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Stock Rating

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Industry View

In-Line

Shin Kong FHC

Weaker than Expected 3Q08 Results

Investment conclusion: The successful equity placement completed in end-October, combined with the recent RBC rule changes should strengthen the life subsidiary's RBC ratio and ease near-term recap pressure. However, with the equity market still quite volatile and more CDO/CBO write-downs likely, there remain risks to Shin Kong's book value from mark-to-market accounting.

What's new: Shin Kong reported net profit of NT\$1.03 billion in 3Q08, reducing 9M08 loss to NT\$11.32 billion. Despite the booking of NT\$3.2 billion gain from Xinyi CLC land disposal, the 3Q result came in below our estimate on larger-than-projected unrealized equity losses and NT\$1.6 billion loss from Lehman bond investment. First year premium was weaker than expected as management chose to maintain profit margin instead of growing low-margin products. As a result, FYP in 9M08 contracted 2% YoY vs. industry growth of 21%.

Despite the NT\$1 billion net profit, the large unrealized losses incurred on AFS investments resulted in 19% decline in the group's book value in the quarter. The RBC ratio remained above 200% despite the weak equity performance because of a regulation change recently announced.

Given the weaker results, we lowered our 2008 and 2009 to NT\$(1.87) and NT\$0.54 from NT\$(1.85) and NT\$0.55, respectively. We discuss the key operating trends of the life insurance and bank subsidiaries inside.

Key Ratios and Statistics

Reuters: 2888.TW Bloomberg: 2888 TT

Taiwan Financial Services

Price target	++
Shr price, close (Nov 6, 2008)	NT\$8.60
52-Week Range	NT\$27.76-6.60
Sh out, dil, curr (mn)	5,673
Mkt cap, curr (mn)	NT\$48,786
Avg daily trading volume (mn)	NT\$947

Fiscal Year ending	12/07	12/08e	12/09e	12/10e
ModelWare EPS (NT\$)	0.89	(1.73)	0.51	0.77
Prior ModelWare EPS (NT\$)	-	(1.60)	0.51	0.77
EPS, basic (NT\$)*	0.97	(1.87)	0.54	0.82
Prior EPS, basic (NT\$)*	-	(1.85)	0.55	0.82
ModelWare net inc (NT\$ mn)	5,008	(10,573)	3,324	5,045
P/E	23.6	NM	17.0	11.2
P/BV	1.4	0.7	0.7	0.7
ROE (%)	5.7	(12.6)	4.2	6.3

Unless otherwise noted, all metrics are based on Morgan Stanley ModelWare framework (please see explanation later in this note).

* = GAAP or approximated based on GAAP

e = Morgan Stanley Research estimates

++ = Stock Rating, Price Target or Estimates are not available or have been removed due to applicable law and/or Morgan Stanley policy.

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Shin Kong FHC: Consolidated Financial Summary

PROFIT AND LOSS STATEMENT

Financial year ended 31 December (NT\$mil)	2006	2007	2008E	2009E
Premium Income	149,421	150,284	144,520	137,291
Interest Income	46,706	51,045	46,709	51,302
Recovered Reserves	54,261	78,311	72,185	88,833
Other Income	72,672	122,440	152,272	75,321
Total Operating Revenue	323,060	402,080	415,685	352,747
Provision for Prem. Resv.	150,893	153,503	157,032	153,921
Insurance Claim Payments	66,731	90,528	75,114	83,613
Interest Expense	4,996	6,154	6,822	7,462
Other Costs	60,895	122,393	160,481	83,426
Finance Operating Costs	283,514	372,578	399,449	328,422
Operating Expenses	22,782	23,551	21,602	21,248
Operating Income	16,764	5,951	(5,365)	3,077
Non Operating Income	(10,162)	(998)	(4,661)	1,007
Non Operating Expenses	1,230	-	4,587	76
Pretax Income	5,373	4,953	(14,614)	4,007
Income Tax Exp./(Benefit)	(672)	(133)	(4,040)	683
Ordinary Income	6,045	5,086	(10,573)	3,324
Net Income for Minority	116	78	-	-
Net Income (reported)	5,928	5,008	(10,573)	3,324

BALANCE SHEET

Financial year ended 31 December (NT\$mil)	2006	2007	2008E	2009E
Assets				
Current Assets	379,765	463,510	243,696	255,831
Bills and Loans	406,600	459,743	388,842	415,887
L-T Investments	605,004	611,638	901,084	970,283
Net Property and Equip.	24,827	21,079	27,005	27,839
Other Assets	76,106	132,025	170,635	220,154
Total Assets	1,492,302	1,687,996	1,731,261	1,889,995
Liabilities				
Current Liabilities	73,521	104,807	42,394	37,866
L-T Liabilities	20,722	15,710	18,654	20,657
Insurance & assoc. reserves	1,025,433	1,153,474	1,243,461	1,376,093
Deposits and other	281,779	313,891	332,754	359,374
Total Liabilities	1,401,455	1,587,883	1,637,263	1,793,989
Shareholders' equity				
Common Stock	46,996	50,254	61,616	61,616
Preferred Stock	-	-	-	-
Capital Surplus	13,626	19,325	23,295	23,295
Retained Earnings	12,517	11,342	(4,614)	(2,606)
Treasury Stock & adjustments	17,707	19,192	13,700	13,700
Total Shareholders' Equity	90,847	100,113	93,997	96,005

SEGMENT DATA

Financial year ended 31 December (NT\$mil)	2006	2007	2008E	2009E
Net Income				
Shin Kong Life	10,834	2,417	(11,709)	2,008
Shin Kong Bank	(7,276)	1,423	1,136	1,316
Other	2,370	1,168	(0)	0
Shin Kong Group	5,928	5,008	(10,573)	3,324
% Net Income				
Shin Kong Life	183%	48%	111%	60%
Shin Kong Bank	-123%	28%	-11%	40%
Other	40%	23%	0%	0%
Shin Kong Group	100%	100%	100%	100%
ROE %				
Shin Kong Life	17.4	3.7	(24.4)	5.4
Shin Kong Bank	(36.6)	7.0	5.4	6.0
Other	--	--	--	--
Shin Kong Group	7.4	5.2	(10.9)	3.5
Assets				
Shin Kong Life	1,114,186	1,226,222	1,291,179	1,428,638
Shin Kong Bank	351,532	382,838	400,490	422,513
Other	26,585	78,935.81	39,591.95	38,843.78
Shin Kong Group	1,492,302	1,687,996	1,731,261	1,889,995

% Assets to Group

Shin Kong Life	74.7	72.6	74.6	75.6
Shin Kong Bank	23.6	22.7	23.1	22.4
Other	1.8	4.7	2.3	2.1
Shin Kong Group	100.0	100.0	100.0	100.0

RATIO Analysis

	2006	2007	2008E	2009E
ROAE (%)	7.7	5.8	(13.0)	4.2
ROAA (%)	0.4	0.3	(0.6)	0.2
Reported EPS	1.35	0.97	(1.87)	0.54
Modelware EPS	1.28	0.89	1.73	0.51
P/E (Reported EPS)	6.4	8.8	(4.6)	15.9
DPS	0.94	0.51	0.00	0.29
Dividend Yield	10.90	5.93	0.00	3.36
BVPS	17.51	15.99	12.75	13.08
P/B	0.5	0.5	0.7	0.7
Growth Rates (%)				
Revenues	12.0	28.2	2.5	(13.9)
Expenses	13.2	28.8	7.4	(17.8)
Net Income	(16.0)	(15.5)	(311.1)	(131.4)

E = Morgan Stanley Research estimates
Source: Company data, Morgan Stanley Research

November 7, 2008
Shin Kong FHC

Morgan Stanley is currently acting as financial advisor to Shin Kong FHC in relation to its proposed private placement to strategic investor announced on September 9, 2008.

The proposed offer is to be conditional, among other things, upon shareholders and regulatory approvals.

Shin Kong FHC has agreed to pay fees to Morgan Stanley for its financial services, including transaction fees that are contingent upon the consummation of the proposed transaction.

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Commentary on Life Insurance Business in 3Q08

Shin Kong Life reported net profit of NT\$1.9 billion despite the falling equity market in 3Q08 because of several exceptional items: 1) land disposal gain of NT\$3.2bn; 2) reversal of FX loss of NT\$3-4bn, on our estimate; and 3) reclassification of trading assets to available-for-sale that resulted in a gain of NT\$3.7bn. Despite the NT\$1.9bn profit, the life unit's total equity shrank by NT\$14bn (or 28%) to NT\$35bn, due entirely to MTM loss of NT\$16bn from its available-for-sale investments. Key operating trends include:

FYP Trend – Growth Driven by Low-Margin Interest-sensitive Annuity

First-year premium (FYP) declined by 34% QoQ, while cumulative FYP in 9M08 declined by 2% YoY vs. industry growth of 21%. The sequential decline was attributed to: 1) continued weakness in VUL due to sustained bearish equity market sentiment; 2) slower sales momentum in structured-note-linked policies. According to management, Shin Kong is less aggressive than its peers in promoting this low-margin product after 1Q08 due to margin concern.

Exhibit 1

Shin Kong Life: FYP Trends, 2Q08

NT\$ billion	3Q08	QoQ	9M08	YoY
Traditional	1.8	-12%	5.5	-10%
Investment-linked				
VUL / VA	0.0	-97%	3.6	-92%
Structured Note	4.7	-69%	43.2	735%
Interest Sensitive				
Annuity	8.5	70%	17.2	52%
Life	0.2	-16%	0.7	-77%
PA, Health, and others	0.9	45%	2.1	-5%
Total	16.0	-34%	72.3	-2%

Source: Company data, Morgan Stanley Research

Asset Allocation – Yield Improved Sequentially on Land Disposal Gain and Reversal of FX Losses taken in 1H08

Annualized investment yield improved slightly to 2.26% in 9M08 from 1.12% in 1H08, due largely to reversal of FX losses taken in 1H08 and land disposal gain of NT\$3.2bn. We understand that the below-industry-average domestic bond yield of 1.1% was due to write-down on its NT\$-denominated CBO portfolio in 1Q08. Investment yield of domestic bonds actually improved from 0.6% in 1H08 to 1.1% in 9M08 as the negative impact from CBO write-down has been diluted. In addition, the 7.8% return from domestic equity does not capture unrealized MTM losses. Management guided the return would decline to -16% (vs. Taiex's decline of 33% year-to-date) should we incorporate the unrealized MTM losses. On asset mix, management indicated that the original plan to increase overseas investments to 40% of total assets is complicated by recent volatile FX market, which has made some hedging tools more costly than expected. That partially explains why Shin Kong's cash & equivalent increased by 1 percentage point in 3Q.

Exhibit 2

Shin Kong Life: Asset Allocation and Yields, 9M08

	9M08		1H08	
	Mix	Yield*	Mix	Yield*
Cash & equivalents	9%	2.1%	8%	2.3%
Equities - Domestic	6%	7.8%	7%	2.3%
Bonds - Domestic	28%	1.1%	29%	
Equities - International	4%	-0.5%	4%	-3.1%
Bonds - International	28%		27%	
Mortgage Loans	7%	3.8%	6%	4.0%
Policy Loans	11%	6.1%	10%	6.0%
Real Estate	7%	8.4%	8%	4.1%
Total	100%	2.26%	100%	1.12%

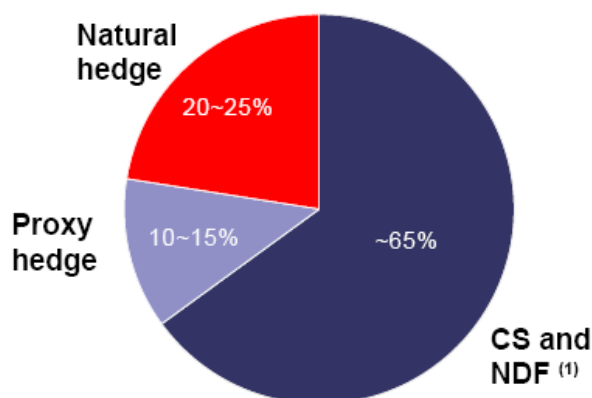
Source: Company data, Morgan Stanley Research

Update on Hedging Strategy

Shin Kong increased natural hedge positions (i.e., to leave some overseas investment un-hedged) to 20–25% of total overseas assets from 10% last quarter. Looking back, the strategy worked well and helped Shin Kong to reverse NT\$3-4bn FX losses recognized in 1H08. However, we note that the natural/proxy hedge positions could be a double-edged sword that may hurt Shin Kong if the currency trend unexpectedly moves in a different direction.

Exhibit 3

Shin Kong Life: Mix of Hedging Strategies Used



(1): Currency swaps and non-delivery forwards
Source: Company data, Morgan Stanley Research

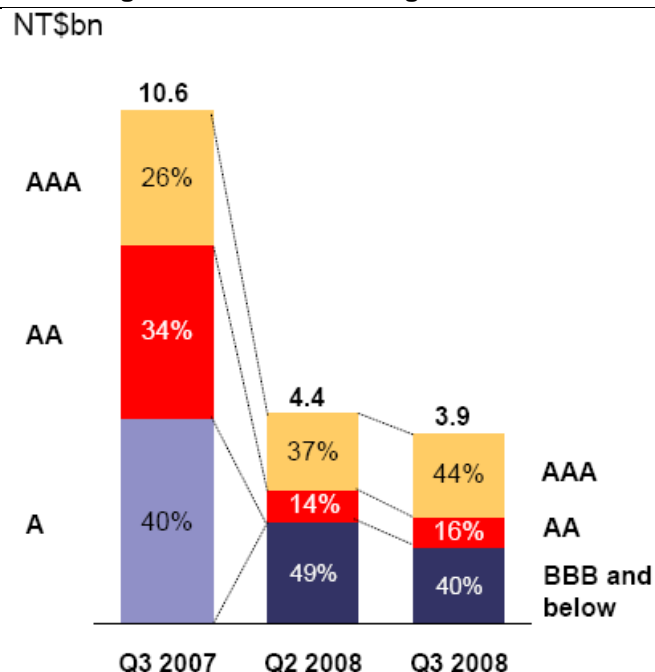
Update on CDO/CBO

Shin Kong's net exposure to CDO increased slightly to NT\$27bn in 3Q08 (vs. NT\$26bn in 2Q08 and peak level of NT\$37bn), due to US\$ appreciation. The riskiest ABS CDO declined to NT\$3.9bn from NT\$4.4bn in 2Q08 and the peak of NT\$10.6bn in 3Q07. Management indicated that 97% of originally-A-rated ABS CDOs were written off. In our model, we assume Shin Kong will need to write down additional NT\$2.2 billion of ABS CDOs, the positions currently rated AA and below, as shown in Exhibit 4. On corporate CDO and CMBS, we double our loss ratio assumption to 10% in light of weakening macro environment and in particular deteriorating credit quality of worldwide financial institutions. As of 3Q08, 60% of Shin Kong's corporate CDOs still have AA or above ratings.

Shin Kong has fully written down its positions in E.Sun CBO 2007-2 tranche (totalled NT\$2.4 billion) in 1Q08. There is no change in its NT\$-denominated CBO portfolio in 2Q08/3Q08. It still owns NT\$31.4 billion, including NT\$1.2 billion of below-A-rated, corporate-bond-linked positions. Conservatively, we assume this NT\$1.2 billion below-A-rated bonds will be fully wiped out in our base case valuation.

Exhibit 4

Shin Kong Life: ABS CDO Rating Distribution



Source: Company data, Morgan Stanley Research

Commentary on Banking Business in 3Q08

Shin Kong Bank reported net loss of NT\$477 million in 3Q08, compared with a profit of NT\$74 million and NT\$607mn in 2Q08 and 1Q08, respectively. The sharp decline was mainly due to prop trading loss and provision of NT\$520mn set aside for the bank's Lehman exposure. Core revenue declined ~3% QoQ, with growing net interest income more than offset by falling wealth management fees. We highlight key operating trends below:

- NIM improved 2 bps sequentially to 1.69% in 3Q08 due to re-pricing of mortgage and management focus to retire low-yielding less-profitable corporate loans.
- Total loans remained flattish QoQ but grew 9.1% YoY. Management has applied more stringent credit policies for mortgage origination. LTV ratio was reduced from 80% to 70% for urban planning areas and from 70% to 60% for non-urban planning areas. LTV ratio for Taipei city remained unchanged at 70%.
- Net fee income declined by 13% QoQ due to reduced wealth management fees (down 37% QoQ).

- Asset quality remained largely unchanged. NPL ratio increased slightly to 1.97% from 1.84% with loan loss coverage ratio up slightly to 66% from 63%. Mortgage NPL ratio remained stable at 0.98%.

Company Description

Shin Kong FHC is one of the largest financial services companies in Taiwan by market capitalization. Its subsidiaries include the third-largest life insurer and the seventh-largest non-government bank.

Taiwan Financial Services

Industry View: In-Line

While we believe overall risk-reward for the sector has improved after the recent correction, we admit there are limited catalysts in the near term to drive a sustainable performance of the sector.

MSCI Country: Taiwan

Asia Strategist's Recommended Weight: 11.9%

MSCI Asia/Pac All Country Ex Jp Weight: 12.1%



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(as of October 31, 2008)

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November 7, 2008

Shin Kong FHC

Stock Rating Category	Coverage Universe		Investment Banking Clients (IBC)		
	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	869	39%	275	42%	32%
Equal-weight/Hold	983	44%	286	44%	28%
Underweight/Sell	403	18%	89	14%	22%
Total	2,255		650		

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Overweight (O or Over) - The stock's total return is expected to exceed the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

Equal-weight (E or Equal) - The stock's total return is expected to be in line with the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

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Industry Coverage: Taiwan Financial Services

Company (Ticker)	Rating (as of)	Price (11/06/2008)
Lily Choi		
Cathay Financial Holdings (2882.TW)	O (07/08/2008)	NT\$36.35
Chang Hwa Bank (2801.TW)	E (03/26/2007)	NT\$11.95
Chinatrust Financial Holding (2891.TW)	E (06/26/2008)	NT\$10.9
Fubon Financial Holdings (2881.TW)	O (01/08/2008)	NT\$19.7
Mega Holdings (2886.TW)	U (10/16/2008)	NT\$9.77
Shin Kong FHC (2888.TW)	++	NT\$8.6
Taishin Financial Holdings (2887.TW)	E (01/14/2008)	NT\$5.02
Yuanta Financial Holding Company (2885.TW)	E (02/29/2008)	NT\$13.25
Bruce Chou		
E.Sun Financial (2884.TW)	E (11/19/2007)	NT\$7.7
First Financial (2892.TW)	E (07/29/2008)	NT\$16.65
SinoPac Holdings (2890.TW)	E (04/29/2008)	NT\$7

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