	3.9	4.0	4.2	4.5

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied. Valuations: based on an average share price that year, (E): based on a share price of HK\$142.80 on 10 Feb 2015 22:38 HKT

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Forecast returns

Forecast price appreciation	-16.0%
Forecast dividend yield	3.9%
Forecast stock return	-12.1%
Market return assumption	6.7%
Forecast excess return	-18.8%

Statement of Risk

The primary risks related to the HK banking sector and to Hang Seng are macroeconomic related. Changes in overall economy, particularly with regards to the unemployment rate, trade performance, and property prices, could affect our estimates. An uncertain interest rate outlook adds to earnings and valuation volatility for HK banks. HK have large proportions of their balance sheets linked to US\$ denominated assets. Should interest rates rise sharply after being so low for such a prolonged period of time this could lead to an asset price correction in Hong Kong and rising loan impairment charges. This could present significant downside risk to our current earnings forecasts. In addition, the "RMB internationalisation" has clearly increased the inter-linkages between the China and HK banking systems. If China's banks have a hard landing, the HK banking system is likely to be significantly affected as well.

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12-Month Rating	Definition	Coverage ¹	IB Services ²
Buy	FSR is > 6% above the MRA.	47%	37%
Neutral	FSR is between -6% and 6% of the MRA.	42%	32%
Sell	FSR is > 6% below the MRA.	11%	21%
Short-Term Rating	Definition	Coverage ³	IB Services ⁴
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

Source: UBS. Rating allocations are as of 31 December 2014.

1:Percentage of companies under coverage globally within the 12-month rating category. 2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

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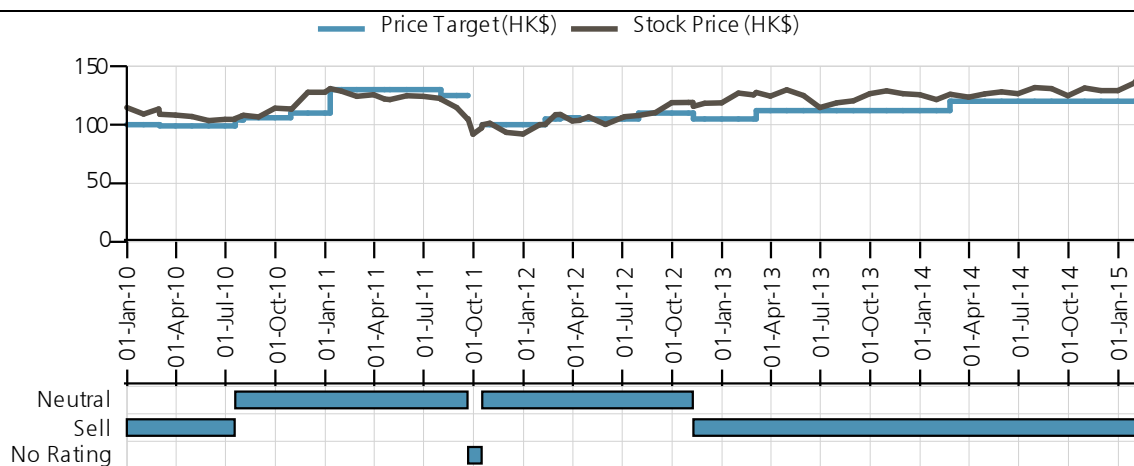
Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Hang Seng Bank	0011.HK	Sell	N/A	HK\$142.80	10 Feb 2015

Source: UBS. All prices as of local market close.

Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

Hang Seng Bank (HK\$)



Source: UBS; as of 10 Feb 2015

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