Hang Seng Bank

Valuation remains the issue upon stable outlook

Neutral

0011.HK, 11 HK

Price: HK$139.90

Price Target: HK$142.00

Hong Kong
Asia Financials

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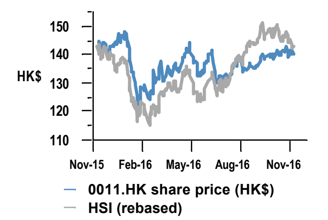
We retain our Neutral rating on HSB. We expect modest recovery on PPOP in 2H16 driven by low-base at non-interest income but momentum remains lukewarm with limited upside potential. Despite underperformance versus HSI YTD, current valuation remains stretched compared to peers but we do not rule out short-term trading opportunities in the near term boosted by a potential US rate hike in December.

- **Potential NIM contraction HoH in 2H16.** With loan growth at HSB still largely focusing on defensive segments such as mortgages and large corporate syndications where lending yields still face strong competition, we expect NIM to contract modestly HoH in 2H16 despite further improvement on funding structure/deposit costs.
- **Limited chance for further capital management in the short term.** While current capital position is more than sufficient, management highlighted uncertainties from the review of Basel regime, potential TLAC (total loss absorption capital) requirements, and higher earnings volatility as a result of incoming IFRS9, and thus we believe a chance for further distribution of special dividends or material increase in cash payout ratio is limited in the next six months.
- **Higher opex for Fintech.** HSB has delivered prudent cost control in recent years but we forecast operating expenses could potentially outgrow revenue in FY17 as management guided to invest in Fintech-related projects for IT system and branch upgrade to facilitate customer service.
- **Retain Neutral.** Based on our forecasts of 12-13%normalized ROE in the foreseeable future, current valuation of 1.8-1.9x P/B still fails to justify reasonable risk-reward we think. As one of the best proxies to a US rate hike, HSB share price could be boosted in the near term when approaching December but it is our view that real NIM benefits may not come across until 2H17 at the earliest.

Price Performance



	YTD	1m	3m	12m
Abs	-5.2%	-1.1%	3.4%	-1.9%
Rel	-9.2%	3.3%	2.0%	-2.2%

Hang Seng Bank Ltd. (Reuters: 0011.HK, Bloomberg: 11 HK)

HK$ in mn, year-end Dec	FY14A	FY15A	FY16E	FY17E	FY18E
Operating Profit (HK$ mn)	20,594	20,541	20,699	22,086	24,179
Net Profit (HK$ mn)	15,131	27,494	16,517	17,793	19,552
Cash EPS (HK$)	7.91	14.22	8.47	9.13	10.05
Adjusted EPS (HK$)	7.91	8.66	8.47	9.13	10.05
DPS (HK$)	5.60	8.70	5.70	5.70	5.80
EPS growth (%)	(43.3%)	79.7%	(40.4%)	7.8%	10.1%
ROE	12.3%	11.8%	11.4%	12.0%	12.5%
P/E (x)	17.7	9.8	16.5	15.3	13.9
BVPS (HK$)	72.81	74.26	74.13	78.13	83.10
P/BV (x)	1.9	1.9	1.9	1.8	1.7
Dividend Yield	4.0%	6.2%	4.1%	4.1%	4.1%

Source: Company data, Bloomberg, J.P. Morgan estimates.

Company Data	
52-week Range (HK$)	145.60-118.42
Market Cap (HK$ mn)	267,467
Market Cap ($ mn)	34,486
Shares O/S (mn)	1,912
Fiscal Year End	Dec
Price (HK$)	139.90
Date Of Price	07 Nov 16
3M - Avg daily val (HK$ mn)	165.36
3M - Avg daily val ($ mn)	21.3
3M - Avg daily vol (mn)	1.20
HSI	22,642.62
Exchange Rate	7.76
Price Target End Date	31-Dec-17

See page 6 for analyst certification and important disclosures, including non-US analyst disclosures.

Key catalysts for the stock price:	Upside risks to our view:	Downside risks to our view:
• Potential divestment of Industrial Bank stake • Loosening of mortgage tightening measurements	• Tighter liquidity conditions to drive up HIBOR and thus NIM expansion • Stronger momentum at wealth management and credit cards to result in better related fees	• Worse-than-expected asset quality deterioration to push up credit costs • Sharp decline of Industrial Bank share price to put more pressure on capital position and deduction in shareholders' equity

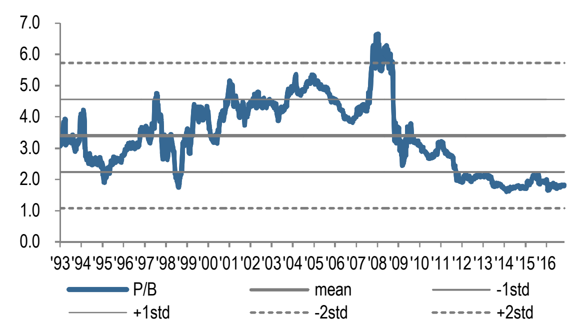
Key financial metrics	FY15A	FY16E	FY17E	FY18E
NII (LC)	21,165	22,034	23,265	25,081
Total revenue (LC)	31,047	31,458	33,601	36,526
Revenue growth (%)	2.8%	1.3%	6.8%	8.7%
Costs (LC)	(10,372)	(10,626)	(11,381)	(12,212)
PPOP (LC)	20,541	20,699	22,086	24,179
LLP (LC)	(1,108)	(1,468)	(1,420)	(1,460)
Net income (LC)	27,494	16,517	17,793	19,552
NIMs (%)	1.7%	1.7%	1.8%	1.8%
Non-II/revenue (%)	31.8%	30.0%	30.8%	31.3%
CIR (%)	33.8%	34.2%	34.3%	33.8%
Costs/assets (%)	0.8%	0.8%	0.8%	0.8%
PPOP/assets (%)	1.8%	1.8%	1.8%	1.8%
LLP/loans (%)	0.2%	0.2%	0.2%	0.2%
ROA (%)	1.3%	1.2%	1.2%	1.3%
ROE (%)	11.8%	11.4%	12.0%	12.5%
Tier 1 capital (%)	11.7%	14.8%	14.7%	14.5%
NPL ratio (%)	0.4%	0.5%	0.5%	0.6%
NPL coverage (%)	71.2%	59.2%	60.9%	64.0%
Key model assumptions	**FY15A**	**FY16E**	**FY17E**	**FY18E**
Loan growth (%)	4.6	2.3	5.8	8.5
Fee income growth (%)	12.6	(8.8)	9.9	11.3
CASA ratio (%)	71.1	71.1	71.1	71.1

Source: Bloomberg, Company data and J.P. Morgan estimates.

Valuation and price target basis

Our Dec-17 price target of HK$142 is based on 1.9x 2016E BV, which is lower than its long-term average P/BV and is justified by its 11-12% ROE. Our PT implies 5% potential upside and is equivalent to 17x EPS (FY16E).

HSB forward P/BV



Source: Bloomberg, Company data and J.P. Morgan calculations.

Sensitivity analysis	Operating profits		EPS	
Sensitivity to	FY16E	FY17E	FY16E	FY17E
10bps chg in NIM	6.3%	6.1%	7.4%	7.2%
10% chg in fee income	3.3%	3.4%	4.0%	4.0%
10% chg in provision	-0.8%	-0.7%	-0.9%	-0.8%
1% chg in CI ratio	-1.6%	-1.6%	-1.9%	-1.9%

Source: Bloomberg, Company data and J.P. Morgan estimates.

JPMe vs. consensus, change in estimates

EPS	FY16E	FY17E
JPMe old	8.59	9.32
JPMe new	8.47	9.13
% chg	*-1.4%*	*-2.0%*
Consensus	8.48	9.07

Source: Bloomberg, Company data and J.P. Morgan estimates.

HK banks: Valuation comparison

Company	Ticker	7-Nov-16 Price (HK$)	Mkt Cap US$MM	PT HK$	Rating	P/E (x) 16E	P/E (x) 17E	P/B (x) 16E	P/B (x) 17E	ROE 16E	ROE 17E	Dvd yield 16E
BOCHK	2388 HK	27.00	36,805	31.0	OW	5.3	10.9	1.3	1.2	26.1%	11.5%	6.8%
HSB	11 HK	139.90	34,484	142.0	N	16.5	15.3	1.9	1.8	11.4%	12.0%	4.1%
DSF	440 HK	51.35	2,218	59.0	N	8.9	3.0	0.8	0.7	9.1%	25.0%	2.8%
DSBG	2356 HK	13.98	2,529	18.0	OW	8.7	7.9	0.8	0.8	10.1%	10.2%	2.9%
BEA	23 HK	31.00	10,802	25.0	UW	20.8	20.4	1.0	1.0	5.1%	5.1%	2.1%

Source: Bloomberg, J.P. Morgan estimates.

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Investment Thesis, Valuation and Risks

Hang Seng Bank *(Neutral; Price Target: HK$142.00)*

Investment Thesis

We continue to like the defensive nature and quality management of HSB but believe the current valuation has largely priced in such premium given only 12-13% ROE outlook with limited upside potential on underlying operation or capital management. We see more attractive risk-reward at HK$125 (implying 1.6x P/B).

Valuation

Our Dec-17 price target of HK$142 is based on 1.8x 2017E BV, 51% lower than its long-term P/BV of 3.5x. Our PT implies 5% potential upside from current levels and is equivalent to 15x EPS (FY17E).

Risks to Rating and Price Target

Downside risks include:
• Worse-than-expected asset quality deterioration to push up credit costs
• Weaker credit demand to result in more fierce pricing competition

Upside risks include:
• Tighter liquidity conditions as a result of US rate hike to drive up HIBOR and thus NIM expansion
• Stronger momentum in wealth management fees on recent buoyant market conditions

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Hang Seng Bank: Summary of Financials

Income Statement				
HK$ in millions, year end Dec	FY15	FY16E	FY17E	FY18E
NIM (as % of avg. assets)	1.7%	1.7%	1.8%	1.8%
Earning assets/assets	89.0%	88.9%	88.9%	89.1%
Margins (as % of Avg. Assets)	1.5%	1.5%	1.6%	1.6%
Net Interest Income	21,165	22,034	23,265	25,081
Total Non-Interest Income	9,882	9,424	10,336	11,445
Fee Income	7,038	6,422	7,058	7,855
Dealing Income	2,054	2,190	2,411	2,656
Total operating revenues	31,047	31,458	33,601	36,526
Operating costs	(10,506)	(10,760)	(11,515)	(12,346)
Pre-Prov. Profits	20,541	20,699	22,086	24,179
Provisions	(1,108)	(1,468)	(1,420)	(1,460)
Other Inc	267	50	100	100
Other Exp.	-	-	-	-
Exceptionals	10,636	0	0	0
Associate	152	152	167	184
Pre-tax	30,488	19,432	20,933	23,003
Tax	(2,994)	(2,915)	(3,140)	(3,450)
Minorities	0	0	0	0
Attributable Income	27,494	16,517	17,793	19,552

Per Share Data HKD	FY15	FY16E	FY17E	FY18E
EPS	14.22	8.47	9.13	10.05
DPS	8.70	5.70	5.70	5.80
Payout	61.2%	67.3%	62.4%	57.7%
Book value	74.26	74.13	78.13	83.10
Fully Diluted Shares	1,912	1,912	1,912	1,912
PPOP per share	10.74	10.83	11.55	12.65

Key Balance sheet HK$ in millions	FY15	FY16E	FY17E	FY18E
Net Loans	688,946	704,326	744,837	807,746
LLR	(1,615)	(2,109)	(2,552)	(2,948)
Gross Loans	690,561	706,435	747,388	810,694
NPLs	2,737	3,558	4,092	4,501
Investments	432,143	452,017	476,764	494,797
Other earning assets	40,825	41,241	41,672	42,118
Avg. IEA	1,156,534	1,202,147	1,252,540	1,327,583
Goodwill	12,221	12,832	13,474	14,147
Assets	1,334,429	1,371,496	1,444,834	1,534,239
Deposits	959,228	988,005	1,047,285	1,120,595
Long-term bond funding	30,290	30,406	31,927	33,523
Other Borrowings	0	0	0	0
Avg. IBL	958,421	1,003,965	1,048,811	1,116,665
Avg. Assets	1,299,210	1,352,962	1,408,165	1,489,537
Common Equity	141,981	141,716	149,376	158,877
RWA	485,760	497,353	525,868	568,654
Avg. RWA	473,735	491,557	511,610	547,261

Growth Rates	FY15	FY16E	FY17E	FY18E
Loans	4.6%	2.3%	5.8%	8.5%
Deposits	7.0%	3.0%	6.0%	7.0%
Assets	5.6%	2.8%	5.3%	6.2%
Equity	2.0%	(0.2%)	5.4%	6.4%
RWA	5.2%	2.4%	5.7%	8.1%
Net Interest Income	6.5%	4.1%	5.6%	7.8%
Non-Interest Income	(4.4%)	(4.6%)	9.7%	10.7%
of which Fee Grth	12.6%	(8.8%)	9.9%	11.3%
Revenues	2.8%	1.3%	6.8%	8.7%
Costs	9.3%	2.4%	7.0%	7.2%
Pre-Provision Profits	(0.3%)	0.8%	6.7%	9.5%
Loan Loss Provisions	(3.1%)	32.5%	(3.3%)	2.8%
Pre-Tax	68.9%	(36.3%)	7.7%	9.9%
Attributable Income	79.7%	(40.4%)	7.8%	10.1%
EPS	79.7%	(40.4%)	7.8%	10.1%
DPS	55.4%	(34.5%)	0.0%	1.8%

Balance Sheet Gearing	FY15	FY16E	FY17E	FY18E
Loan/deposit	72.0%	71.5%	71.4%	72.3%
Investment/assets	31.2%	32.7%	33.0%	32.6%
Loan/Assets	52.0%	51.6%	51.6%	52.3%
Customer deposits/liab.	80.4%	80.3%	80.8%	81.5%
LT debt/liabilities	2.6%	2.5%	2.5%	2.5%

Asset Quality/Capital	FY15	FY16E	FY17E	FY18E
Loan loss reserves/loans	(0.2%)	(0.3%)	(0.3%)	(0.4%)
NPLs/loans	0.4%	0.5%	0.5%	0.6%
Loan loss reserves/NPLs	71.2%	59.2%	60.9%	64.0%
Growth in NPLs	29.4%	30.0%	15.0%	10.0%
Tier 1 Ratio	11.7%	14.8%	14.7%	14.5%
Total CAR	11.7%	14.5%	14.3%	14.0%

Du-Pont Analysis	FY15	FY16E	FY17E	FY18E
NIM (as % of avg. assets)	1.7%	1.7%	1.8%	1.8%
Earning assets/assets	89.0%	88.9%	88.9%	89.1%
Margins (as % of Avg. Assets)	1.5%	1.5%	1.6%	1.6%
Non-Int. Rev./ Revenues	31.8%	30.0%	30.8%	31.3%
Non IR/Avg. Assets	0.8%	0.7%	0.7%	0.8%
Revenue/Assets	2.4%	2.3%	2.4%	2.5%
Cost/Income	33.8%	34.2%	34.3%	33.8%
Cost/Assets	0.8%	0.8%	0.8%	0.8%
Pre-Provision ROA	1.6%	1.5%	1.6%	1.6%
LLP/Loans	(0.2%)	(0.2%)	(0.2%)	(0.2%)
Loan/Assets	52.0%	51.6%	51.6%	52.3%
Other Prov, Income/ Assets	0.9%	0.0%	0.0%	0.0%
Operating ROA	1.5%	1.4%	1.5%	1.5%
Pre-Tax ROA	2.4%	1.4%	1.5%	1.6%
Tax rate	9.8%	15.0%	15.0%	15.0%
Minorities & Outside Distbn.	0.0%	0.0%	0.0%	0.0%
ROA	1.3%	1.2%	1.2%	1.3%
RORWA	3.5%	3.3%	3.4%	3.5%
Equity/Assets	10.8%	10.5%	10.3%	10.3%
ROE	11.8%	11.4%	12.0%	12.5%

Source: Company reports and J.P. Morgan estimates.

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JPM Q-Profile

Hang Seng Bank, Limited (HONG KONG / Financials)

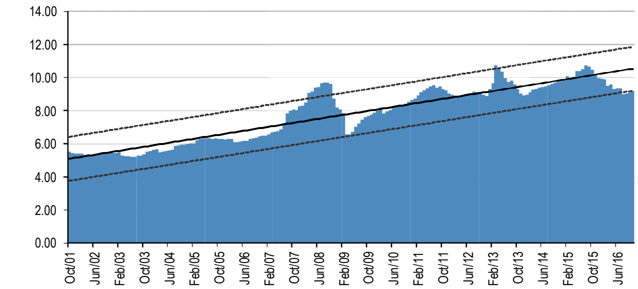
As Of: 03-Nov-2016

Global Equity Quantitative Analysis

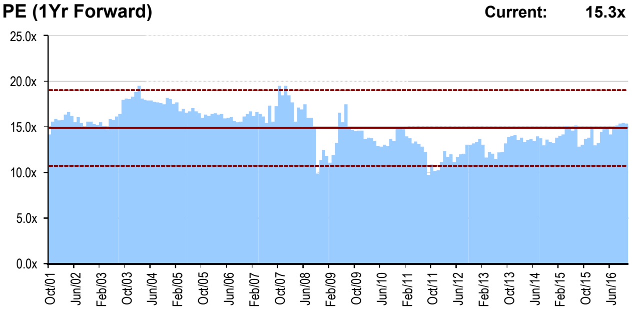
Quant_Strategy@jpmorgan.com

Local Share Price Current: 140.50

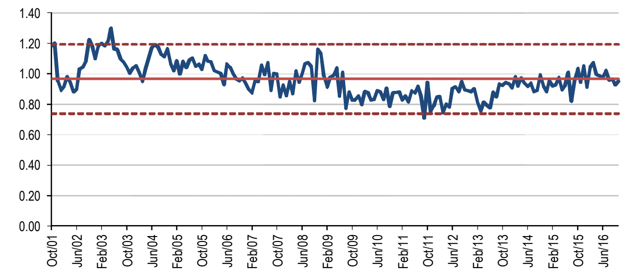
12 Mth Forward EPS Current: 9.17



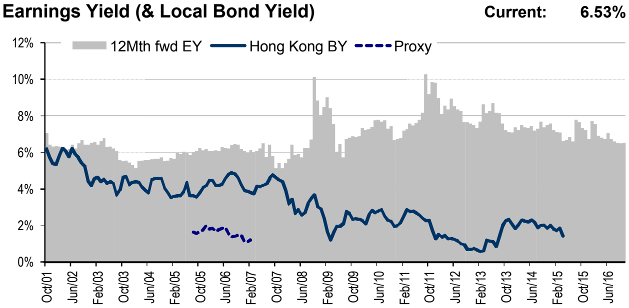
PE (1Yr Forward) Current: 15.3x



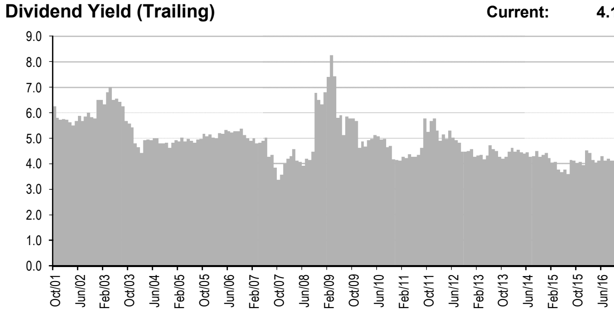
P/E Relative to Hong Kong Index Current: 0.95



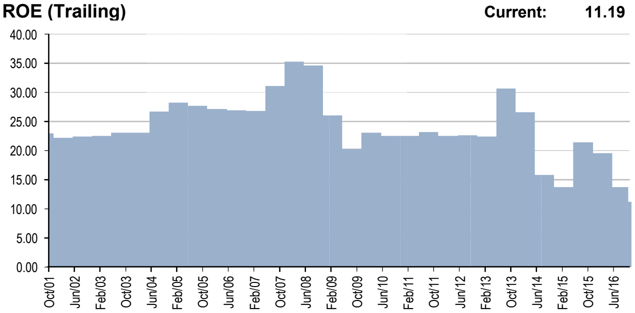
Earnings Yield (& Local Bond Yield) Current: 6.53%



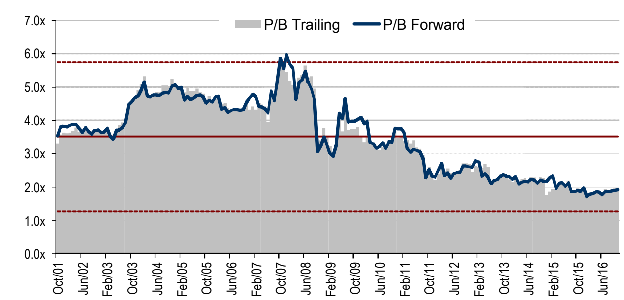
Dividend Yield (Trailing) Current: 4.12



ROE (Trailing) Current: 11.19



Price/Book (Value) Current: 2.0x



Summary

Hang Seng Bank, Limited								**As Of:**			03-Nov-16
HONG KONG	**TICKER**	**11 HK EQUITY**						**Local Price:**			140.50
Financials								**EPS:**			9.17
	Latest	**Min**	**Max**	**Median**	**Average**	**2 S.D.+**	**2 S.D. -**	**% to Min**	**% to Max**	**% to Med**	**% to Avg**
12mth Forward PE	**15.33x**	9.73	19.52	14.97	14.87	19.04	10.70	-37%	27%	-2%	-3%
P/BV (Trailing)	**1.96x**	1.73	5.89	3.53	3.51	5.75	1.27	-12%	200%	80%	79%
Dividend Yield (Trailing)	**4.12**	3.38	8.25	4.83	4.93	6.57	3.30	-18%	100%	17%	20%
ROE (Trailing)	**11.19**	11.19	35.27	23.05	24.14	34.19	14.09	0%	215%	106%	116%

Source: Bloomberg, Reuters Global Fundamentals, IBES CONSENSUS, JPMorgan Quantitative & Derivative Strategy

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- **Client:** J.P. Morgan currently has, or had within the past 12 months, the following entity(ies) as clients: Hang Seng Bank.
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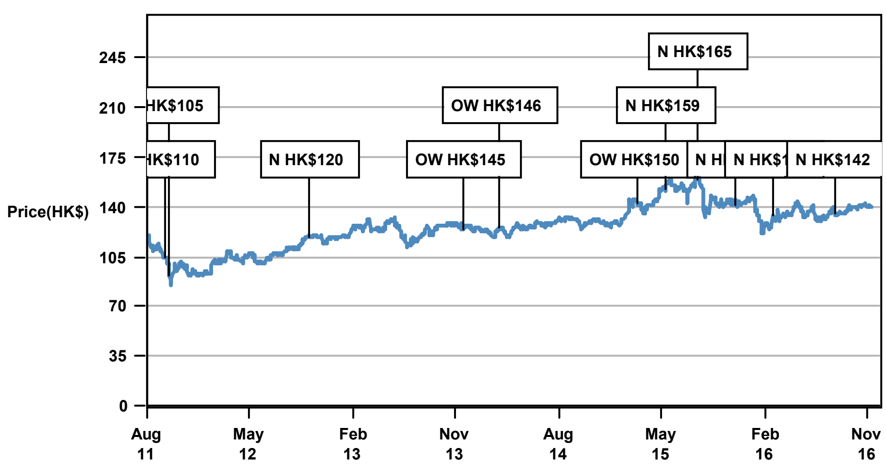
Hang Seng Bank (0011.HK, 11 HK) Price Chart



Date	Rating	Share Price (HK$)	Price Target (HK$)
20-Sep-11	N	105.00	110.00
01-Oct-11	N	91.85	105.00
04-Oct-12	N	118.60	120.00
21-Nov-13	OW	124.40	145.00
24-Feb-14	OW	125.00	146.00
23-Feb-15	OW	142.70	150.00
11-May-15	N	151.70	159.00
04-Aug-15	N	159.60	165.00
11-Nov-15	N	141.30	153.00
23-Feb-16	N	134.50	146.00
03-Aug-16	N	135.10	142.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Sep 20, 2011.

The chart(s) show J.P. Morgan's continuing coverage of the stocks; the current analysts may or may not have covered it over the entire period.
J.P. Morgan ratings or designations: OW = Overweight, N= Neutral, UW = Underweight, NR = Not Rated

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