

## Company Focus

15 October 2008 | 10 pages

# First Financial (2892.TW)

 Target price change   
 Estimate change 

## Buy: Pullback Overdone with Valuations Back to Trough

- Playing a market bounce** — We think the market is too negative on the impact of a more challenging environment for First FHC, with the stock now trading below historic trough at 0.8x adjusted and 1.0x reported P/B based on 2008E. Aside from a strong deposit franchise, we believe concerns on SME exposure appear overdone. Maintain Buy / Low Risk (1L) rating.
- Baking in more conservative numbers** — We are cutting our EPS forecasts for 2008-10E to reflect the tougher environment. Our new forecasts assume a 24% rise in provisions amid new NPL influx rising to 77bps from 52bps and 0% growth in fees into 2009E. Consequently, we lower our target to NT\$25 (from NT\$36), still based on Gordon Growth but using a lower LT ROE of 11.5% and moving to reported book vs. adj. book excl. unrealized property gains.
- Strong deposit franchise** — Given government ownership and a Taipei-focused branch network, First typically benefits from additional funds as depositors remain cautious. We expect management can take this opportunity to reduce funding cost, with LDR steady at 85%. As fear recedes eventually, we anticipate these funds will likely be a good source of wealth management fees.
- SME risks exaggerated** — The stock took a hit on SME concerns, with loans to this segment accounting for almost 30% of loans. Although we could see higher credit costs in the coming quarters, especially as it writes off exposures to LEH at US\$25m and WaMu at US\$13m, the company has been relatively more conservative in expanding its SME book posting CAGR of only 6.7% over the past five years, having upgraded its risk management policies in 2003.

<b>Buy/Low Risk</b>	<b>1L</b>
Price (15 Oct 08)	NT\$16.95
Target price	NT\$25.00
	<i>from NT\$36.00</i>
Expected share price return	47.5%
Expected dividend yield	6.2%
<b>Expected total return</b>	<b>53.7%</b>
Market Cap	NT\$104,492M
	US\$3,228M

### Price Performance (RIC: 2892.TW, BB: 2892 TT)



Figure 1. First FHC – Statistical Abstract

Year to	Net profit	EPS	EPS Growth	P/E	ABV	P/ABV	DPS	Yield	RoAE
31-Dec	(NT\$ Mils.)	(NT\$)	(%)	(x)	(NT\$)	(x)	(NT\$)	(%)	(%)
2006	10,918	1.77	-26	9.6	20.78	0.8	1.12	6.6	10.0
2007	12,026	1.95	10	8.7	21.72	0.8	1.50	8.8	10.4
2008E	10,777	1.75	-10	9.7	21.59	0.8	1.68	9.9	9.2
2009E	9,885	1.60	-8	10.6	22.04	0.8	1.05	6.2	8.4
2010E	10,615	1.72	7	9.8	22.70	0.7	0.96	5.7	8.7

Source: Company Reports and CIR estimates

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Fiscal year end 31-Dec	2006	2007	2008E	2009E	2010E
<b>Valuation Ratios</b>					
P/E adjusted (x)	9.6	8.7	9.7	10.6	9.8
P/E reported (x)	9.6	8.7	9.7	10.6	9.8
P/BV (x)	1.0	1.0	1.0	1.0	0.9
P/Adjusted BV diluted (x)	0.8	0.8	0.8	0.8	0.7
Dividend yield (%)	6.6	8.8	9.9	6.2	5.7
<b>Per Share Data (NT\$)</b>					
EPS adjusted	1.77	1.95	1.75	1.60	1.72
EPS reported	1.77	1.95	1.75	1.60	1.72
BVPS	16.42	17.21	17.02	17.58	18.34
Tangible BVPS	16.42	17.21	17.02	17.58	18.34
Adjusted BVPS diluted	20.78	21.72	21.59	22.04	22.70
DPS	1.12	1.50	1.68	1.05	0.96
<b>Profit &amp; Loss (NT\$M)</b>					
Net interest income	20,381	21,941	23,016	24,172	25,852
Fees and commissions	4,495	6,884	5,330	5,332	6,399
Other operating Income	3,181	3,609	3,601	2,912	3,039
<b>Total operating income</b>	<b>28,057</b>	<b>32,435</b>	<b>31,947</b>	<b>32,417</b>	<b>35,289</b>
Total operating expenses	-13,586	-14,200	-14,474	-14,588	-15,684
<b>Oper. profit bef. provisions</b>	<b>14,472</b>	<b>18,235</b>	<b>17,473</b>	<b>17,829</b>	<b>19,605</b>
Bad debt provisions	-4,736	-6,062	-5,527	-6,872	-7,336
Non-operating/exceptionals	4,521	3,499	1,757	1,400	1,000
<b>Pre-tax profit</b>	<b>14,257</b>	<b>15,672</b>	<b>13,703</b>	<b>12,357</b>	<b>13,269</b>
Tax	-3,340	-3,646	-2,926	-2,471	-2,654
Extraord./Min. Int./Pref. Div.	0	0	0	0	0
<b>Attributable profit</b>	<b>10,918</b>	<b>12,026</b>	<b>10,777</b>	<b>9,885</b>	<b>10,615</b>
Adjusted earnings	10,918	12,026	10,777	9,885	10,615
<b>Growth Rates (%)</b>					
EPS adjusted	-26.3	10.2	-10.4	-8.3	7.4
Oper. profit bef. prov.	13.1	26.0	-4.2	2.0	10.0
<b>Balance Sheet (NT\$M)</b>					
<b>Total assets</b>	<b>1,574,022</b>	<b>1,626,348</b>	<b>1,675,139</b>	<b>1,775,647</b>	<b>1,864,429</b>
Avg interest earning assets	1,311,791	1,386,824	1,431,392	1,486,799	1,568,712
Customer loans	979,929	1,079,408	1,112,267	1,181,220	1,241,763
Gross NPLs	15,406	16,234	17,284	20,538	23,047
<b>Liab. &amp; shar. funds</b>	<b>1,574,022</b>	<b>1,626,348</b>	<b>1,675,139</b>	<b>1,775,647</b>	<b>1,864,429</b>
Total customer deposits	1,219,889	1,260,175	1,314,001	1,360,068	1,411,466
Reserve for loan losses	8,035	8,780	9,852	11,501	12,676
Shareholders' equity	<b>87,125</b>	<b>89,742</b>	<b>88,578</b>	<b>91,997</b>	<b>96,681</b>
<b>Profitability/Solvency Ratios (%)</b>					
ROE adjusted	13.3	13.6	12.1	10.9	11.3
Net interest margin	1.55	1.58	1.61	1.63	1.65
Cost/income ratio	48.4	43.8	45.3	45.0	44.4
Cash cost/average assets	0.9	0.9	0.9	0.8	0.9
NPLs/customer loans	1.6	1.5	1.6	1.7	1.9
Reserve for loan losses/NPLs	52.2	54.1	57.0	56.0	55.0
Bad debt prov./avg. cust. loans	0.5	0.6	0.5	0.6	0.6
Loans/deposit ratio	80.3	85.7	84.6	86.9	88.0
Tier 1 capital ratio	8.4	7.3	6.8	6.7	6.7
Total capital ratio	11.0	10.8	10.3	10.2	10.2

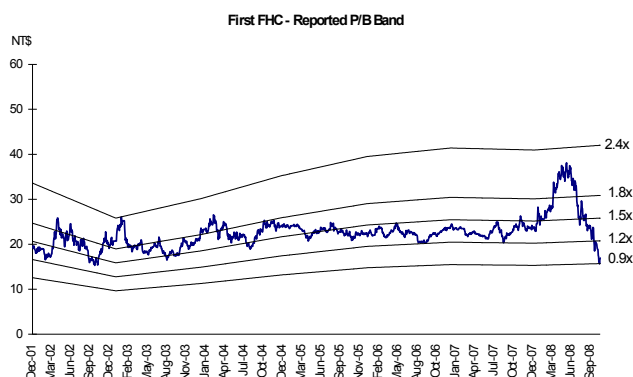
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## Buy: Pullback Overdone with Valuations Back to Trough

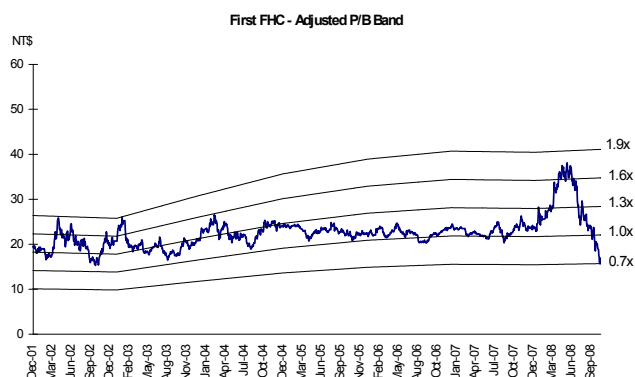
We are maintaining our Buy / Low Risk (1L) rating on First FHC shares and expect it will be a beneficiary of a market bounce. Although we could see all stocks benefit at the onset, we anticipate the market will be more selective as the rally matures. For First FHC, we think the market is too negative on the impact of a more challenging environment going into 2009E. Aside from a strong deposit franchise, we believe concerns on SME exposure appear overdone. The stock is now trading below historic trough at 0.8x adjusted P/B (with unrealized gains on property) and 1.0x reported P/B (excluding unrealized gains on property) based on 2008E.

Figure 2. First FHC – Price/Reported BV Bands



Source: Datastream, Citi Investment Research

Figure 3. First FHC – P/Adjusted BV Bands



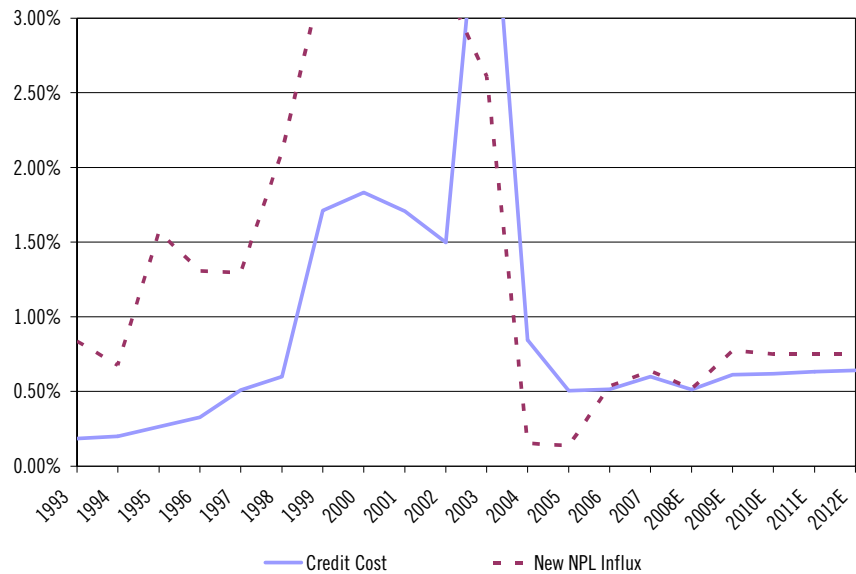
Source: Datastream, Citi Investment Research

We have lowered our 12-month target price to NT\$25 (from NT\$36), still based on Gordon Growth, but taking into account the following changes:

1. Lowering LT ROE assumption to 11.5% from 12-13% previously and moving closer to trough valuations (1.4x) vs. mid cycle valuations (1.6x) on P/B.
2. Moving to reported book without unrealized gains on property from previous adjusted book taking into account unrealized gains on property. Although we can argue that the NT\$22-23bn in unrealized gains on property is conservative as it is based on a 2002 valuation benchmark, we have decided to remove it from our valuation methodology given a more cautious view on the property market.

We have decided to bake in more conservative estimates on credit costs and fee income contribution amid a tougher operating environment. As such, we are cutting our EPS forecasts for 2008-10E. Our new forecasts assume a 20% rise in credit costs and a 24% rise in loan-loss provisions, with new NPL formation rising to 77bps in 2009E vs. an estimated 52bps in 2008E. We have also conservatively imputed a 0% growth in fees, even after an expected 25% decline in 2008E. Although we could see upside if markets show signs of recovery in 2H09, we think it is better to present a more conservative view in light of present market conditions.

Figure 4. First FHC—Credit Costs and New NPL Influx, 1993-2012E (Percent)

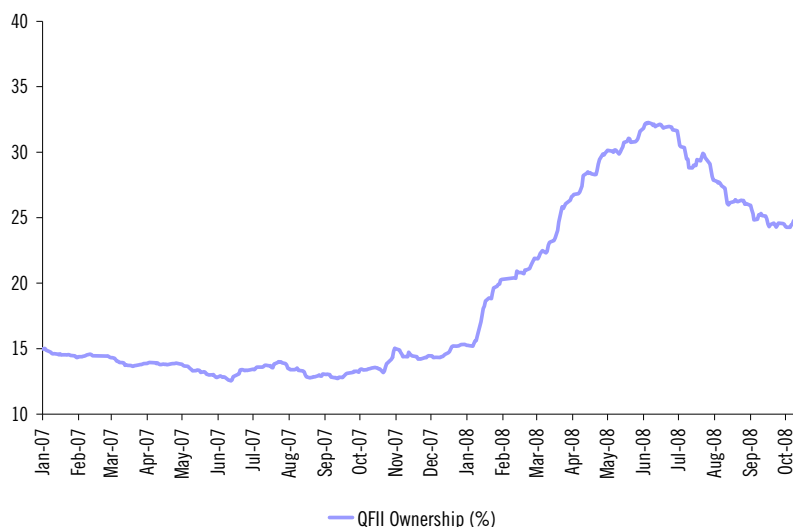


Source: Company Reports and Citi Investment Research

Given government ownership and a Taipei-focused branch network, we believe First boasts a very strong deposit franchise that will typically benefit from additional funds as depositors remain cautious. With loan-to-deposit ratio steady at 85%, we expect management can take this opportunity to reduce funding cost, especially following cuts in benchmark rates and reserve requirement ratios. As depositor fears will recede eventually as the market recovers, we anticipate fresh funds will likely be a good source to tap wealth management fees.

The stock took a hit on SME concerns, with loans to this segment accounting for almost 30% of loans. Although we could see higher credit costs in the coming quarters, especially as it writes off exposures to LEH at US\$25m and WaMu at US\$13m, the company has been relatively more conservative in expanding its SME book. Having upgraded its risk management practices following its GDR issue in 2003, First's SME loans have only posted CAGR of 6.7% over the past five years. As of end-2Q08, management reported NPL ratio at 1.4% and loan-loss reserve coverage at 55%. It also reported SME NPL ratio remained firm at 2.1% vs. 2.4-2.5% in 2006-07.

Figure 5. First FHC – QFII Ownership (%)



Source: TEJ, Citi Investment Research

Figure 6. First FHC – Estimate Revisions

Year to 31 Dec	Net Profit (NT\$ Mils.)		Diluted EPS (NT\$)			Dividend Per Share (NT\$)	
	Old	New	Old	New	% Chg	Old	New
2008E	11,914	10,777	1.93	1.75	-9.5	1.68	1.68
2009E	12,723	9,885	2.06	1.60	-22.3	1.16	1.05
2010E	13,152	10,615	2.13	1.72	-19.3	1.24	0.96

Source: Citi Investment Research estimates

## First Financial

### Company description

First Commercial Bank is the oldest and largest non-wholly owned government bank in Taiwan based on assets, loans and deposits servicing over 4m customers. Founded in 1899 as Savings Bank of Taiwan, it was renamed First Commercial Bank in 1949, and privatized in 1998. However, the government still exerts a significant influence through its remaining 24.8% direct and 11.1% indirect stake. It was reorganized under an FHC structure in 2003.

## **Investment strategy**

We rate First FHC shares Buy / Low Risk (1L). We expect valuations could re-rate on expectations of improved cross-strait and better banking system reform. Among all government banks, we still think First FHC is the most attractive among state-owned banks because: the balance sheet has already been cleaned up, likely allowing the recent profitability improvement to be sustained; it has a strong distribution platform and customer base more heavily focused on the Taipei area. The company has also successfully shored up earnings performance, following its balance sheet clean-up in 2002-03. Outside of stable fundamentals, its exposure to US sub-prime is limited.

## **Valuation**

Our target price of NT\$25 is based on 1.4x 2009E reported book, excluding any unrealized gains on property. Although we still argue that the NT\$22-23bn in unrealized gains on property for First FHC is conservative as it is based on a 2002 valuation benchmark, we have decided to remove it from our valuation methodology given a more cautious view on the property market in Taiwan. Our fair value P/B multiple of 1.4x is based on a Gordon Growth valuation approach, using LT ROE of 11.5%, cost of equity at 9% and long-term growth rate of 3%. We use P/B as our primary valuation method as it is a measure most investors use when valuing financial institutions. On a P/E basis, the stock would trade at 14-15x 2008-10E EPS at our target.

## **Risks**

We rate First FHC shares Low Risk, in line with our quantitative risk rating system. Risks that could prevent the shares reaching our target price include: if consolidation takes longer than we expect; uncertainties surrounding its consumer and wealth management initiative; insufficient capital to cover additional reserve requirements; merger integration risk; volatile earnings risk from non-bank subsidiaries.

# Appendix A-1

## Analyst Certification

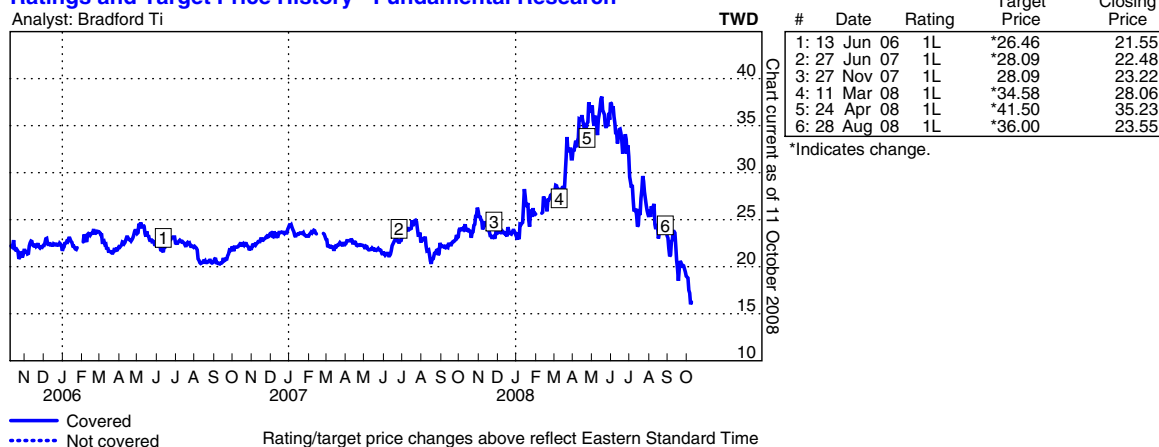
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