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HSBC (0005.HK)
HOLD

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Price (HK\$)	86.6	<ul style="list-style-type: none"> ▪ HSBC FY09 earnings miss for lower trading profit in 2H09 ▪ FY10 earnings rely heavily on magnitude of US bad-debt charges reduction ▪ Earnings forecast to rise 28% to US\$7.5bn assuming 20% reduction in US credit losses ▪ TP of HK\$88.8 on 1.6x FY09 P/Book and 18x FY11 P/E
Target price (HK\$)	88.8	
Mkt Cap (HK\$bn)	1,418,163	
52-week high	98.25	
52-week low	30.56	
Avg Vol (HK\$m)	2430.70	
FY09 PE (x)	32.65	
FY10 PE (x)	26.92	
Historic P/B (x)	1.55	
Forward P/B (x)	1.56	
FY09 ROE (%)	5.26	<p>Final results surprised market on the downside for weaker trading profit and reversal of revaluation gains of its owned debt issued in 2H09: Full-year reported net profit was US\$5.83bn, up 2% yoy, versus the market consensus of US\$8-11bn. We have made an earnings forecast of US\$5.5bn FY09 profit in Aug09. In FY08, HSBC reported yoy fall in profit of 70% yoy. Net profit for the 2H09 profit was US\$2.61bn, representing 21% hoh increase, versus market consensus expecting a HoH increase. The earnings miss are largely attributable to:</p> <ol style="list-style-type: none"> 1) Normalized trading profit of US\$3.6bn, 42% HoH fall from 1H09's record gains of US\$6.2bn 2) Further US\$4.7bn reversal of own-debt revaluation gains (1H09: US\$1.5bn) as prices of HSBC's issued bond rose and posted marked-to-market gains during 2H09. The deficits were attributable to continued credit spread improvement which mainly attributable to HSBC Finance (FY09 revaluation reversal: US\$3.5bn) as risk of imminent default of this unit faded.
FY09 Yield (%)	3.06	
FY10 Yield (%)	3.06	

The negative impact for these two factors has been larger than positive earnings contributions from

- 1) 10% HoH decline in credit losses and bad-debt charges to US\$12.5bn
- 2) US\$576m disposal gains from disposal of Paris headquarters,
- 3) Surprise tax credit of US\$901m in 2H09, versus tax expenses of US\$1.28bn in 1H09

HSBC Holdings (0005.HK)						
Profit & Loss						
YE Dec (US\$ mn)	1H08A	2H08A	1H09A	2H09A	YoY %	HoH %
Net interest income	21,178	21,385	20,538	20,192	(5.6)	(1.7)
Fees income	10,991	9,033	8,428	9,236	2.2	9.6
Trading profit	3,834	2,726	6,255	3,608	32.4	(42.3)
Dividend income	88	184	57	69	(62.5)	21.1
Other operating income	3,384	8,879	(537)	(1,665)	(118.8)	210.1
Operating income	39,475	42,207	34,741	31,440	(25.5)	(9.5)
Admin expenses	(20,140)	(18,395)	(16,658)	(17,737)	(3.6)	6.5
Amort/write-off of goodwill & except	(10,564)	-	-	-	n.m.	n.m.
Operating profit before	19,335	13,248	18,083	13,703	3.4	(24.2)
Bad debt & credit risk im	(10,058)	(14,879)	(13,931)	(12,557)	(15.6)	(9.9)
Operating profit	9,277	(1,631)	4,152	1,146	n.m.	(72.4)
Joint venture & associat	970	691	867	914	32.3	5.4
Profit before tax	10,247	(940)	5,019	2,060	n.m.	(59.0)
Taxation	(1,941)	(868)	(1,286)	901	(203.8)	(170.1)
MI	(584)	(186)	(386)	(474)	154.8	22.8
Net profit	7,722	(1,994)	3,347	2,487	n.m.	(25.69)

Source: Company Account, VC Estimates

Impact of owned-debt marked-to-market movement on earnings. In FY09, HSBC reported marked-to-market reversal of gains of US\$6.2bn which the management said not related its core performance as it reflects the improvement of HSBC's group credit spread. It compared with FY08's gains of US\$6.67bn. If the impact of own-debt revaluation and goodwill impairment losses were excluded, HSBC should have reported net profit of US\$12bn, up 25% yoy from FY09's US\$9.6bn.

EPS and Dividend – 100% payout ratio. EPS fell 17% yoy to US\$0.34 attributable to share dilution after the rights issue. HSBC proposed US\$0.10 fourth interim DPS, totalling full-year DPS of US\$0.34 representing 100% payout ratio. Excluding impact of goodwill impairment in FY08, the payout ratio in FY08 was 78.2%.

Book value improvement for lower valuation losses of AFS securities reserves and positive FX reserve. HSBC's net assets increased by US\$34bn, or 37% yoy to US\$128.3bn. The change in net assets are mainly comprised of 1) US\$18.3bn capital raised in rights issue, 2) US\$10bn reduction in deficits of AFS securities to US\$9.9bn thanks to price rebound in asset-backed securities, 3) US\$4.8bn increase in FX reserve from a deficit of US\$1.85bn to a surplus of US\$3bn, as dollar weakened during the period with GBP rallied 18%. Book value per share only fell 4% from US\$7.44 to US\$7.17.

Earnings contribution by geographic regions. Hong Kong is the largest earnings contributor to HSBC in FY09 with US\$5bn contribution to its pre-tax profit of US\$7bn. Asia ex-Middle East was the second largest contributor with US\$4.2bn profit, followed by Europe's US\$4bn. North America posted US\$7.7bn losses. Middle East's profit fell 75% to US\$455m.

Hong Kong and Asia are two regions demonstrating relative earnings stability, albeit falling 7% and 28% respectively. Earnings/losses from Europe and US were very volatile for 1) owned-debt revaluation gains and losses which hugely distorted its core earnings by overstating / understating profit during bad / good time; 2) Volatile trading gains and 3) Sharp movement in credit losses totalling US\$21.2bn, of which North America's portion is peaking out while Europe's portion is on the rise.

Earnings before tax (reported)						
USD mn	1H07A	2H07A	1H08A	2H08A	1H09A	2H09A
Europe	4,050	4,545	5,177	5,692	2,976	1,033
Hong Kong	3,330	4,009	3,073	2,388	2,501	2,528
Other Asia Pacific	3,344	2,665	3,624	2,844	2,022	2,633
North America	2,435	(2,344)	(2,893)	(12,635)	(3,703)	(4,035)
South America	1,000	1,178	1,266	771	580	544
	14,159	10,053	10,247	(940)	4,376	2,703

Source: VC Estimates

Earnings contribution by business segments. In FY09, Global Banking and Markets contributed US\$10.4bn pretax profit, up 200% yoy. The second largest contributor was commercial banking and its contribution was US\$4.2bn, down 40% yoy. Personal Financial Services' loss contribution amounted US\$2bn, down from FY09's US\$10.9bn losses largely due to non-recurrence of US\$10.5bn goodwill impairment for HSBC Finance (Household). If this non-cash item were excluded, loss expanded by US\$2bn. Private banking's pretax profit dropped 24% yoy to US\$1.1bn. In sum, HSBC's current earnings base relies heavily on Global Banking and Market including trading performance. However, the record trading performance in FY09 looks unlikely to recur in FY10.

FY10 earnings outlook: The earnings outlook for FY10 is cautiously positive. The non-recurrence of revaluation loss of owned-debts in 2010, or potential gains if recent credit market tightens further, may help to boost bottom-line earnings. Potential fall in US bad-debt charges after peaking out in 2H09, as its economy begins to stabilize, may also contribute increase in net profit. Sustained low interest rate environment will continue to support net interest margin at relatively high levels. These positive factors will help to reduce the impact of expected sharp fall in earnings contributions from trading profits and various disposal gains. FY10 earnings are expected to increase by 28% to US\$7.5bn.

Our assumption of US bad-debt charges trend – 20% drop. In projecting FY10 earnings, we have assumed 20% reduction in bad-debt charges in North America from US\$15.6bn to US\$12.5bn. We have taken the following factors into considerations: 1) initial signs of peak-out in consumer loans delinquencies; 2) risk of continued high charge-off ratios as HSBC Finance's attempt to offer loan consolidation and government's incentives to pause foreclosures may lengthen the provisioning process over years; 3) Tendency of continuously high delinquency during poor unemployment condition and pressure from high interest rates charged (HSBC Finance's NIM at 6.18%); 4) HSBC's personal financial services portfolio in North America is still sizable at US\$151bn; 5) Credit losses disclosed in the quarterly report from US banking groups.

Risk factors for earnings / NAV outlook:

- 1) Slow global economic recovery or potential double-dip recession will interrupt the actual pace of impairment loss decline, leaving the charges at currently record levels
- 2) Dubai crisis may add potentially hundred millions impairment in case of haircut.
- 3) Spill-over of Greece crisis and its impact on HSBC's bond portfolio which is sized to US\$378bn.
- 4) Potential fall in book value if British pound followed euro to fall further, as about 55% of HSBC's total assets are in Europe. We estimate about 20% fall in euro and pound will lead to about 6% fall in HSBC's book value
- 5) Trading performance is vulnerable to charges in prevailing market condition, which can weaken if euro problems unfolded

Valuation. HSBC is currently valued at 1.55x P/Book. HSBC's P/Book averaged at 2.11x since 1998 and followed a steady declining trend. On P/E valuation, HSBC is currently valued at 32x FY09 P/E and 27x FY10 P/E. The actual P/E valuation compared to HSBC's yearend closing price of HK\$89 was the highest levels according to our statistics since 1991.

Its forward P/E of 27x based on current price also placed current valuation at the high-end of valuation range over past two decades. As such, HSBC shares are hardly termed as undervalued from price-earnings multiple perspective, unless core earnings from US and Europe can demonstrate solid recovery. At present, North America and Europe remains HSBC's core business areas accounting for 53% and 20% of its total assets.

As HSBC shares have been close to its high-end valuation, upside earnings surprise in FY10 is necessary to support a sustainable valuation re-rating. Share pressure may build gradually if HSBC investors become unwilling to pay a premium for recovery story in its US consumer business. As discussed, HSBC's FY10's earnings still relies heavily on trading performance in UK and impairment losses movement in loss-contributing personal financial services business. HSBC may also need to find new growth drivers as historically highflying regions such as Middle East and Europe are beginning to show weakness. China and other emerging markets in Asia, which are currently premature to make significant contribution, should be its next business focus.

HOLD. We maintain our HOLD rating with TP unchanged at HK\$88.8, representing 17.8x FY11 P/E and 1.6 FY09 P/Book.

Financial Summary - HSBC (5 HK)

Year-end Dec	FY07A	FY08A	FY09A	FY10F	FY11F
Net profit (US\$m)	19,133	5,728	5,834	7,504	11,594
% yoy	21.18	-70.06	1.85	28.63	54.50
EPS (US\$)	1.65	0.41	0.34	0.41	0.64
% yoy	14.58	-75.15	-17.07	21.31	54.50
P/E (x)	6.73	27.08	32.65	26.92	17.42
DPS (US\$)	0.87	0.64	0.34	0.34	0.39
% yoy	14.47	-26.44	-46.88	0.00	15.00
Yield (%)	7.84	5.76	3.06	3.06	3.52
BVPS (US\$)	10.72	7.44	7.17	7.12	7.37
P/book (x)	1.04	1.49	1.55	1.56	1.51
ROE (%)	16.18	5.17	5.26	5.82	8.79
NIM (%)	2.76	3.08	2.86	2.83	2.83
Market price (HK\$)		86.60			

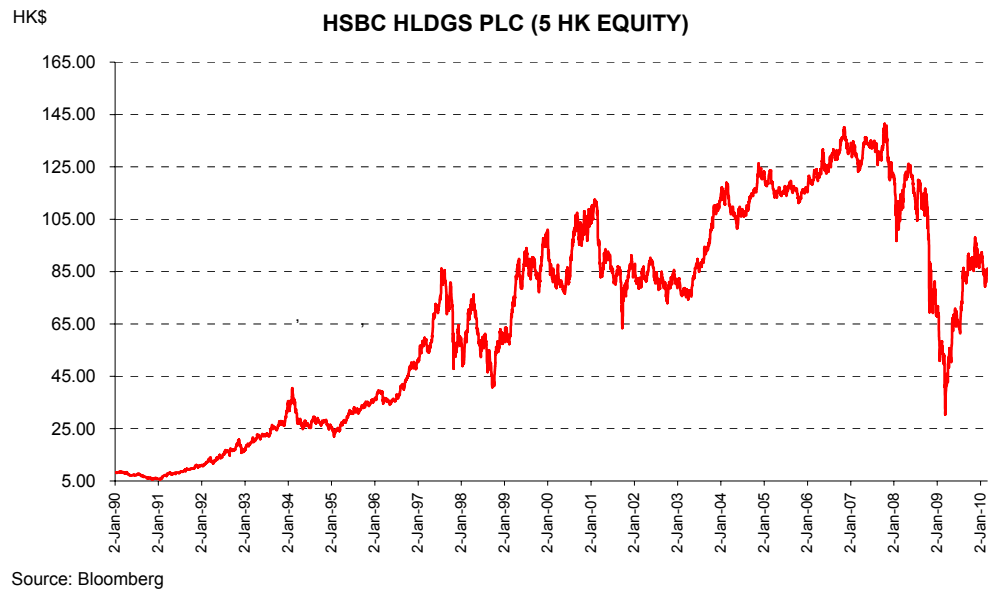
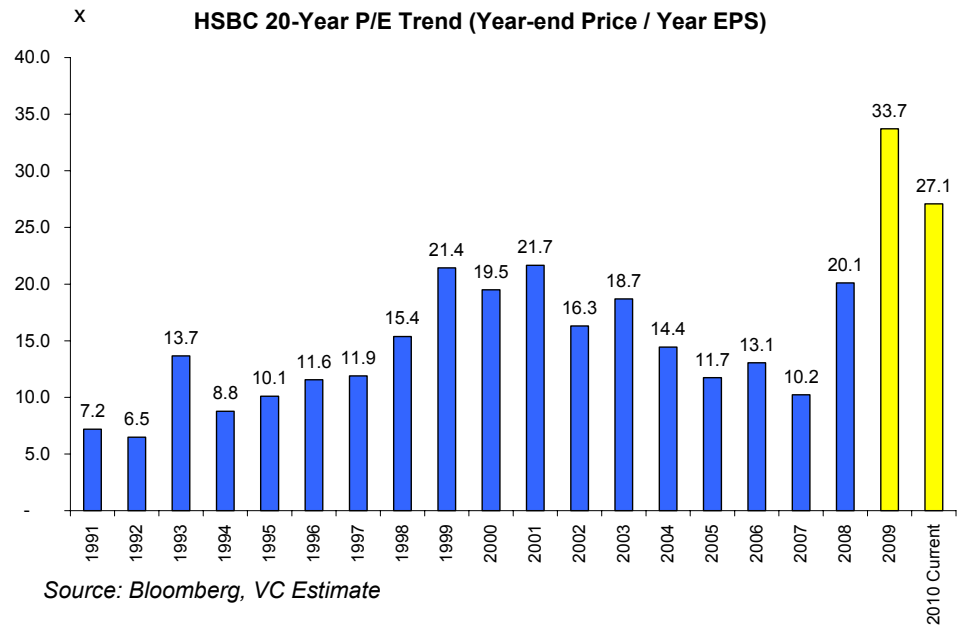
Source: Company, VC Brokerage

HSBC Holdings (0005.HK)

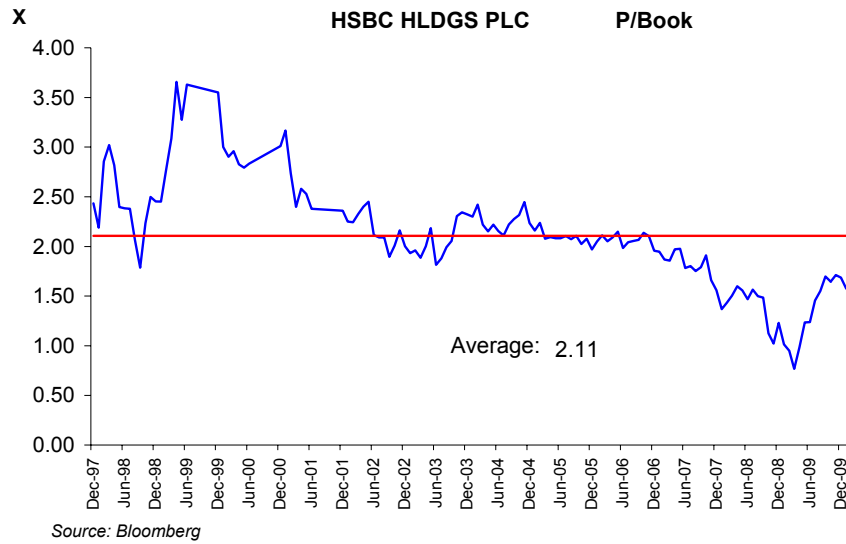
Profit & Loss						
YE Dec (US\$ mn)	FY06A	FY07A	FY08A	FY09A	FY10F	FY11F
Net interest income	34,486	37,795	42,563	40,730	38,439	38,271
Fees income	17,182	22,002	20,024	17,664	16,359	15,973
Trading profit	8,222	9,834	6,560	9,863	7,744	7,756
Dividend income	340	324	272	126	194	204
Other operating income	5,136	9,038	12,263	(2,202)	3,421	3,860
Operating income	65,366	78,993	81,682	66,181	66,157	66,063
Admin expenses	(33,553)	(39,042)	(38,535)	(34,395)	(34,581)	(34,840)
Amort/write-off of goodwill & exc	-	-	(10,564)	-	-	-
Operating profit before provis	31,813	39,951	32,583	31,786	31,576	31,224
Bad debt & credit risk impairmen	(10,573)	(17,242)	(24,937)	(26,488)	(23,523)	(20,758)
Operating profit	21,240	22,709	7,646	5,298	8,053	10,465
Joint venture & associates	846	1,503	1,661	1,781	1,953	2,144
Profit before tax	22,086	24,212	9,307	7,079	10,006	12,609
Taxation	(5,215)	(3,757)	(2,809)	(385)	(2,001)	(385)
MI	(1,082)	(1,322)	(770)	(860)	(500)	(630)
Net profit	15,789	19,133	5,728	5,834	7,504	11,594
yoy change	4.7%	21.2%	-70.1%	1.9%	28.6%	54.5%
Retained profit	7,020	8,892	(1,832)	(352)	1,318	4,480
Shareholders' funds	108,352	128,160	93,591	128,299	129,617	134,098
Basic EPS (US\$)	1.44	1.65	0.41	0.34	0.41	0.64
DPS (US\$)	0.76	0.87	0.64	0.34	0.34	0.39

Source: Company Account, VC Estimates

Share Price Valuation & Trend



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