

Undemanding valuation, upgrade to Neutral

Upgrade to Neutral

ESUN's share price has corrected by 55% since June. Currently trading at 0.5x 2009E P/BV for ~6% 2009E-10E ROE, we no longer consider its valuation demanding. We are impressed by its mortgage asset quality but have reservations about its SME loan quality (20% of total loan book) in light of the prevailing macro uncertainties. We cut 2008E-09E earnings by 37% and PO by 33% to NT\$11hare.

Earnings improvement likely to be slow in 2008-10

We are conservative in our forecasts of ESUN's earnings in 2009-10 and expect an improvement only from 2011 because we think the company will raise its general provisions to 50bp by 2010 from the current 10bp (every 10bp increase means an extra NT\$550mn in provision). We also expect a spike in credit costs for SME loans from an abnormally low level in 2008. ESUN's provisions would be relatively heavy vs other quality banks given its higher coverage ratio.

Need to strengthen long-term competitiveness

ESUN is relatively stronger in wealth management and mortgage businesses but is still lagging in corporate banking. Smaller FHCs or banks like EUSN face more difficulty in becoming customers' primary banks; thus, their ROE improvement is correspondingly slower. We believe if ESUN were to consider a tie-up with a major FHC or regional bank for balance sheet backup, it would go a long way to enhance its long-term competitiveness.

Estimates (Dec)

(NT\$)	2006A	2007A	2008E	2009E	2010E
Net Income (Adjusted - mn)	494.63	3,294	2,376	2,810	3,131
EPS	0.12	0.96	0.67	0.79	0.88
EPS Change (YoY)	-91.5%	679.4%	-30.1%	18.3%	11.4%
Dividend / Share	0.940	0	0.373	0.268	0.317
Pre-exceptional EPS	0.144	0.959	0.670	0.793	0.883
Pre-exceptional EPS Change (YoY)	-90.1%	565.9%	-30.1%	18.3%	11.4%
Book Value / Share	14.18	14.96	14.96	15.56	16.06

Valuation (Dec)

	2006A	2007A	2008E	2009E	2010E
P/E	65.0x	8.3x	11.9x	10.1x	9.1x
Dividend Yield	11.75%	0%	4.66%	3.35%	3.96%
Pre-exceptional PE	55.56x	8.34x	11.94x	10.09x	9.06x
Price / Book	0.622x	0.593x	0.546x	0.527x	0.508x
RoE / PB	1.52x	11.90x	8.72x	10.08x	11.24x
Price / Pre-Provision Profit	4.95x	4.49x	4.39x	3.63x	3.23x

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Refer to important disclosures on page 8 to 9. Analyst Certification on Page 6. Price Objective Basis/Risk on page 6.

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Consumer/Commercial
13 October 2008



Merrill Lynch

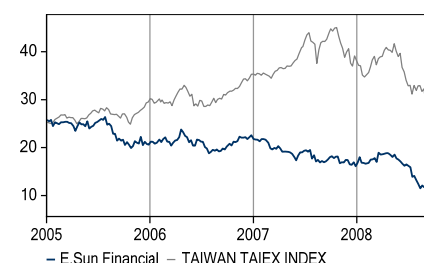
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Stock Data

Price	NT\$8.00
Price Objective	NT\$17.50 to NT\$11.00
Date Established	13-Oct-2008
Investment Opinion	C-3-7 to C-2-7
Volatility Risk	HIGH
52-Week Range	NT\$7.51-NT\$18.70
Mrkt Val / Shares Out (mn)	US\$874 / 3,544.4
Average Daily Volume	9,256,598
ML Symbol / Exchange	ESUFF / TAI
Bloomberg / Reuters	2884 TT / 2884.TW
ROE (2008E)	4.8%
Total Dbt to Cap (Dec-2007A)	NA
Est. 5-Yr EPS / DPS Growth	5.0% / 5.0%
Free Float	45.0%



13 October 2008

iQprofileSM E. Sun Financial Holdings Co. Ltd.

Key Income Statement Data (Dec)	2006A	2007A	2008E	2009E	2010E
(NT\$ Millions)					
Net Interest Income	9,869	9,526	10,538	11,469	12,685
Net Fee Income	2,662	3,870	3,599	4,141	4,624
Securities Gains / (Losses)	933.43	822.76	1,049	1,368	1,392
Other Income	70.44	22.51	175.88	277.70	329.70
Total Non-Interest Income	3,666	4,715	4,823	5,786	6,346
Total Operating Income	13,535	14,242	15,362	17,255	19,030
Operating Expenses	(7,985)	(8,123)	(8,901)	(9,439)	(10,241)
Pre-Provision Profit	5,550	6,119	6,460	7,817	8,789
Provisions Expense	(5,157)	(2,175)	(3,439)	(4,223)	(4,787)
Operating Profit	392.69	3,944	3,021	3,594	4,002
Non-Operating Income	72.03	0	0	0	0
Pre-Tax Income	464.72	3,944	3,021	3,594	4,002
Net Income to Comm S/Hold.	422.61	3,294	2,376	2,810	3,131
Adjusted Net Income (Operating)	494.63	3,294	2,376	2,810	3,131

Key Balance Sheet Data

Total Assets	693,789	772,183	838,450	895,905	950,544
Average Interest Earning Assets	552,605	630,351	703,826	755,248	801,038
Weighted Risk Assets	488,793	623,297	664,848	697,766	733,279
Total Gross Customer Loans	442,128	516,736	560,014	593,618	629,166
Total Customer Deposits	506,264	589,441	649,319	688,838	730,728
Tier 1 Capital	39,588	45,564	45,729	47,699	49,289
Tangible Equity	41,786	43,933	48,031	49,891	51,898
Common Shareholders' Equity	45,568	47,842	51,940	53,799	55,807

Key Metrics

Net Interest Margin	1.79%	1.51%	1.50%	1.52%	1.58%
Tier 1 Ratio	8.1%	7.3%	6.9%	6.8%	6.7%
Effective Tax Rate	9.1%	16.5%	21.4%	21.8%	21.8%
Loan / Assets Ratio	63.3%	66.6%	66.5%	65.8%	65.6%
Loan / Deposit Ratio	86.7%	87.3%	85.8%	85.6%	85.4%
Oper Leverage (Inc Growth - Cost Growth)	-7.4%	3.5%	-1.7%	6.3%	1.8%
Gearing (Assets / Equity)	15.2x	16.1x	16.1x	16.7x	17.0x
Tangible Common Equity / Assets	6.0%	5.7%	5.7%	5.6%	5.5%
Tangible Common Equity / WRAs	8.5%	7.0%	7.2%	7.2%	7.1%
Revenue Growth	-12.4%	5.2%	7.9%	12.3%	10.3%
Operating Expense Growth	-5.0%	1.7%	9.6%	6.0%	8.5%
Provisions Expense Growth	285.1%	-57.8%	58.1%	22.8%	13.4%
Operating Revenue / Average Assets	2.0%	1.9%	1.9%	2.0%	2.1%
Operating Expenses / Average Assets	1.2%	1.1%	1.1%	1.1%	1.1%
Pre-Provision ROA	0.8%	0.8%	0.8%	0.9%	1.0%
ROA	0.1%	0.4%	0.3%	0.3%	0.3%
Pre-Provision ROE	12.4%	13.1%	12.9%	14.8%	16.0%
ROE	0.9%	7.1%	4.8%	5.3%	5.7%
RoTE	1.2%	7.5%	4.9%	5.6%	6.0%
RoWRAs	0.1%	0.5%	0.4%	0.4%	0.4%
Dividend Payout Ratio	764.4%	0%	55.6%	33.8%	35.9%
Efficiency Ratio (Cost / Income Ratio)	63.4%	60.5%	62.2%	59.4%	58.1%
Total Non-Interest Inc / Operating Inc	27%	33%	31%	34%	33%
Market-Related Revenue / Total Revenues	15.6%	18.6%	17.2%	19.8%	19.6%
Provisioning Burden as % of PPP	92.9%	35.5%	53.2%	54.0%	54.5%
NPLs plus Foreclosed Real Estate / Loans	0.7%	0.8%	0.7%	0.7%	0.7%
Loan Loss Reserves / NPLs	91.0%	53.5%	74.9%	97.6%	118.3%
Loan Loss Reserves / Total Loans	0.7%	0.4%	0.5%	0.7%	0.8%
Provisions Expense / Average Loans	1.3%	0.5%	0.6%	0.7%	0.8%

Other Metrics

Income / Employee	3.27	3.31	3.41	3.70	3.96
(Operating Expenses) / Employee	1.93	1.89	1.97	2.03	2.13
Pre-Provision Profit / Employee	1.34	1.42	1.43	1.68	1.83
Net Profit / Employee	0.102	0.765	0.527	0.603	0.651

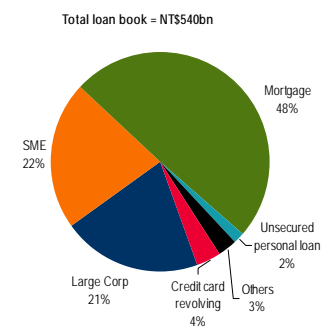
Company Description

E.SUN FHC is a bank-centric medium-sized FIG with total assets of US\$22.5bn. Its major subsidiaries include E.SUN Bank (78% of FHC profits in 9M07, 2.7% loan market share) E.SUN Securities, E.SUN Investment Trust, E.SUN Venture Capital, and E.SUN Insurance Brokerage. E.SUN FHC has a strategic alliance with Temasek Holdings, wherein Temasek invested US\$400mn in E.SUN ECB and would likely become the largest shareholder by 2008.

Investment Thesis

We no longer deem ESUN expensive after its recent share price correction. However, a relatively slower ROE improvement makes ESUN less attractive than other bank-centric FHCs in our coverage universe. We are impressed by its mortgage asset quality but prefer to monitor the quality of its SME lending as the book has not been tested by an economic downcycle.

Chart 1: Loan breakdown



Source: ESUN FHC

Stock Data

Price to Book Value 0.5x

Decent firm but ROE slow to mend

ESUN's share price has fallen by 55% since June. Year to date, the stock has underperformed the financial sector by 17%. Our downgrade earlier this year was prompted by our concern over its untested SME loans (20% of total loan book) and relatively high valuations. Investors used to pay a high premium for ESUN because of its solid corporate governance.

For now, we need to monitor ESUN's corporate loan quality amid the credit downturn and the potential impact on earnings as the company's SME loans tripled in the past four years on the heels of a booming macro environment. We have already factored into our 2008-10 earnings assumptions the possibility of rising SME credit costs and extra provisions for performing loans, and noted that the stock has corrected to a more reasonable valuation at the current price level (0.5x 2009E P/BV for ~6% 2009E-10E ROE). We therefore expect limited downside for the share price.

Having said that, expectation of slow ROE improvement in 2008-2010 should make ESUN pale in attractiveness to other quality names that have also corrected to deep valuations. Moreover, it could have earnings risk in corporate loans remain if SME asset quality deteriorates worse than expected. On balance, we would rate ESUN a Neutral despite an upside potential of >30% to its fair value. We would revisit our rating if the company's SME asset quality turns out better than we expect.

Table 1: ESUN: PO of NT\$11/share

Subsidiaries	Multiple	Value	% of total	Per share
Bank	0.8x P/BV	38,850	94%	11.0
Securities	0.7x P/BV	2,579	6%	0.7
Others and FHC Net Debt	1x P/BV	(96)	0%	(0.0)
Total Value		41,333	100%	11.7
Per Share Value		11.66		
Dividend		0.27		
Per Share Value		11.93		
Target Price		11.00		
Share Price		8.00		
Upside Potential		38%		

Source: Merrill Lynch estimates

Cut 2008E-09E earnings by ~37%

We slash our 2008E-09E earnings for ESUN by ~37% to reflect the worse-than-expected macro deterioration and potential impact on its core earnings. We did not make significant changes to our provision forecasts as we have already conservatively assumed credit costs to rise in 2008-09 and the need for extra provisions in 2008-10.

- **Lower loan growth:** We cut YoY loan growth to 8% from the original 10%. YTD 7% loan growth fell short of our expectation due to market competition and macroeconomic slowdown. Management has decided to scale down its loan growth target and instead focus on risk management and strengthening of client relationships for more fee income generation.
- **NIM stabilizing:** NIM has been stable at ~1.6bp in 1H08. With the central bank easing its monetary policy, we expect NIM to be flat in 2008 and slightly improve in 2009.
- **Fee income:** Fee growth did not live up to expectation and we expect further

deterioration in equity-market related fee in 2H08. We forecast 25% YoY decline in wealth management fee, which would lead to a 6-7% fall in total fee income

- **Trading:** Trading gains were also behind expectation as most financial institutions' year-to-date MTM gains have been weaker due to the ongoing global financial market uncertainty.
- **NPL provisions:** Mortgage asset quality remains intact with ~20bp credit costs. Our channel check also suggests that ESUN's mortgage quality is still intact. But we expect credit costs in SMEs to increase and ESUN will need to raise its general provisions by 2010 to comply with the new provisioning rule in 2011 which requires sufficient performing loan protection.

Table 2: ESUN: 2008E-09E net profit cut by 37%

(NT\$m)	Original		New		% chg	
	2008E	2009E	2008E	2009E	2008E	2009E
Bank	3,291	3,996	2,009	2,449	-39%	-39%
Securities	236	224	148	191	-37%	-14%
FHC & others	244	290	218	169	-11%	-42%
Consolidate Net Profit	3,771	4,510	2,376	2,810	-37%	-38%

Source: Merrill Lynch estimates

Earnings models

Table 3: FHC consolidated profit and loss statement

(NT\$m)	2006	2007	2008E	2009E	2010E
Net Interest Income	9,869	9,526	10,538	11,469	12,685
Net Fee Income	2,662	3,870	3,599	4,141	4,624
FX Gains/losses	409	139	323	473	523
Trading Income	933	823	1,049	1,368	1,392
Associate Contribution	(2)	(40)	18	20	22
Other Operating Income	(336)	(76)	(165)	(215)	(215)
Operating Revenue	13,535	14,242	15,362	17,255	19,030
Operating Expenses	(7,985)	(8,123)	(8,901)	(9,439)	(10,241)
Pre-provision Profit	5,550	6,119	6,460	7,817	8,789
Provisions	(5,157)	(2,175)	(3,439)	(4,223)	(4,787)
Pretax Profits	393	3,944	3,021	3,594	4,002
Tax	(42)	(650)	(646)	(784)	(871)
Extraordinary Item	72	0	0	0	0
Net Income	423	3,294	2,376	2,810	3,131

Source: Merrill Lynch estimates, financial reports

Table 4: FHC consolidated balance sheet

(NT\$m)	2006	2007	2008E	2009E	2010E
Cash & Equivalent	15,797	8,959	11,196	20,425	23,687
CBC and Interbank	37,046	31,671	34,948	37,110	39,403
Financial Asset-MTM	80,949	100,026	109,729	116,133	122,921
Credit Card Receivables	25,889	24,202	27,832	31,172	34,912
Margin Loan	3,048	4,050	3,380	3,380	3,380
Other Current Asset	5,403	4,375	4,831	5,099	5,383
Net Loans	439,172	514,649	557,166	589,647	624,019
LT Investment	63,996	61,626	67,436	71,225	75,241
Net Fixed Assets	11,771	12,915	12,915	12,915	12,915
Other Assets	10,718	9,711	9,017	8,800	8,684

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Table 4: FHC consolidated balance sheet

(NT\$m)	2006	2007	2008E	2009E	2010E
Total Assets	693,789	772,183	838,450	895,905	950,544
Due to banks	29,747	32,516	32,516	32,516	32,516
ST Debts	913	1,774	1,501	1,501	1,501
Repo Bond & MTM Liabilities	31,934	27,207	28,364	28,974	39,157
Other Current Liabilities	14,599	8,479	9,277	9,804	10,362
Deposits	506,264	589,441	649,319	688,838	730,728
Debenture, ECB, and LT Borrowings	60,984	61,324	61,934	76,874	76,874
Other Liabilities	3,778	3,599	3,599	3,599	3,599
Total Liabilities	648,220	724,340	786,509	842,106	894,738
Total Common Equity	45,568	47,841	51,940	53,799	55,807
Total Liabilities & Equity	693,789	772,183	838,450	895,905	950,544

Source: Merrill Lynch estimates, financial reports

Table 5: ESUN Bank: Profit and loss statement

(NT\$m)	2006	2007E	2008E	2009E	2010E
Net Interest Income	9,227	8,823	9,834	10,774	11,999
Net Fee Income	2,223	3,255	3,062	3,606	4,090
FX Gains/losses	315	167	350	500	550
Trading Income	1,063	625	850	1,100	1,100
Associate Contribution	(2)	(40)	-	-	-
Other Operating Income	(80)	228	200	200	200
Operating Revenue	12,745	13,057	14,296	16,180	17,939
Expenses	(7,242)	(7,474)	(8,282)	(8,817)	(9,615)
Pre-provision Profit	5,503	5,583	6,014	7,363	8,324
Provisions	(5,140)	(2,294)	(3,439)	(4,223)	(4,787)
Operating profit after provisions	363	3,289	2,575	3,140	3,538
Non-operating Profit (Loss)	-	-	-	-	-
Pretax Profits	363	3,289	2,575	3,140	3,538
Tax	37	(698)	(567)	(691)	(778)
Extraordinary Items	46	-	-	-	-
Net Profit (Loss)	447	2,591	2,009	2,449	2,759

Source: Merrill Lynch estimates, financial reports

Price objective basis & risk

E.Sun FHC (ESUFF)

Our PO of NT\$11/share is based on a fully-diluted SOTP valuation, whereby we apply P/BV multiples to each subsidiary based on long-term normalized ROE and industry positions. Our SOTP valuation includes (1) 0.8x 2009E P/BV for E.Sun Bank, given its normalized ROE of 6pct to 8pct, (2) 0.7x 2009E P/BV for E.Sun Securities, and (3) 1x 2009E P/BV for other subsidiaries and FHC net debts. Our PO reflects potential dilution from upcoming ECB issuance. Upside risks: ROE enhancement and better-than-expected SME credit quality. Downside risks: Unexpected trading gains/losses and influx/recovery of NPLs.

Analyst Certification

I, Katherine Hu, 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
	NEUTRAL			

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Taiwan Coverage Cluster

Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
	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
	Hotai 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	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	$\text{Total Assets} - \text{Current Liabilities} + \text{ST Debt} + \text{Accumulated Goodwill Amortization}$
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	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Other LT Liabilities}$	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

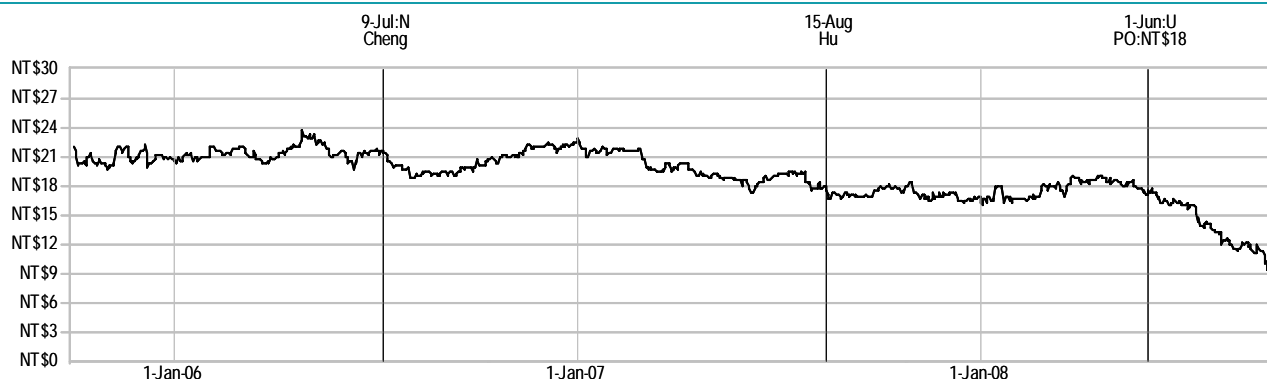
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Important Disclosures

ESUFF Price Chart



ESUFF

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*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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