



Rating
Sell

Asia
Hong Kong

Banking / Finance
Banks

Company
Hang Seng Bank

Reuters 0011.HK	Bloomberg 11 HK	Exchange HSI	Ticker 0011
ADR Ticker HSNGY	ISIN US41043C3043		

Date
21 February 2018

Results

Price at 20 Feb 2018 (HKD)	189.20
Price target - 12mth (HKD)	169.00
52-week range (HKD)	194.50 - 153.40
HANG SENG INDEX	31,115

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Earnings resilient but dividend continues to lag. Sell

DPS is likely to move up only on a steady path

HSB's premium valuation is a reflection of the quality of its retail franchise and earnings stability, as seen in today's result (2% above Dbe). Moreover, its dividend policy has historically been one of the key stock price drivers. However, in today's results, there was no positive surprise – a progressive absolute dividend payout of HKD6.70/share in FY17 (+10% YoY). The current yield looks low (3.9%) vs. the historical average (~5%) as the increase in dividend payout fell to catch up to share price expectations. At 2.5x P/B and 14% 2018E RoE, the valuation looks demanding; maintaining Sell.

Key highlights of 2H17 results:

- **Net interest income (+8% HoH, +13% YoY)** was supported by loan growth (+8% HoH) although margins remained flat at 1.94% HoH, due to loan competition for corporate lending.
- **Non-interest income (-16% HoH, +20% YoY)** was largely attributable to lower FX and trading gains, while fees remained resilient (+5% HoH, +12% YoY). WM income fell 16% HoH (+26% YoY).
- **Asset quality** remains benign, with the impaired loan % at 24bps (1H17: 42bps) while credit costs dropped to 10bps (1H17: 19bps). Provision coverage improved to 81% (from 68% in 1H17). Overdue loans fell to 20bps (1H17: 26bps).
- **Loans (+8% HoH) and deposits (+6% HoH):** Loan growth was strong, supported by overseas lending (+13% HoH) while domestic lending rose (+7% HoH) on corporate property (+7%), financial concerns (+33%), mortgages (+5%) and credit cards (+15%). LDR tightened to 73% (1H17: 71%), with better CASA at 79% (1H17: 78%).
- **Others – capital:** CET1 remained strong at 16.5% (1H17: 16.2%), and should be 15.5% after stripping out the 4Q17 dividend. **CTI** was 33% (1H17: 30%) and annualized **RoE** was 14.4% (1H17: 14.5%).

Maintaining Sell; key analysts' briefing takeaways; risks

As expected, much of the focus of the analysts' briefings was on dividend policy and NIM trend – the 2H17 outcome was a disappointment, in our view. As discussed above, dividend payout remains a crucial share price driver for HSB, on which expectations have run ahead of fundamentals. Due to progressive absolute DPS policy, the payout ratio actually fell to 64% (FY16: 72%) – not to mention that this ratio is already much higher than that of SG banks (our preferred sector). Management also highlighted that there is a risk of higher RWA reflation from the final Basel ruling (vulnerable given HSB's lowest risk weight density among coverage banks), which could put pressure on seemingly higher CET1. The NIM transmission from higher rates have been low in 2H17 largely due to loan competition and HIBOR has been relatively flat on an average basis. While the bank believes higher rates in the US should continue to benefit the bank's NIM, this has been largely factored into expectations already and if HSB has to issue TLAC bonds in the future, this could also result in higher cost of funds.

Price/price relative



Performance (%)	1m	3m	12m
Absolute	-0.2	2.4	16.0
HANG SENG INDEX	-3.5	6.3	28.9

Source: Deutsche Bank

Stock data

Market cap (HKDm)	361,713
Market cap (USDm)	46,239
Shares outstanding (m)	1,911.8
Major shareholders	HSBC (62.7%)
Free float (%)	37
Avg daily value traded (USDm)	29.3

Source: Deutsche Bank

We value HSB using a GGM. Upside risk: higher rates leading to significant margin expansion. Downside risk: a significant property price drop



Key operating trends

Figure 1: HSB 2H17 results summary

	2H17	1H17	2H16	HoH (%)	YoY (%)	Comments
P&L account (HKD m)						
Net interest income	12,763	11,814	11,251	8.0	13.4	Helped by loan growth, although NIM was flat
Net fee income	3,461	3,294	3,086	5.1	12.2	
Other non-interest income	1,476	2,549	1,045	-42.1	41.2	Lower FX and trading gains
Total income	17,700	17,657	15,382	0.2	15.1	
Operating expenses	-5,513	-5,255	-5,272	4.9	4.6	
Pre-provision profit	12,187	12,402	10,110	-1.7	20.5	
Bad debt charges	-372	-670	-592	-44.5	-37.2	NPL fell by 18bps to 24bps
Operating profit	11,815	11,732	9,518	0.7	24.1	
Non-recurring items and others	213	-86	73	-347.7	191.8	
Pre-tax profit	12,028	11,646	9,591	3.3	25.4	
Taxation & minority	-1,844	-1,812	-1,384	1.8	33.2	
Net profit	10,184	9,834	8,207	3.6	24.1	
EPS (HKD)	5.3	5.1	4.3	3.6	24.1	
DPS (HKD)	4.3	2.4	3.9	79.2	10.3	
BVS (HKD)	75.9	72.1	69.9	5.2	8.5	
Balance sheet (HKD m)						
Advances to customers (gross)	808,170	745,299	700,851	8.4	15.3	Helped by overseas lending
Deposits (incl. CDs, SDs)	1,175,923	1,105,038	1,080,073	6.4	8.9	CASA improved to 79% (1H17: 78%)
Key ratios (%)				HoH bps	YoY bps	
Return on equity	14.4	14.5	12.5	-9	193	
Return on assets	1.4	1.4	1.2	0	20	
Net interest margin	1.94	1.94	1.85	0	9	
Costs/income	31.1	29.8	34.3	139	-313	
LDR	68.7	67.4	64.9	128	384	
CET 1 ratio	16.5	16.2	16.6	34	-12	15.5% post 4Q17 dividend
Gross NPL ratio	0.24	0.42	0.46	-18	-22	
Annualised credit costs	0.10	0.19	0.17	-9	-8	

Source: Deutsche Bank, Company data

Positives:

- **Strong loan growth** (+8%) and stable deposit growth (+6% including CDs), with CASA further improving to 79%
- **Asset quality** – continues to improve, with the NPL ratio at 24bps (1H17: 42bps), resulting in much lower credit costs at an annualized 10bps (1H17: 19bps)
- **Strong capital ratios** – CET1 is at 16.5% (1H17: 16.2%) – with post dividend ratio at 15.5% (1H17: 15.8%).

Negatives:

- **Net interest margin** was flat HoH at 1.94%
- **Non-interest income** fell on lower FX and trading gains.



2H17 operating trends

Figure 2: HSB net interest margin

Margin was flat

%	2H17	1H17	2H16	bps HoH	bps YoY
Net interest margin	1.94%	1.94%	1.85%	0	9
				% HoH	% YoY
Net interest income (HKD m)	12,763	11,814	11,251	8.0	13.4
AIEA (HKD m)	1,303,983	1,230,985	1,203,355	5.9	8.4

Source: Deutsche Bank, Company data

Figure 3: Non-interest income breakdown

Non-interest income fell due to lower FX gains and trading profits. Fee franchise remained resilient

HKD m	2H17	1H17	2H16	% HoH	% YoY
Gross fees & commissions	4,791	4,418	4,266	8.4	12.3
Less: fees & commission expenses	-1,330	-1,124	-1,180	18.3	12.7
Net fees & commissions	3,461	3,294	3,086	5.1	12.2
FX gains	915	1,169	1,023	-21.7	-10.6
Rental income	0	0	0	n/a	n/a
Profit from trading	866	1,207	310	-28.3	179.4
Net revenue from insurance activities	-981	-921	-1,449	6.5	-32.3
Dividend income	181	7	16	2,485.7	1,031.3
Others	495	1,087	1,145	-54.5	-56.8
Total non-interest income	4,937	5,843	4,131	-15.5	19.5

Source: Deutsche Bank, Company data

Figure 4: Net fee income breakdown

Fee income growth was led by brokerage

HKD m	2H17	1H17	2H16	% HoH	% YoY
Securities broking and related	953	720	630	32.4	51.3
Retail investment funds	925	969	832	-4.5	11.2
Insurance agency	293	293	412	0.0	-28.9
Account services	265	246	235	7.7	12.8
Remittances	285	255	247	11.8	15.4
Cards	1,453	1,289	1,323	12.7	9.8
Credit facilities	204	259	190	-21.2	7.4
Trade services	218	203	207	7.4	5.3
Others	195	184	190	6.0	2.6
Total fee income	4,791	4,418	4,266	8.4	12.3
Total fee expenses	-1,330	-1,124	-1,180	18.3	12.7
Net fee income	3,461	3,294	3,086	5.1	12.2

Source: Deutsche Bank, Company data



Figure 5: Gross NPL and credit costs (%)

%	2H17	1H17	2H16	bps HoH	bps YoY
Gross NPL ratio	0.24	0.42	0.46	-17.7	-21.8
Annualised credit costs	0.10	0.19	0.17	-9.0	-7.6

Source: Deutsche Bank, Company data

Asset quality metrics improved HoH.

Provision coverage improved to 81% (1H17: 68%). This was mainly due to lower gross NPLs.

Figure 6: Loans and advances breakdown by sector

HKD m	2H17	1H17	2H16	% HoH	% YoY	Composition %
Industrial, commercial & financial sectors						
Property development	62,715	57,788	51,935	8.5	20.8	7.8
Property investments	136,214	128,985	119,553	5.6	13.9	16.9
Financial concerns	8,757	6,574	5,049	33.2	73.4	1.1
Stockbrokers	150	50	141	200.0	6.4	0.0
Wholesale and retail trade	27,523	27,363	26,880	0.6	2.4	3.4
Manufacturing	23,548	24,359	23,079	-3.3	2.0	2.9
Transport and transport equipment	14,153	13,255	9,302	6.8	52.2	1.8
Other commercial	72,257	60,961	53,195	18.5	35.8	8.9
Sub-total: corporate	345,317	319,335	289,134	8.1	19.4	42.7
Individuals						
Loans for HOS/PSPS	22,046	20,361	17,808	8.3	23.8	2.7
Mortgages	174,068	165,778	161,165	5.0	8.0	21.5
Credit cards	29,229	25,458	27,019	14.8	8.2	3.6
Other personal	24,888	24,222	20,385	2.7	22.1	3.1
Sub-total: individuals	250,231	235,819	226,377	6.1	10.5	31.0
Trade finance	47,125	43,230	43,235	9.0	9.0	5.8
Loans for use outside HK	165,497	146,915	142,105	12.6	16.5	20.5
Total	808,170	745,299	700,851	8.4	15.3	100.0

Source: Deutsche Bank, Company data

Loan growth was led by overseas lending.

Figure 7: HSB's deposit breakdown by type

HKD m	2H17	1H17	2H16	% HoH	% YoY
Current	117,525	105,628	99,051	11.3	18.7
Savings	757,828	713,849	686,371	6.2	10.4
Time	235,991	228,178	230,207	3.4	2.5
Total	1,111,344	1,047,655	1,015,629	6.1	9.4

Source: Deutsche Bank, Company data

The CASA ratio improved further to 79% (1H17: 78%), with LDR tightening to 73% (1H17: 71%).

Figure 8: HSB's capital ratios (%)

%	2H17	1H17	2H16	bps HoH	bps YoY
CET 1 ratio	16.5	16.2	16.6	34	-12
Tier 1 capital ratio	17.7	17.4	17.9	30	-22
Total CAR	20.1	20.2	20.8	-10	-67
LCR	225.9	262.2	268.8	-660	510
				% HoH	% YoY
Risk Weighted Assets (HKD m)	572,723	555,759	528,268	3.1	8.4

CET1 % remains strong – and should fall to 15.5% after the 4Q17 dividend.



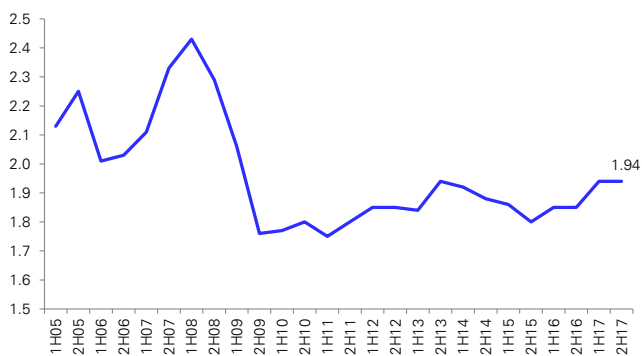
Source: Deutsche Bank, Company data

Figure 9: HSB's business segment performance in HK – 2H17

Profit & Loss account (HKD m)	Personal			Corporate			Global Banking and Markets		
	2H17	% HoH	% YoY	2H17	% HoH	% YoY	2H17	% HoH	% YoY
Net interest income	7,048	6.5	14.1	3,742	13.8	19.9	1,984	0.8	0.6
Operating income	2,492	-21.8	36.0	1,227	-15.5	7.3	767	-24.1	-9.1
Total operating income	9,540	-2.7	19.1	4,969	4.8	16.5	2,751	-7.7	-2.3
Operating expenses	-3,214	1.4	-1.7	-1,479	10.6	17.4	-460	-9.3	-1.7
Operating profit before provisions	6,326	-4.7	33.4	3,490	2.6	16.1	2,291	-7.3	-2.5
Provisions for bad & doubtful debts	-229	-12.3	-37.6	-134	-67.3	-38.5	-9	n.m	28.6
Operating profit	6,097	-4.3	39.4	3,356	12.1	20.4	2,282	-7.7	-2.6
Income from associates	124	-191.2	275.8	0	n.m	n.m	0	n.m	n.m
PBT	6,221	-0.3	41.2	3,356	12.1	20.4	2,282	-7.7	-2.6

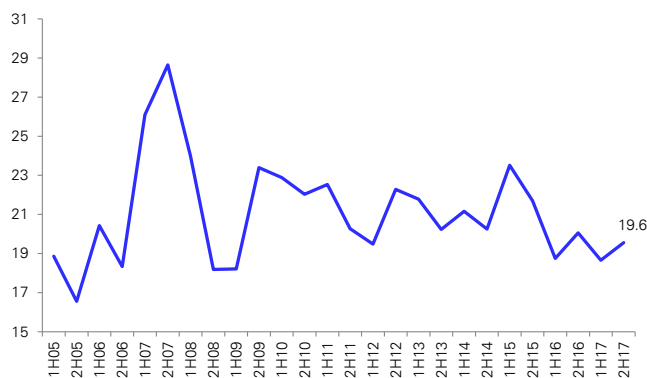
Source: Deutsche Bank, Company data

Figure 10: HSB: net interest margin (%) trend



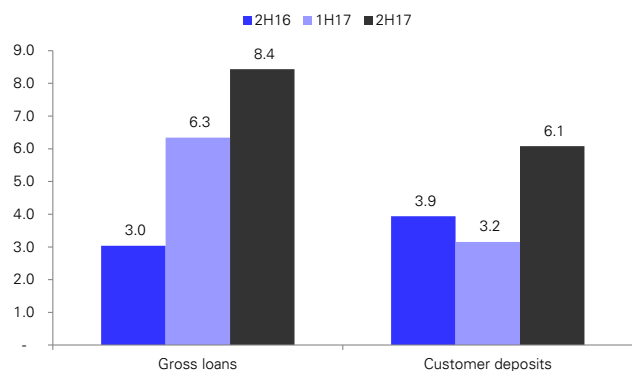
Source: Deutsche Bank, Company data

Figure 11: HSB: fee income as a % of operating income



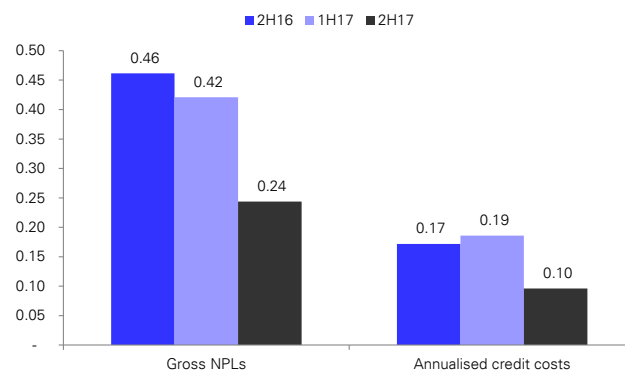
Source: Deutsche Bank, Company data

Figure 12: HSB: loan and deposit growth (% HoH)



Source: Deutsche Bank, Company data

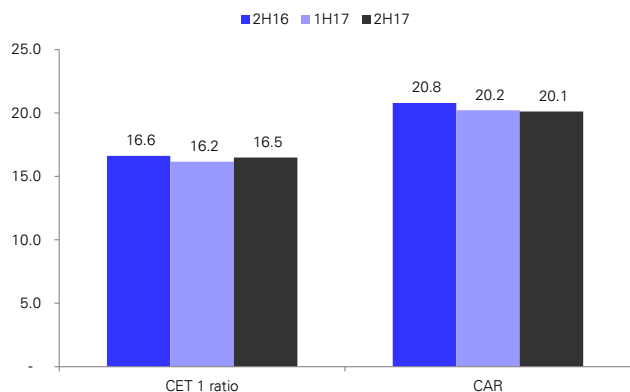
Figure 13: HSB: asset quality ratios (%)



Source: Deutsche Bank, Company data

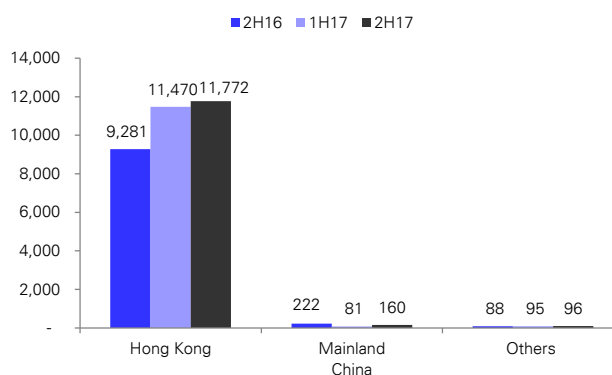


Figure 14: HSB: capital ratios (%)



Source: Deutsche Bank, Company data

Figure 15: Geographical contribution to PBT (HKD m)



Source: Deutsche Bank, Company data

Valuation and risks

Valuation

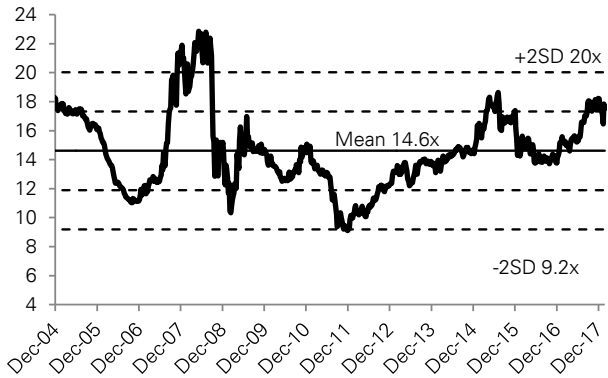
We value HSB using the average of (1) Gordon Growth Model ($P/B = ROE-g/COE-g$) to obtain a target price-to-book ratio. Our key assumptions are a sustainable ROE of 16%, a cost of equity of 8%, and a long-term growth rate of 2%. This gives us a target price-to-book-value ratio of 2.3x and, when applied to the end of 2018 book value, it yields our 12-month target price. In our GGM target price, the property reserves' valuation amounts to HKD9/share. In view of continued elevated property prices, we believe the MTM of self-owned premise method increasingly discounts the core operation RoE of the bank. Therefore, we separate it out to more accurately reflect the higher sustainable core operation RoE of the bank and (2) SOTP for 2018E from its business mix. Given the benefits of having one of the highest LCR in the region and the highest contribution from retail banking, with one of the safest conventional banks, we believe applying a higher multiple for the bank makes sense. Hence, we apply 17.5x P/E for its retail banking franchise (e.g. referencing the P/E multiple of "The List" EM banks) and 13.5x for corporate/others (e.g. similar to the Australian banks' P/E multiple). The proportion of estimated earnings is as follows: 58% in retail, 25% in corporate, 26% in treasury, 4% in insurance and 6% in others.

Risks

Key upside risks include: (1) a worse-than-expected economic outlook, which should lead the market to assign a premium to HSB's defensiveness, and (2) a significant earnings improvement from rate hikes.

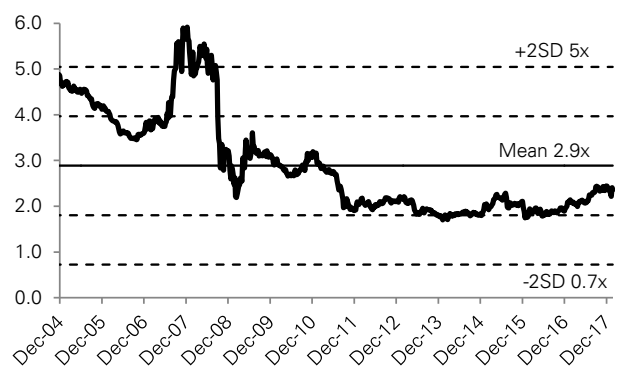


Figure 16: HSB: One-year forward P/E



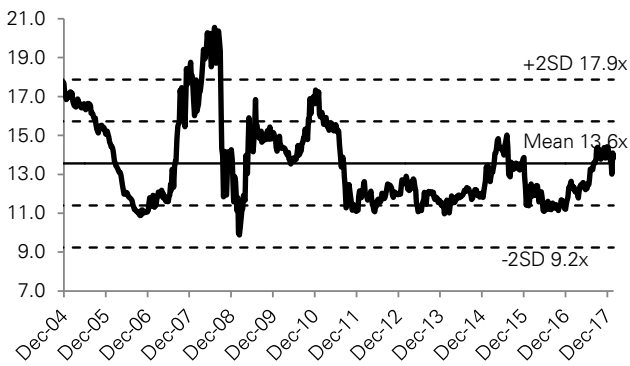
Source: Deutsche Bank

Figure 17: HSB: One-year forward P/B



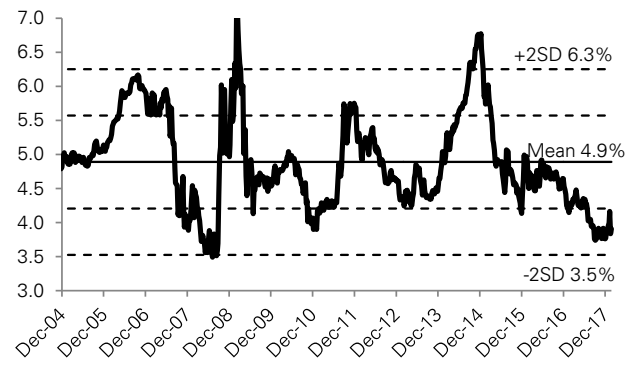
Source: Deutsche Bank

Figure 18: HSB: One-year forward P/POPOP



Source: Deutsche Bank

Figure 19: HSB: One-year forward Dividend yield



Source: Deutsche Bank



Model updated: 20 February 2018

Fiscal year end 31-Dec

2015 2016 2017 2018E 2019E 2020E

Running the numbers

Asia
Hong Kong
Banks

Hang Seng Bank

Reuters: 0011.HK Bloomberg: 11 HK

Sell

Price (20 Feb 18)	HKD 189.20
Target Price	HKD 169.00
52 Week range	HKD 153.40 - 194.50
Market Cap (m)	HKDm 361,713 USDm 46,239

Company Profile

Founded in 1933, Hang Seng Bank Limited (HSB) is the second-largest domestic commercial bank in HK by asset and deposit franchise. The bank provides a wide range of banking and related financial services, including personal wealth management, corporate banking, treasury and private banking. HSB also established a local incorporation in China in 2007 and currently operates 18 outlets on the mainland. The HSBC Group is its largest strategic shareholder, with a 62% stake.

Data Per Share

EPS (stated) (HKD)	14.38	8.48	10.47	10.64	11.66	12.37
EPS FD (stated) (HKD)	14.38	8.48	10.47	10.64	11.66	12.37
EPS FD (DB adj.) (HKD)	9.17	8.46	10.41	10.65	11.66	12.38
Growth rate - EPS (stated) (%)	81.71	-41.03	23.48	1.61	9.55	6.13
DPS (HKD)	8.70	6.10	6.70	7.30	7.90	8.10
BVPS (stated) (HKD)	70.61	69.91	75.87	79.43	83.42	87.54
BVPS (DB adj.) (HKD)	70.61	69.91	75.87	79.43	83.42	87.54
Average market cap	277,411	261,721	325,631	361,713	361,713	361,713
Shares in Issue (m)	1,912	1,912	1,912	1,912	1,912	1,912

Valuation Ratios & Profitability Measures

P/E (stated)	10.1	16.1	16.3	17.8	16.2	15.3
P/E FD (stated)	10.1	16.1	16.3	17.8	16.2	15.3
P/E FD (DB adj.)	15.8	16.2	16.4	17.8	16.2	15.3
P/B (stated)	2.1	2.1	2.6	2.4	2.3	2.2
P/B (DB adj.)	2.1	2.1	2.6	2.4	2.3	2.2
ROE (stated.) (%)	20.6	12.1	14.4	13.7	14.3	14.5
ROA (adj.) (%)	2.1	1.2	1.4	1.3	1.4	1.4
Dividend yield(%)	6.0	4.5	3.9	3.9	4.2	4.3
Dividend cover(x)	1.7	1.4	1.6	1.5	1.5	1.5
Payout ratio (%)	60.5	71.9	64.0	68.6	67.8	65.5

Profit & Loss (HKDm)

Net interest revenue	21,165	22,254	24,577	27,433	30,264	32,854
Non interest income	9,888	8,345	10,780	9,711	10,307	11,223
Fees & Commissions	7,038	5,939	6,755	7,344	7,914	8,274
Trading Revenue	1,912	1,758	4,157	2,726	2,768	2,812
Insurance revenue	-3,123	-2,475	-1,902	-2,000	-2,000	-1,500
Dividend income	142	190	188	207	227	250
Other revenue	3,919	2,933	1,582	1,434	1,397	1,388
Total revenue	31,053	30,599	35,357	37,144	40,571	44,077
Total operating costs	10,482	10,252	10,768	11,429	12,182	13,083
Pre-provision profit/(loss)	20,571	20,347	24,589	25,715	28,389	30,994
Bad debt expense	1,132	1,313	1,042	1,651	2,028	3,017
Operating Profit	19,439	19,034	23,547	24,063	26,361	27,977
Goodwill	0	0	0	0	0	0
Pre-tax associates	152	93	-14	-14	-14	-14
Extraordinary & Other Items	10,897	-37	141	0	0	0
Pre-tax profit	30,488	19,090	23,674	24,049	26,347	27,963
Tax	2,994	2,886	3,671	3,717	4,072	4,322
Minorities	0	-8	-15	-8	-8	-8
Preference dividends	0	0	0	0	0	0
Stated net profit	27,494	16,212	20,018	20,340	22,283	23,649
DB adj. core earnings	17,530	16,164	19,911	20,352	22,294	23,661

Key Balance Sheet Items (HKDm) & Capital Ratios

Risk-weighted assets	509,474	528,268	572,723	645,390	710,475	774,642
Interest-earning assets	1,250,564	1,289,232	1,385,576	1,479,880	2,222,376	1,624,296
Total loans	690,561	700,851	808,170	874,026	918,251	964,715
Total deposits	1,041,318	1,080,073	1,175,923	1,258,984	1,323,424	1,378,380
Stated shareholders equity	135,000	133,645	145,049	151,852	159,480	167,354
Preference share capital	na	na	na	na	na	na
Tier 1 capital	97,257	94,748	101,439	102,003	110,344	124,830
Tier 1 ratio (%)	19	18	18	16	16	16
Tangible equity/ total assets (%)	10	10	10	10	10	10

Credit Quality

Gross NPLs / Total loans (%)	0.4	0.5	0.2	0.3	0.4	0.6
Provisions / NPLs (%)	59.0	57.5	81.1	96.7	102.9	106.2
Bad debt exp/ Avg loans (%)	0.2	0.2	0.1	0.2	0.2	0.3

Growth Rates & Key Ratios

Growth in net interest income (%)	6.5	5.1	10.4	11.6	10.3	8.6
Growth in fee income (%)	12.6	-15.6	13.7	8.7	7.8	4.5
Growth in non-interest income (%)	-4.3	-15.6	29.2	-9.9	6.1	8.9
Growth in revenues (%)	2.8	-1.5	15.5	5.1	9.2	8.6
Growth in costs (%)	9.0	-2.2	5.0	6.1	6.6	7.4
Pre-provision earnings growth (%)	-0.1	-1.1	20.8	4.6	10.4	9.2
Growth in bad debts (%)	-1.0	16.0	-20.6	58.5	22.8	48.8
Growth in RWA (%)	8.4	3.7	8.4	12.7	10.1	9.0
Growth in loans (%)	4.6	1.5	15.3	8.1	5.1	5.1
Growth in deposits (%)	5.0	3.7	8.9	7.1	5.1	4.2
Loan-to-deposits ratio (%)	66.3	64.9	68.7	69.4	69.4	70.0
Net int. margin (%)	1.8	1.8	1.8	2.0	2.1	2.1
Cost income ratio (%)	33.8	33.5	30.5	30.8	30.0	29.7
Cost asset ratio (%)	0.8	0.8	0.8	0.7	0.8	0.8
Trading income/ Total Rev (%)	6.2	5.7	11.8	7.3	6.8	6.4

Source: Company data, Deutsche Bank estimates





Appendix 1

Important Disclosures

Additional information available upon request

Disclosure checklist

Company	Ticker	Recent price*	Disclosure
Hang Seng Bank	0011.HK	189.20 (HKD) 20 Feb 18	7,14,15

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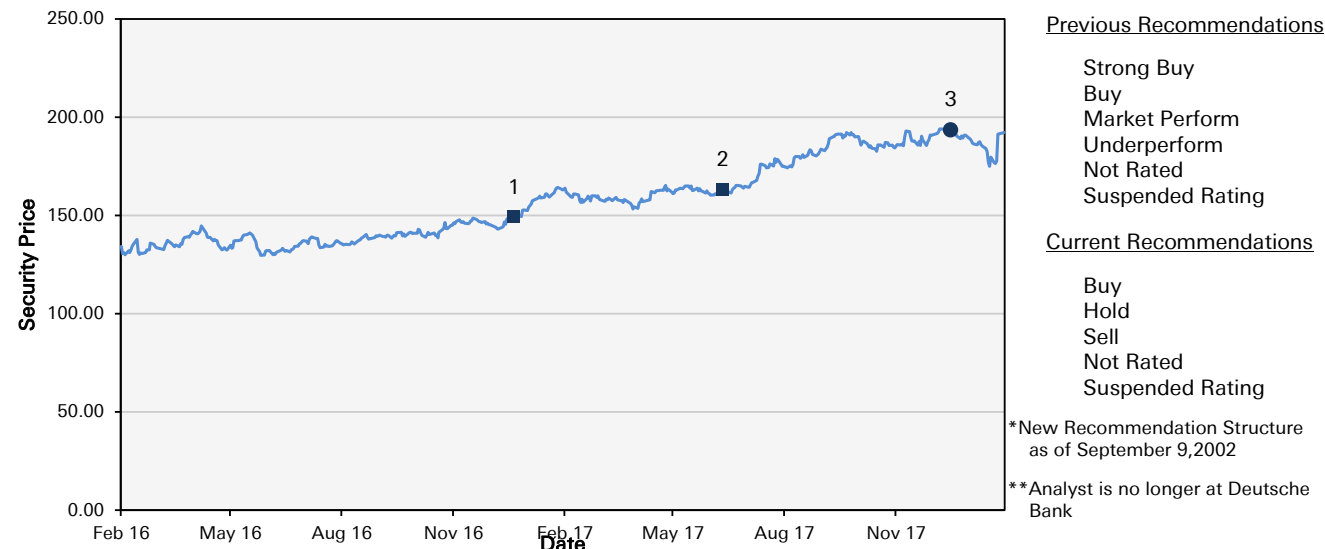
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Historical recommendations and target price: Hang Seng Bank (0011.HK)

(as of 2/20/2018)



1.	12/01/2017:	Hold, Target Price Change HKD145.00 Franco Lam	3.	07/01/2018:	Downgrade to Sell, Target Price Change HKD169.00 Franco Lam
2.	03/07/2017:	Hold, Target Price Change HKD158.00 Franco Lam			

Equity rating key

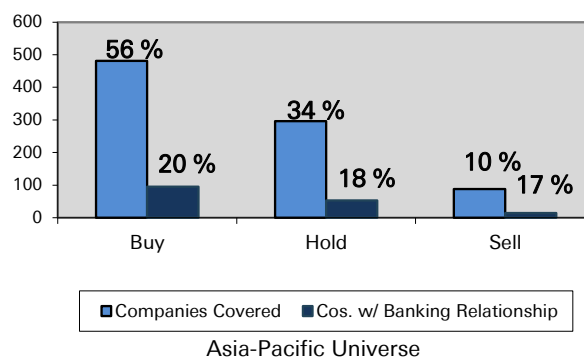
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Sell: Based on a current 12-month view of total share-holder return, we recommend that investors sell the stock

Hold: We take a neutral view on the stock 12-months out and, based on this time horizon, do not recommend either a Buy or Sell.

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