

Short-term MTM concerns offer buying opportunity

Buy into concerns; 53% upside to our PO of NT\$18

Investor concerns on Taiwan life insurers' rights issue needs may continue as MTM loss from falling TAIEX is eroding lifers' book values, and hence, solvency margins. However, our analysis suggested that the market is already discounting a scenario of 40% share dilution from potential rights issues for China Life. We have cut 2008E EPS by 23% but retain 2009E EPS unchanged. We have cut PO by 36%, reflecting lower normalized asset yields from 4.75% to 4%.

MTM loss a valid short-term concern for all; China Life safer

Most life insurers are facing bigger unrealized MTM loss after 30% TAIEX YTD correction. Their shrunken BV leads to concerns on insufficient risk-based capital (RBC) ratio. China Life's prudent investment discipline (zero CDO or sub-prime) has helped it to contain risk only to TAIEX MTM volatility, but the insurer is not completely immune, with listed equities accounting for 8% of its assets. We estimate 16% share dilution should China Life raise capital to fulfill capital shortfall. Potential government approval to revise RBC formula or allow sub-debt issuance could mitigate part of the dilution.

Strong YTD profit buffering MTM loss

China Life's 8M08 net profit of NT\$1.5bn (EPS NT\$) has already surpassed our original full-year forecast of NT\$1.3bn. The results were supported by (1) 75% YoY growth in new business, (2) disciplined investment and FX strategy that prevented write-down and FX loss, and (3) stronger trading gains in 1H08. Our 2008E EPS cut mainly reflects potential reduction in one-off trading gain in the rest of the year given the poor TAIEX.

Estimates (Dec)

(NT\$)	2006A	2007A	2008E	2009E	2010E
Net Income (NT\$m)	702	1,615	1,064	1,546	2,065
EPS Published	0.64	1.48	0.91	1.32	1.76
EPS growth (YoY)	4.42%	129.91%	(38.55)%	45.28%	33.59%
BVPS	10.81	12.17	9.35	12.38	15.85

Valuation (Dec)

	2006A	2007A	2008E	2009E	2010E
P/E	18.35x	7.98x	12.99x	8.94x	6.69x
Price/Book Value	1.17x	1.04x	1.26x	0.95x	0.74x
Dividend Yield	0%	0%	0%	0%	0%
ROE	6.52%	12.87%	8.78%	12.15%	12.49%
ROAA	0.32%	0.61%	0.34%	0.42%	0.48%
RoE / PB	5.57x	12.37x	6.96x	12.74x	16.78x



Sophia Cheng +886 2 2376 3732

Research Analyst
sophia_cheng@ml.com

Katherine Hu +886 2 2376 3726

Research Analyst
katherine_hu@ml.com

Alistair Scarff >> +852 2536 3966

Research Analyst
Merrill Lynch (Hong Kong)
alistair_scarff@ml.com

Stock Data

Price	NT\$11.80
Price Objective	NT\$28.00 to NT\$18.00
Date Established	13-Oct-2008
Investment Opinion	A-1-9
Volatility Risk	LOW
52-Week Range	NT\$10.00-NT\$25.84
Mrkt Val / Shares Out (mn)	US\$426 / 1,171.4
Average Daily Volume	8,900,176
ML Symbol / Exchange	CHLJF / TAI
Bloomberg / Reuters	2823 TT / 2823.TW
ROE (2008E)	8.8%
Net Dbt to Eqty (Dec-2007A)	NA
Est. 5-Yr EPS / DPS Growth	15.0% / 0%
Free Float	40.0%



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Refer to important disclosures on page 13 to 14. Analyst Certification on Page 11. Price Objective Basis/Risk on page 11.

iQprofileSM China Life Insurance Co. Ltd.

Key Income Statement Data (Dec)	2006A	2007A	2008E	2009E	2010E
(NT\$ Millions)					
Life Net Earned Premium Income	52,199	54,293	66,713	75,986	83,005
Premium Income (Reinsurance)	56	49	50	51	52
Total Premiums	52,255	54,342	66,763	76,037	83,057
Management Fees	2	16	27	14	23
Life Investment Income	8,047	10,045	11,217	13,759	16,272
Life Realized Gains	359	470	-1,243	-782	-525
Other Revenue	240	536	622	632	653
Total Revenue	60,904	65,409	77,385	89,661	99,481
Gross Claims	-19,344	-26,003	-20,620	-21,673	-31,034
Reinsurance & Other Recoveries	95	129	148	147	161
Net Claims	-19,249	-25,873	-20,472	-21,526	-30,873
Administration Cost (incl commissions)	-3,116	-3,185	-4,010	-4,265	-4,628
Levies / Insurance Fund Provision	-38,052	-35,151	-51,710	-62,107	-61,668
Depreciation & Amortization	-125	-122	-122	-126	-130
Operating profit	486	1,200	1,194	1,762	2,311
Non-Operating Income (net)	216	415	0	0	0
Pretax Income Before Extraords	702	1,615	1,194	1,762	2,311
Tax expense	0	0	-130	-217	-246
Net Income	702	1,615	1,064	1,546	2,065
Preferred Dividends	NA	NA	NA	NA	NA
Net Income Adjusted	702	1,615	1,064	1,546	2,065
Net Premium Growth (YoY %)	6.77	3.99	22.86	13.89	9.23
Net Inv Income Growth (YoY %)	28.54	24.83	11.67	22.66	18.27

Balance Sheet Analysis

Total Cash and Investments	215,406	261,079	309,729	374,924	440,093
Net fixed assets	2,752	2,760	2,843	2,928	3,016
Other Assets	10,929	14,563	15,328	16,417	17,435
Separate Accounts	8,010	12,382	4,187	1,598	7,276
Total Assets	237,096	290,783	332,087	395,866	467,820
Accounts payable	379	635	778	886	967
Unearned premium income provisions (net)	699	839	1,001	1,126	1,220
Reserves	214,560	259,120	310,787	372,863	434,508
Outstanding claim provisions (net)	162	199	242	273	297
Short term debt	0	0	0	0	0
Other current liabilities	1,192	3,833	3,704	4,186	4,552
Total Reserves (Liabilities)	NA	NA	NA	NA	NA
Separate Account	8,010	12,382	4,187	1,598	7,276
Total liabilities	225,290	277,441	321,133	381,366	449,255
Ordinary shareholders' equity	11,806	13,291	10,954	14,500	18,565
Preferred equity	0	0	0	0	0
Net Assets (Total Equity)	11,806	13,291	10,954	14,500	18,565
Asset Growth (%)	15.31	22.64	14.20	19.21	18.18
Investment Asset Growth (YoY %)	16.11	21.20	18.63	21.05	17.38

Capital Adequacy

Valuation (per Share)

Company Description

China Life is a small but fast growing life insurer with special focus on participating life insurance policies. It has enjoyed rapid growth in asset accumulation and doubled assets in the past two years (> NT\$200bn) after new management injection in 2003. As the company grew rapidly in recent years of low interest rates, relatively lower guarantee rates of < 2.5% have reduced its average liability cost and it no longer suffers a negative spread.

Investment Thesis

We remain positive on China Life core business growth, potential improvement in participating policies as customers risk appetite shift to wealth protection in anticipation of volatile global equity market. China Life's acquisition of Winterthur also should start to bring more meaning investment-linked revenue starting 2009. We also appreciate company's conservative risk management discipline (1) no CDO or sub prime exposure and (2) hedged most of its overseas assets.

Stock Data

Risks known; buy into concerns

China Life's share price has corrected by 47% since its peak in April. Post the recent 36% rebound, we expect higher share price volatility but would consider any weakness a buying opportunity. We have revised down PO by 35% to NT\$18 as we have cut long-term achievable asset yield to 4%, from 4.75%. China Life is trading at <0.8x P/EV and we expect 53% 12M return. Buy.

- **Short-term weakness looks overdone:** The significant share price correction mainly reflected industry-wide concerns on rights issue needs, hence dilution, and China Life's share price has suffered more given its small market capitalization and trading volume. Its zero exposure to CDO and sub-prime has substantially eliminated the risk of unexpected write-downs. The price-to-embedded-value (P/EV) ratio of 06.6-0.8x 2007-08 P/EV is attractive in our view even after considering dilution arising from TAIEX MTM loss.
- **Positive long-term prospects:** China Life's focus on traditional products and de-emphasizing investment-linked policies has helped it to protect itself from the recent market panic triggered by wealth contraction due to lower fund NAV. It has taken advantage of lower customer risk appetite and has grown 8M08 new business by 75% to NT\$34bn. Completion of integrating Winterthur investment-linked team in 2009 would leave it in an excellent position for expansion into investment-linked products at the right time.
- **Rights issue concerns temporary:** Our analysis suggested that the market is discounting a potential 40% dilution in share price from the rights issue should China Life need to seek capital injection against falling TAIEX MTM loss eroding capital. We expect final dilution to be 16% should TAIEX stay at 5,500 levels, which should be lower than market concerns. We expect government to consider allowing life insurers to raise sub-debt or adjust the RBC formula to reduce RBC ratio short-term volatility.

Our price objective of NT\$18/shr is based on 1.1x price to 2008E embedded value (EV) assuming 4.0% long-term achievable asset yields and sustainable FYP growth of 8% at stable new business margins. Risks to our PO are:
 (1) significant investment gains/losses affecting adjusted net worth and
 (2) unexpected reserves/claims.

Table 1: EV may decline end 2008 due to MTM loss on adjusted net worth; recovery in 2009

(NT\$bn)	Dec-06	Dec-07	Dec-08E	Dec-09E
Adjusted Net Worth	17.1	17.5	14.1	16.9
Value of In-force Policies Rollover	8.4	10.5	11.8	12.3
Cost of Solvency Capital	(4.2)	(5.2)	(6.1)	(7.3)
Value of new business - Rollover			1.5	1.9
Experience loss on investment yield			(2.3)	(1.8)
Embedded value	21.3	22.8	19.0	21.9
EV Per Share	19.5	20.9	16.2	18.7
Value for New Business	10.0	14.9	18.9	21.3
Appraisal Value	12.3	37.7	37.9	43.2
AV Per Share	30.8	34.5	32.4	36.9
EV Growth Rate	22.7%	7.3%	-16.7%	15.1%
AV Growth	19.6%	12.1%	0.7%	13.9%
Price Objective			18.0	18.0
Target P/EV			1.1	1.1

Source: Merrill Lynch estimates, company data

Strong YTD FYP growth and earnings

China Life focuses on traditional insurance policies. It targets annuity and universal life for wealth management type policies, instead of investment-linked products considering the thin margins (only referral fee and rebates). The strategy of building a brand in traditional policies including participating policies boosted new business growth when many policyholders started to reduce their risk in late 2007, worried as they were about global equity market risks.

In the first eight months China Life achieved NT\$34bn first-year premium (FYP), up 75% YoY, and reached 86% of our full-year forecast. Total premium for the same period amounted to NT\$52bn, up 45%. The results should be better than consensus but in line with our expectation. We have retained our 2008E FYP forecast unchanged at NT\$39bn because we conservatively assume possible industry-wide slower new purchase in 4Q08 while our earnings models tend to assume lower single premium elements (less inflation of premium). We expect China Life to grow FYP by 28% and 13% in 2008 and 2009, respectively.

Table 2: Strong new business growth without inflation from investment-linked policies

(NT\$bn)	8M08	%YoY	2008E	%YoY
First-year premium (FYP)	34	86%	39	27%
Total Premium	52	45%	68	23%

Source: Merrill Lynch estimates, Company data

Safe overseas book but vulnerable to local equity market volatility

We were impressed by China Life's 1H08 strong profit as it did not suffer write-downs on any overseas sub-prime exposure, and had realized sizable capital gains in Taiwan. We have assumed the gain to be partly offset in 2H08 as we expect the fast fall in TAIEX since June to lead to significant MTM loss in the book value of most life insurers (held as available-for-sale AFS).

We still have not seen clear signs of TAIEX recovering strongly enough to bounce back to positive territory. We have, therefore, forecast 2008 net profit at NT\$1.1bn, a 23% cut from our previous forecast, since 2H08 TAIEX was much weaker than we had expected. The earnings cut is mainly to reflect one-off MTM losses, which could recover in 2009. We have retained our 2009 forecast unchanged at NT\$1.5bn (EPS NT\$1.32).

Timely integration of investment-linked team ready for growth in 2010

China Life seems rare compared with most Taiwan life insurers in Taiwan. The firm's insistence on zero sub-prime and CDO investment prevented it from write-downs, while its passive strategy of selling investment-linked policies but focusing on traditional policies and annuities brought opportunities when customers' preference changed in favor of wealth preservation. We are positive on the company's potential to come out with diversified insurance products in 2009, after the integration of Winterthur's 300+ agents dedicated to investment-linked policies. This product expansion is also timely if we assume possible recovery in global equity markets after 2009.

Table 3: Earnings revisions

	Original		New		Change	
	2008E	2009E	2008E	2009E	2008E	2009E
Net Profit	1,386	1,560	1,064	1,546	-23%	-1%
EPS	1.27	1.43	0.91	1.32	-28%	-8%
EPS Growth	-15.0%	12.5%	-38.6%	45.3%		
PER	10.1	9.0	13.9	9.6		
BV/Shr	12.53	14.69	9.35	12.38		
P/B Ratio	1.02	0.87	1.35	1.02		
RoE	10.28%	10.49%	8.78%	12.15%		
RoA	0.44%	0.43%	0.34%	0.42%		
P/EV			0.78	0.68		

Source: Merrill Lynch

Table 4: China Life P&L: positive on long-term growth

(NT\$m)	2006	2007	2008E	2009E	2010E
FYP	30,197	30,840	39,376	43,030	44,375
Renewal premium	22,279	23,715	27,769	33,387	39,059
Reinsurance Premium	56	49	50	51	52
Total Premium	52,532	54,604	67,195	76,468	83,486
Net Written Premium	52,291	54,385	66,926	76,162	83,151
Net Earned Premium	52,255	54,342	66,763	76,037	83,057
Reserves	(38,052)	(35,151)	(51,710)	(62,107)	(61,668)
Claim	(19,249)	(25,873)	(20,472)	(21,526)	(30,873)
Investment	8,406	10,515	9,974	12,977	15,748
Other Revenue	240	536	622	632	653
Separate Account	2	16	27	14	23
Acquisition Cost and Expenses	(3,116)	(3,185)	(4,010)	(4,265)	(4,628)
Non-operating Income	216	415	-	-	-
Pretax	702	1,615	1,194	1,762	2,311
Income Tax	0	(0)	(130)	(217)	(246)
Net Income	702	1,615	1,064	1,546	2,065

Source: Merrill Lynch estimates; financial reports

ST concerns on MTM loss & capital adequacy

According to our estimates, 8% of China Life's assets are invested in local equity market, which is relatively higher than Cathay Life, Shin Kong Life and Fubon Life's 5-7%. Hence, it is more sensitive to TAIEX volatility that brings MTM loss to book value. Thus, capital injection concerns remain should TAIEX stay very weak for the rest of the year.

Our analysis of the potential capital needs of listed life insurers or FHC's life subsidiaries suggested that: (1) China Life's RBC could remain 200% above legal requirement should TAIEX recover back to 6,500 levels, while others would need TAIEX to recover back to at least 8,000 to meet the legal requirement. (2) However, China Life would be the most sensitive to TAIEX volatility given its relatively smaller balance sheet but higher asset allocation to equity market.

Table 5: China Life more sensitive to TAIEX volatility but less risky due to other factors

	Cathay Life	Shin Kong Life	Fubon Life	China Life
TAIEX Level to Sustain RBC at 200%	7,500	8,000	7,800	6,000
Assumed Listed Equity Investment/Assets	6%	5%	12%	8%
Sensitivity to TAIEX Volatility	High			High
Buffer form Parent Debt Issuance	Some	limited	Best	None
Right Issue Dilution Volatility		High		High
Risk to Investment Write down	High	High	Some	Low
Risk to Declining New Premium	Higher	Highest	Some	Lower
1H08 Investment-linked, VUL % of FYP	54%	75%	28%	1%

Source: Merrill Lynch Analysis, company data

Rights issue would not be wasted for China Life, if it occurs

The recent sharp movements in share price excessively reflect such concerns, in our view. If the poor TAIEX triggers the need for a rights issue, the cash call proceeds would not be wasted even if TAIEX recovers later in 2009. Originally, we expected China Life to raise capital by late 2009 or 2010 to support its continuous premium growth. The TAIEX volatility pulls the potential rights issue earlier at a much lower share price, in our view – a positive to existing shareholders if the issue is open to existing shareholders. Management prefers not to come out with a rights issue given the low share price currently as it hopes to maximize proceeds and minimize share dilution.

Government could become more open minded on solutions

The stress of rights issues is high enough that we expect government to consider solutions including allowing insurers to issue sub-debt (instead of rights issues) or fine-tune the RBC formula to reduce the level of volatility in MTM gain/loss.

1. **Sub-debt issuance:** Taiwanese life insurance companies currently can use only short-term credit line for near-term cash flow management, but cannot issue sub-debt at all. Recently, local life insurers have been suggesting the government reconsider the policy, and we see rising probability of the government relaxing such restriction toward year end.
2. **Reduce MTM gain/loss to RBC volatility:** Currently, Taiwan is one of the very few countries in Asia implementing the RBC and the RBC structure mirrors that in the US. However, according to our understanding, the US only counts for 20% of MTM gain/loss as qualified capital, while Taiwan has adopted a stricter rule requiring 80% of unrealized gain and 100% unrealized loss in risk-based capital calculation. Taiwan's RBC was implemented in July 2003 and the above rule started to become volatile when the country implemented the SFAS 34 that requires financial assets to be marked to the market. The initial impact was positive with a global equity market upturn but this soon turned into a big negative after 2007 when TAIEX corrected rapidly. It is possible that the Taiwanese regulator may consider reducing the level of inclusion of MTM gain/loss into RBC calculation to smooth the volatility. Such consideration would be positive in our view, as we do believe that the current situation creates unnecessary rights issues for life insurers whose capital otherwise seems sufficient in the long term.

No cash flow problem; most life insurers see big operating cash inflow

The recent concerns about life insurance liquidity are not valid, in our view. Our bearish view on life insurers relative to banks is mainly due to much lower 2008-09 earnings visibility on uncertainties over further CDO write-downs, especially for Cathay and Shin Kong (which also have 20%+ proxy hedge positions vulnerable to FX volatilities). China Life has hedged nearly 100% of its overseas assets and holds zero CDOs, containing risks related to Taiwan equity market volatility.

Taiwan life insurers are still at the premium collection stage of industry development (the island's industry is over 10 years behind developed countries, eg, Japan). Traditional endowment policies still contribute a significant part of renewal premiums, though FYPs already consist of considerable annuity and investment-linked policies. The following table illustrates annual premium income, interest income and claim/benefits. With such big surpluses in operating cash flow, Taiwan life insurers face the challenge of how best to invest assets to cover liability costs. We envisage no liquidity problems, unless we see heavy lapses in a short period of time.

Table 6: Major life insurers enjoy strong operating cash flows

(NT\$bn)	Premium	Interest	Claim	Net
Industry				
2005	1,261	189	(466)	984
2,006	1,281	220	(585)	916
2,007	1,357	251	(690)	918
(NT\$bn)	Operating CF	Investing CF	Financing CF	Cash-Ending
Cathay				
2005	163	(103)	(11)	287
2006	169	(172)	(13)	270
2007	131	(193)	(11)	197
1H08	53	(61)	(4)	186
Shin Kong				
2005	127	(141)	(3)	22
2006	67	(48)	(5)	36
2007	91	(27)	(3)	96
1H08	14	(19)	9	101
China Life				
2005	37	(36)	4	28
2006	26	(40)	(1)	14
2007	31	(32)	-	13
1H08	17	(3)	-	27

Source: IROC, TEJ, Financial reports

Potential share dilution 16% for China Life if TAEIX at 5,500

As part of our analysis, we estimated potential capital injection needs for Cathay Life, Shin Kong Life, Fubon Life and China Life. The analysis addressed two major concerns: (1) additional write-downs against sub-prime and exposure to unexpected events in the global financial market such as the impact from Lehman Brothers' bankruptcy filing and (2) additional unrealized MTM losses from the Taiwan equity market should the TAIEX close at various levels by year-end. China Life relatively outperformed peers with sufficient RBC ratio, supported by strong YTD profit and zero sub-prime write-downs.

However, China Life cannot be immune to MTM losses eroding the RBC ratio once TAEIX falls below 6,000, pushing the RBC ratio down below the 200% minimal legal requirement.

The TAIEX has corrected sharply to below 5,500 from 7,046 at the end of August. The stock market correction has created several negative impacts:

1. **MTM losses in book value, hence RBC contraction:** Assuming the market closes at about 5,500, we estimate the likely additional MTM loss occurring in 2H08 would be as high as NT\$32bn for Cathay Life, NT\$16bn for Shin Life, NT\$9bn for Fubon Life and NT\$6bn for China Life. Most of the MTM losses would not occur in the P&L as the investments are mostly booked as available for sale (AFS). The MTM losses would therefore be recognized as book value deductions, which would mainly hurt RBC ratios. Closing at about 5,500, we believe that all life insurers' RBC ratios would be below the minimum legal requirement of 200%.
2. **No longer hidden gains to smooth earnings:** Until the MTM unrealized losses recover to profitable levels, life insurance companies would be forced to carry the losses (to avoid selling the portfolios and transferring the book value losses to P&L losses). A lack of tools to smooth earnings would lead to volatile monthly profits. Companies including Cathay Life and Shin Kong Life could also suffer additional FX losses should the NTD appreciate against proxy hedge currencies (which is possible considering how rapidly the Euro has depreciated against the USD lately).

3. **Big rights issues needs if no regulatory flexibility:** Most life insurers therefore could only passively wait for a recovery in the TAIEX while trying to negotiate with the government on regulatory flexibility to smooth the potential dilution since rights issues may be inevitable.

Table 7: Life insurers estimated rights issues needs should the TAIEX close at 5,500

(NT\$bn)	Cathay FHC	Shin Kong FHC	Fubon FHC	China Life
Additional Loss IV: Further TAIEX Correction				
TAIEX Level (date)	5,500	5,500	5,500	5,500
Correction Since June 08	-27%	-27%	-27%	-27%
MTM Loss Since June	(32)	(16)	(9)	(6)
MTM Book Value	49	24	3	8
RBC	119%	110%	49%	177%
RBC <200%?	RBC<200%	RBC<200%	RBC<200%	RBC<200%
Target RBC Reverses Back to	225%	225%	225%	225%
Right Issue Needs	43.4	25.5	11.3	2.2

Source: Merrill Lynch estimates

Table 8: RBC restore target based on various TAIEX levels

TAIEX Level	RBC Target
7,000 and above	250%
5,500-7,000	225%
5,500 and below	200%

Source: Merrill Lynch assumptions

In the above analysis we have derived rights issue needs based on various RBC ratio targets against TAIEX levels – the higher the TAIEX, the higher the RBC ratio target. This reflects our assumptions that life insurers would be willing to maintain prudent balance sheets and reserve a buffer for unexpected TAIEX volatility going forward, and hence 250% RBC benchmark is applied should the TAIEX recover back to above 7,000. Should the TAIEX remain low at 5,500-7,000 we assume life insurers would hope to maintain RBC ratios of 225% given lower additional downside risk in the equity market and in consideration of the need to manage the level of share dilution. Should the TAIEX fall below 5,500 we assume life insurers would only aim to restore RBC ratios back to the minimum legal requirement of 200%.

We have summarized the potential capital injection needs in Table 9. Based on the above analysis, if assuming the TAIEX closes at 5,500-6,500 the rights issue needs in order to boost RBC ratios back to 225% would be NT\$35-51bn for Cathay, NT\$21-29bn for Shin Kong, NT\$9-13bn for Fubon and NT\$1-4bn for China Life.

Despite China Life's prudent balance sheet, it does not have the backing of a strong parent to buffer against rights issue dilution. A decision by the government to allow life insurers to issue sub debt would ease the pressure. We estimate 16% share dilution based on NT\$13/shr issuing price and the same TAIEX and RBC ratio assumptions mentioned above. Cathay FHC and Fubon FHC both have low FHC debt/equity ratios and hence have capacity for FHC to issue sub debt and smooth part or all of the share dilution pressure. We have summarized our analysis on mostly likely cash call structure and dilution in Table 11.

Table 9: Estimated capital injection needs for life insurers (highlighted sections show likely outcome for RBC targets vs TAIEX levels)

(NT\$bn)	RBC Target	TAIEX Level							
		7,500	7,000	6,500	6,000	5,500	5,000	4,500	4,000
Cathay Life	200%	2	10	17	25	33	41	49	57
	225%	12	20	28	36	43	51	59	67
	250%	22	30	38	46	54	62	69	77
Shin Kong Life	200%	4	8	12	16	20	24	28	32
	225%	10	14	18	22	25	29	33	37
	250%	15	19	23	27	31	35	39	43
Fubon Life	200%	1	3	5	7	10	12	14	16
	225%	2	5	7	9	11	14	16	18
	250%	4	6	8	11	13	15	17	20
China Life	200%	-	-	-	-	1	3	4	6
	225%	-	-	-	1	2	4	5	7
	250%	-	-	0	2	3	5	6	8

Source: Merrill Lynch estimates

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Table 10: Potential share dilution without government regulatory relaxation – Shin Kong the worst

(NT\$bn)	RBC Target	TAIEX Level							
		7,500	7,000	6,500	6,000	5,500	5,000	4,500	4,000
Cathay Life	200%	0%	0%	0%	0%	2%	4%	6%	9%
	225%	0%	0%	2%	3%	5%	7%	9%	11%
	250%	1%	3%	5%	6%	8%	10%	12%	14%
Shin Kong Life	200%	6%	9%	17%	24%	31%	39%	46%	53%
	225%	12%	20%	27%	34%	42%	49%	56%	64%
	250%	23%	30%	37%	45%	52%	59%	67%	74%
Fubon Life	200%	0%	0%	0%	0%	0%	0%	0%	0%
	225%	0%	0%	0%	0%	0%	0%	0%	0%
	250%	0%	0%	0%	0%	0%	0%	0%	0%
China Life	200%	0%	0%	0%	0%	8%	18%	29%	40%
	225%	0%	0%	0%	5%	16%	26%	37%	48%
	250%	0%	0%	2%	13%	24%	34%	45%	56%

Source: Merrill Lynch estimates

Table 11: Right issue needs and dilution post FHC sub debt

(NT\$bn)	Cathay FHC	Shin Kong FHC	Fubon FHC	China Life
Life subsidiary capital injection needs	43	24	11	2
Impact to FHC Before Taking any Action				
FHC CAR	78%	56%	132%	
FHC Double Leverage Ratio	102%	127%	103%	
FHC Debt/Equity Ratio	0%	29%	7%	
IF FHC replenish capital 100% in equity, assuming required capital unchanged				
Share Dilution	12%	47%	None	16%
FHC CAR	106%	95%	142%	
FHC Double Leverage Ratio	101%	117%	103%	
FHC Debt/Equity Ratio	0%	22%	7%	
If FHC Issue Combination of Debt + Equity				
Considering the following Criteria to maintaining dividend payout and credit rating				
FHC CAR >100%				
FHC Double Leverage <120%				
FHC Debt/Equity <30%				
FHC Maximum Debt Issuance (up to 30% of equity)	52	8	36	0
Minimum Right Issue	-	18	-	2
Limit on Debt Issuance	FHC CAR <100%, can only issue sub debt or preferred	FHC CAR <100%, can only issue sub debt or preferred	Sufficient FHC CAR	
Likely Outcome	NT\$20-30bn sub debt + equity	NT\$5-8bn sub debt + equity		
Assumed Debt Issuance	25	6	11	-
Senior Debt			11	
Sub Debt	25	6		-
Right Issue Amount	18	22	-	2
Right Issue Price	40	10	20	13
New Shares Issued	0.46	2.25	-	0.17
Outstanding Shares (billion shares)	9.28	5.39	7.72	1.09
Share Dilution	5%	42%	0%	16%
FHC New CAR Post Cash Call	106%	100%	132%	
FHC New Double Leverage Ratio	118%	126%	111%	
FHC New Debt/Equity Ratio	16%	32%	15%	
Life RBC	225%	225%	225%	225%

Source: Merrill Lynch estimates

Possible partial relief from regulator but not until year-end

A decision by the government to reduce RBC ratio volatility and/or allow life insurers to issue sub debt directly would reduce the level of rights issue dilution. Allowing life insurers to issue sub debt could reduce the potential share dilution by as much as 50% while assuming a lower level of MTM gains/losses in the RBC ratio calculation could massively ease the capital injection pressure.

Table 8 summarizes the benefits should the government allow life insurers to include 0-100% of MTM gains/losses into RBC calculations (insurers are lobbying for 50% being the most reasonable weighting). Currently the US applies a 20% weighting, while Taiwan applies 80% for unrealized gains and 100% for unrealized losses.

If the government were to allow the inclusion of only 50% of MTM losses in RBC calculations, Shin Kong upcoming rights issues would ease ½ of the pain. Cathay Life can also leverage FHC sub debt without needing to raise equity from public shareholders while China Life's RBC would be more than sufficient. The government's final decision therefore could be critical to eventual share dilution.

We don't expect a conclusion on the above potential regulator relaxation until year-end 2008 as the government is likely to prefer to compile all measures and implement in one go. This means life insurers may still suffer short-term market concerns on potential rights issue dilution until late 4Q08 seeing a clearer picture on policy directions. Should the TAIEX continue to correct against global macro uncertainty and slow domestic demand recovery, investors may realize the reduced level of help that the government could offer and refocus on rights issue concerns.

We also believe that life insurers eventually need to review their risk weightings on volatile invested assets such as equities in order to maintain better earnings visibility. Moreover, strengthened capital would still be needed in the future once Taiwan adopts IFRS 4 accounting standard that requires mark-to-market on liabilities reserves.

Table 12: Allowing lower inclusion of MTM losses would significantly ease capital injection pressure

(NT\$bn)	Cathay FHC (47)	Shin Kong FHC (22)	Fubon FHC (10)	China Life (7)
Accumulated MTM loss in Book Value				
% MTM loss inclusion	Adjusted RBC ratio			
0%	233%	211%	206%	325%
25%	205%	186%	166%	288%
50%	176%	160%	127%	251%
75%	148%	135%	88%	214%
100%	119%	110%	49%	177%
% MTM loss inclusion	Revised Capital Shortfall			
0%	233%	211%	206%	325%
25%	205%	186%	166%	288%
50%	176%	160%	127%	251%
75%	148%	135%	88%	214%
100%	119%	110%	49%	177%

Source: Merrill Lynch analysis

Price objective basis & risk

China Life (CHLJF)

Our PO of NT\$18 is based on 1.1x 2008E EV, or 44pct discount to 2008E AV, which is in line with the multiple we applied to Cathay. This is because China Life's relatively smaller in-force policy at lower reserve cost could lead to lower EV erosion should asset yields falls, which offset our concerns on its smaller market capitalization boosting share price volatility. Risks to our price objective: (1) Unexpected reserves and claims and (2) Volatile trading gains/losses.

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I, Sophia Cheng, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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Taiwan Coverage Cluster

Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
BUY	China Life	CHLJF	2823 TT	Sophia Cheng
	Chinatrust	CTFHF	2891 TT	Katherine Hu
	Depo Auto Parts	DUOPF	6605 TT	Albert Hsu
	Far Eastern Textile	FREYF	1402 TT	Albert Hsu
	Fubon FHC	FUISF	2881 TT	Sophia Cheng
	Nak Sealing Tech	XMOOF	9942 TT	Albert Hsu
	SinoPac Financial Holdings	SPACF	2890 TT	Katherine Hu

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Taiwan Coverage Cluster

Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
NEUTRAL				
	Asia Cement	ASIXF	1102 TT	Albert Hsu
	Cathay FHC	CHYYF	2882 TT	Sophia Cheng
	E.Sun FHC	ESUFF	2884 TT	Katherine Hu
	Far East Dept.	FEDTF	2903 TT	Brandon Chen
UNDERPERFORM				
	China Motor	CHUYF	2204 TT	Albert Hsu
	Eternal Chemical	ETXCF	1717 TT	Albert Hsu
	Hota Ind Mfg Co	HOTIF	1536 TT	Albert Hsu
	Hotal Motor Co	HOTAF	2207 TT	Albert Hsu
	Kinik Company	KIKCF	1560 TT	Albert Hsu
	Shin Kong Financ	SKFHF	2888 TT	Sophia Cheng
	Taishin	TSHFF	2887 TT	Sophia Cheng
	Taiwan Cement	TGBMF	1101 TT	Albert Hsu
	Uni-President	XPDSF	1216 TT	Brandon Chen

iQmethodSM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

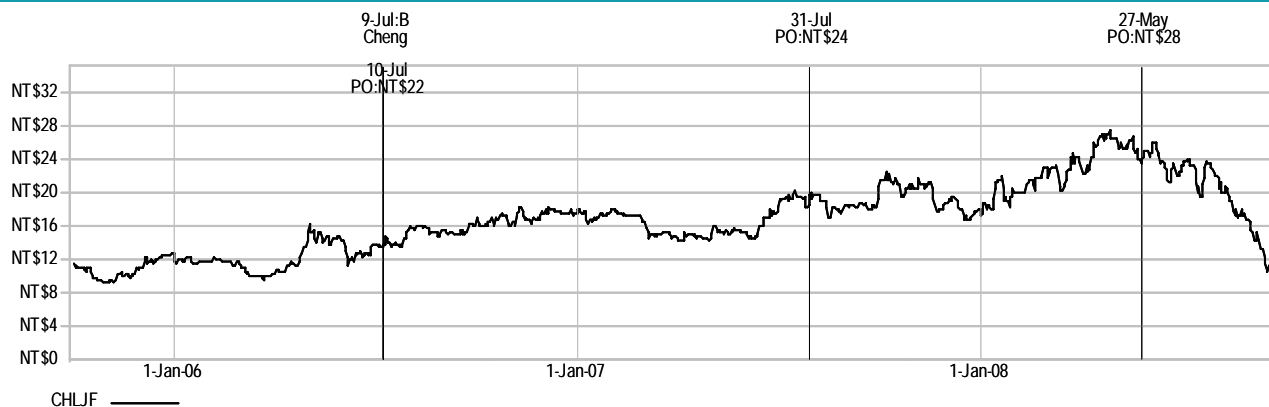
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CHLJF Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid

Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of September 30, 2008 or such later date as indicated.

Investment Rating Distribution: Financial Services Group (as of 01 Oct 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	125	42.23%	Buy	47	38.21%
Neutral	92	31.08%	Neutral	31	34.83%
Sell	79	26.69%	Sell	20	25.64%

Investment Rating Distribution: Global Group (as of 01 Oct 2008)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1647	45.31%	Buy	429	28.83%
Neutral	858	23.60%	Neutral	240	31.41%
Sell	1130	31.09%	Sell	227	22.02%

* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
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Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

* Ratings dispersions may vary from time to time where Merrill Lynch Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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