

19 July 2007 (No. of pages: 10)

Pusan Bank (005280 KS)

6-mth rating: **2**

Share price (18 Jul): W15,650

Target price: W17,900

Banks: Korea

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Strong earnings growth continues amid decreasing concerns over NIM

- After reviewing the 1H07 earnings results, we have raised our target price by 10.5% from W16,200 to W17,900 based on our upward earnings revision of FY07 and FY08 earnings by 5.6% and 7.9%, respectively. We believe that expected high earnings visibility in FY07 (46% YoY growth) and a reasonably high forecast dividend yield of 3.9% make Pusan Bank shares attractive. We maintain our **2** (*Outperform*) rating.
- The bank posted a strong earnings growth in 1H07 (41% YoY) backed by 1) continued low provisioning (73% drop YoY), 2) a 10% YoY increase in net interest income thanks to strong loan growth and improving NIM, and 3) better cost management due to lack of one-off expense incurred from an early retirement program.
- Encouraging signals detected out of the bank's 2Q07 results were 1) stronger than expected loan growth, a benefit from improving regional economy, and 2) a gradual improvement of NIM. We believe these evidences could significantly alleviate investors' concerns over the future profitability of the bank.
- Overall financial quality of the bank during the 2Q07 has shown a sequential improvement thanks to sharply improved asset quality (precautionary and below loans ratio: 2.54% in 1Q07 vs. 1.83% in 2Q07) and NPL coverage ratio (174% in 1Q07 vs. 180% in 2Q07).

Market data

KOSPI		1,930.70
Market cap	(US\$bn)	2.51
3-mth avg daily T/O	(US\$m)	14.7
Shares outstanding	(m; 06)	146.7
ROE	(%; 06)	14.4
ROA	(%; 06)	0.85
Exchange rate	W/US\$	916.1

Investment indicators

PER	(x; 07F)	8.6
	(x; 08F)	7.8
PBR	(x; 06)	1.80
Dividend yield	(%; 07F)	3.9

Source: Daiwa forecasts

Income summary

Year to 31 Dec	Operating profit		Pre-tax profit		Net profit		EPS	DPS
	(Wbn)	(%)	(Wbn)	(%)	(Wbn)	(%)	(W)	(W)
2005A	335.4	6.2	249.6	31.5	178.9	34.8	1,220	405
2006A	308.2	(8.1)	257.4	3.1	183.9	2.8	1,253	420
2007F	415.9	35.0	371.1	44.2	267.9	45.7	1,827	612
2008F	467.3	12.3	408.9	10.2	295.2	10.2	2,012	675
2009F	508.2	8.7	447.2	9.4	322.8	9.4	2,201	738

Source: Daiwa forecasts

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Strong earnings growth continued in 1H07

41% YoY earnings growth was made in 1H07

Pusan Bank posted very strong earnings in 2Q07 by beating its previous record high quarterly earnings made in 1Q07. In fact, 2Q07 earnings of the bank were 33% higher than our forecast earnings mainly due to continued low provisioning burden and better cost management. During the first six months of this year the bank recorded W155.1bn of earnings, which was 41% higher than the earnings it has posted during the same period last year thanks to 1) 10% growth in net interest income backed by strong loan growth (25.7% YoY growth in loans in won), 2) strong growth in fees and commissions due to increased sale of bancassurance products and beneficiary certificates, 3) exceptionally low provisioning as a result of improved asset quality and prudent risk management, and 4) better cost control.

Pusan Bank: 1H07 earnings summary

Year to 31 December	Actual	Actual	Actual	Actual			Actual		Forecast		Forecast	
	2Q06	1H06	1Q07	2Q07	QoQ	YoY	1H07	YoY	2Q07	Diff*	1H07	Diff*
	W'bn	W'bn	W'bn	W'bn	(%)	(%)	W'bn	(%)	W'bn	(A/F-1)*100	W'bn	(A/F-1)*100
Interest income	282.5	556.7	325.9	345.3	6	22	671.2	21	335.3	3	661.2	2
Interest expense	(132.0)	(250.8)	(162.1)	(172.2)	6	30	(334.3)	33	(166.6)	3	(328.7)	2
Net interest income	150.5	306.0	163.8	173.1	6	15	336.9	10	168.7	3	332.5	1
Fees & commissions	15.3	30.0	19.3	25.6	32	67	44.9	50	19.5	31	38.9	15
Other non-interest inc	12.2	6.1	1.8	(2.7)	T.R.	T.R.	(0.9)	T.R.	3.4		5.3	
Total non-interest income	27.6	36.1	21.2	22.8	8	(17)	44.0	22	23.0	(1)	44.1	(0)
Operating income	178.0	342.1	185.0	195.9	6	10	380.9	11	191.7	2	376.7	1
Operating expense	(82.1)	(160.1)	(78.5)	(79.7)	2	(3)	(158.2)	(1)	(93.8)	(15)	(172.3)	(8)
Operating profit	96.0	182.0	106.5	116.2	9	21	222.7	22	98.0	19	204.4	9
Provisions	(10.0)	(29.6)	(0.8)	(7.0)	729	(30)	(7.9)	(73)	(16.0)	(56)	(16.9)	(53)
Pre-tax profit	86.0	152.4	105.6	109.2	3	27	214.8	41	81.9	33	187.6	15
Taxation	(24.0)	(42.7)	(29.4)	(30.3)	3	26	(59.7)	40	(22.8)	33	(52.2)	14
Net profit	62.0	109.8	76.2	78.8	3	27	155.1	41	59.1	33	135.4	15

Source: Bank, Daiwa forecasts

*Difference = (actual/forecast-1)*100

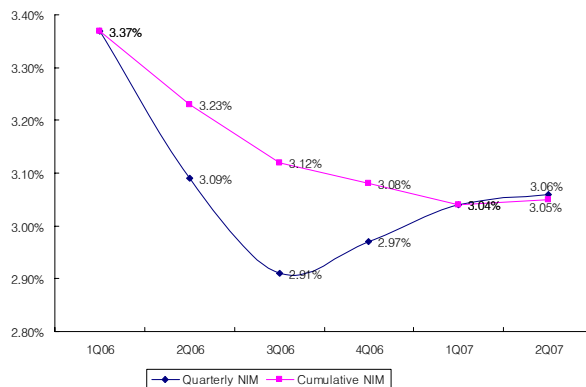
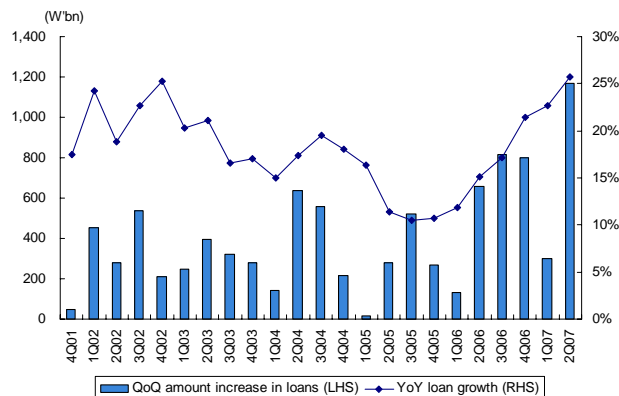
Concerns over the possibility of excessively low loan growth and sizable drop in NIM in the future are undue concerns, in our view

Contrary to the general concerns over the possibility of weak loan growth, actual loan growth of the bank has been remaining very strong as shown in the chart below. 2Q07 loan growth was exceptionally strong. According to the management of the bank, regional economy in the Pusan area is getting stronger since the area has shipbuilding companies and suppliers to those shipbuilders, whose business is booming. In addition, there are many auto parts suppliers, whose business situation is getting better as well. As a result, loan demand for facility investment remains very strong for the bank. We believe that strong demand for loans would continue for the time being and the credit quality of the borrowers, whose business environment is favorable, would remain healthy. Therefore, we believe that concerns over the possibility of excessively weak loan growth going forward are undue concerns.

How about the trend of net interest margin (NIM)? As shown in the chart below, quarterly NIM has started to make a gradual improvement from 4Q06. As of 2Q07, quarterly NIM increased marginally to 3.06% from 3.04% in 1Q07. In addition, cumulative NIM in 2Q07 finally ended its downward trend by posting 1 basis point improvement compared with 1Q07 (3.05% in 2Q07 vs. 3.04% in 1Q07).

Even though it would be a bit early to conclude that NIM would make continuous improvement starting from 2Q07 since most of the NIM pressure comes from the funding side along with decreasing the portion of low cost funding out of total funds, we believe that we can conclude that NIM decrease would be minimal going forward. The reason why we believe so despite remaining uncertain regarding NIM outlook is because the bank management decided to slow down loan growth in 2H07 and focus on profitability of lending business. Therefore, we believe that excessive concerns over the possibility of sizable deterioration of NIM based on the worst case scenario of the combination of stiff competition both in lending and in deposit taking businesses should be alleviated as well.

Loan growth and NIM trend



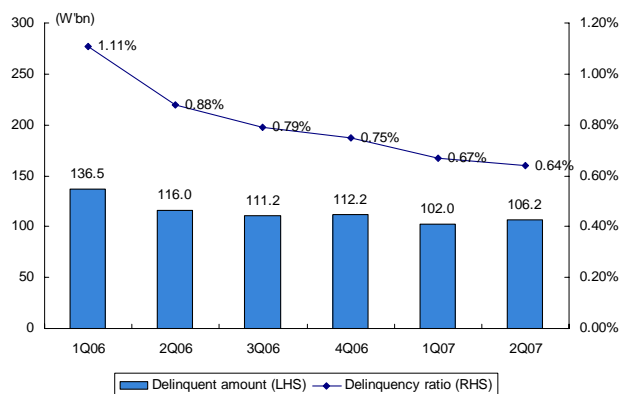
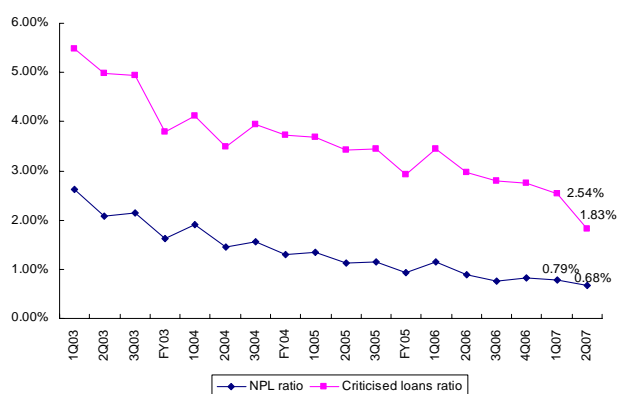
Source: Bank, Daiwa estimates

Improving asset quality and delinquency ratio are positive signals for the future credit cost of the bank

Pusan Bank showed improvements in asset quality in 2Q07. NPL ratio has declined from 0.79% in 1Q07 to 0.68% in 2Q07. In addition, precautionary and below loans ratio has also showed a significant drop by posting 1.83% in 2Q07 compared with 2.54% in 1Q07. According to the bank, major reasons for the decrease in precautionary loans were 1) generally improved credit ratings of borrowers and 2) W20bn of repayment of precautionary loans from a borrower along with its maturity.

Not to mention the trend of NPL ratio and precautionary and below loans ratio, delinquency ratio also showed a continued downward trend in 2Q07 by posting 0.64%, which was 3 bps lower than 1Q07. Given improving asset quality and the improving business environments of most of the borrowers in the region the bank is doing business, we believe that future credit cost burden would continue to remain at a low level.

Improving asset quality: NPL ratio and delinquency ratio trend



Source: Bank, Daiwa

Overall financial quality level has improved during 2Q07

How we assess the financial stability of banks

Making comparisons of banks based on a like-for-like basis

We believe that there are many different ways to assess the overall financial stability of a bank, depending on the level of information available. In our view, asset quality, provisioning levels and capital adequacy are three most important factors in evaluating the financial stability of a bank.

Since the levels of the three factors (asset quality, provisioning level and capital adequacy) are different among banks, we have come up with a common measure that combines all three factors using the following the steps:

- 1) Even though the minimal tier-1 ratio requirement is 4%, we believe that banks' tier-1 capital needs to be at least around 7% to ensure the stability of the banking system. In our view, a BIS ratio of around 11-12% is an adequate and safe level,

with tier-1 and tier-2 ratios of 7% and around 4-5%, respectively. Therefore, we have assumed that all banks need a tier-1 ratio of at least 7%. If a bank's tier-1 capital amount exceeds 7%, we treat this excess portion of tier-1 capital as 'free capital' that the bank can use at its discretion.

- 2) After deriving the so-called 'free capital' amount, we assume that banks would first use this free capital to bring up their NPL coverage ratios to 100%. As a result, we believe that any concerns about existing NPLs would be removed, regardless of their size.
- 3) Next, we assume that normal loans on average require 0.5% provisioning. Therefore, we assume that banks make up 0.5% of provisioning for their normal loans by using the remaining 'free capital'.
- 4) Lastly, we compare the finally remaining 'free capital' with the size of precautionary loans. The reason why we compare the finally remaining 'free capital' with precautionary loans is that normal loans and below substandard loans (NPLs) are all provisioned appropriately, and the only remaining loan category is precautionary loans.

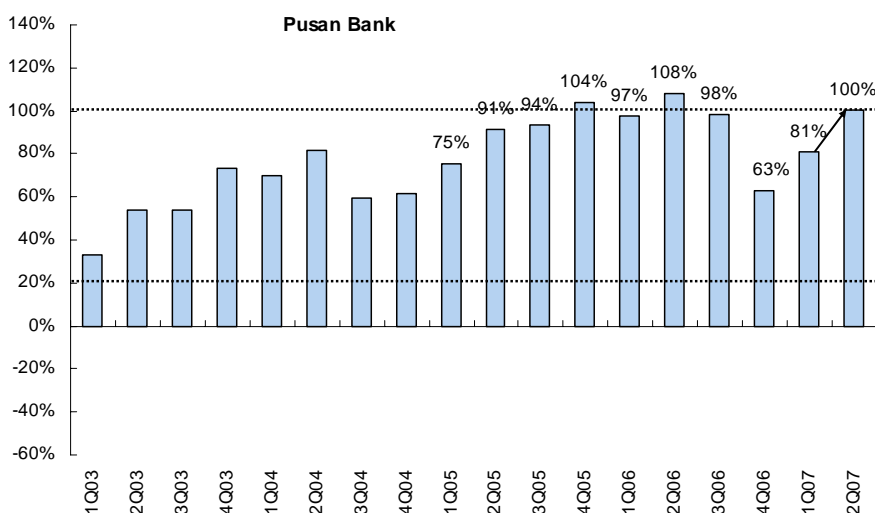
We believe that the percentage of finally remaining 'free capital' out of total precautionary loans can be used as a substitute for the level of safety under an adverse business environment.

By using the financial stability assessment method set out in the previous section, we analyzed the financial stability of Pusan Bank from 1Q03 to 2Q07.

Financial quality of Pusan Bank has improved in 2Q07

Due to a speedy growth in risk-weighted assets as a result of strong loan growth, the bank's tier-1 ratio decreased from 8.35% for 1Q07 to 8.12% for 2Q07. However, overall financial quality of the bank has improved as shown in the chart below because 1) asset quality has improved as we have reviewed in the previous section, and 2) NPL coverage ratio has gone up from 173.7% in 1Q07 to 180.3% in 2Q07. We regard the financial quality level of the bank as a very safe level since excess capital in excess of 7% of tier I ratio and excess loan loss reserve in excess of 100% of NPL coverage fully covers 100% of the total precautionary loan amount.

Pusan Bank: Financial quality ratio trend



Source: Bank, Daiwa estimates

Earnings-forecast revisions

FY07 and FY08 earnings forecasts were revised up by 5.6% and 7.9%, respectively

After reviewing the 2Q07 earnings results of the bank, we have revised up our earnings forecast for FY07 and FY08 by 5.6% and 7.9%, respectively. What we have revised in terms of major assumptions are as follows: 1) We lowered our provisioning forecasts for FY07 and FY08 by 20% and 5%, respectively, by lowering down our assumption of the credit cost as a percentage of average balance of loans and advances from 0.36% in FY07 and 0.35% in FY08 to 0.28% in FY07 and 0.32% in FY08. Even though we have revised down our credit cost forecasts, we believe that we have taken a conservative stance since annualized credit cost in 1H07 was still substantially lower than our current assumption. Therefore, we can not rule out the possibility of actual credit cost being even lower than our revised forecasts. 2) We also corrected our overestimation of operating expenses by factoring in the bank management's determination to control costs more effectively since early retirement programs conducted twice last year are expected to bring down costs during the 2H07. 3) We have revised up net interest income forecasts by assuming higher loan growth in FY07 (17.1%) and FY08 (8.5%) since our previous assumptions for the growth in loans and advances were too conservative given that YTD growth of loans and advances in 2Q07 turned out to be 12.2% while our yearly loan growth assumption for FY07 was 11.2%. We conservatively assumed that net interest margin would be 5 bps lower than our previous forecasts for FY07 and FY08 due to expected difficulty in raising low cost funding. We expect that loan growth would more than outweigh potential decrease in NIM.

Due to the upward earnings revisions for FY07 and FY08, our EPS forecasts were revised up by 5.6% and 7.9%, respectively. Forecast BVPS in FY07 and were also revised up by 0.4% and 1.3%, respectively.

Pusan Bank: Daiwa earnings-forecast revisions (Wbn)

Year to 31 December	Old	New	Old	New	Old	New
	2007F	2007F	2008F	2008F	2009F	2009F
	W'bn	W'bn	W'bn	W'bn	W'bn	W'bn
Interest income	1,353.5	1,384.6	1,483.9	1,561.9	1,605.3	1,701.4
Interest expense	(674.0)	(696.0)	(748.2)	(795.1)	(813.5)	(875.4)
Net interest income	679.5	688.6	735.6	766.9	791.8	826.0
Fees & commissions	79.4	82.3	86.8	93.5	92.6	100.5
Other non-interest inc	(4.7)	(20.7)	(7.3)	(31.6)	(4.4)	(27.5)
Total non-interest income	74.7	61.6	79.5	61.9	88.2	72.9
Operating income	754.2	750.2	815.1	828.8	880.1	898.9
Operating expense	(346.3)	(334.2)	(374.5)	(361.5)	(404.8)	(390.8)
Operating profit	407.9	415.9	440.6	467.3	475.3	508.2
Provisions	(56.3)	(44.8)	(61.5)	(58.4)	(65.3)	(61.0)
Pre-tax profit	351.6	371.1	379.2	408.9	410.0	447.2
Taxation	(97.9)	(103.2)	(105.5)	(113.7)	(114.1)	(124.4)
Net profit	253.8	267.9	273.6	295.2	295.9	322.8
Change (%)		5.6		7.9		9.1
EPS	1,730	1,827	1,865	2,012	2,017	2,201
Change (%)		5.6		7.9		9.1
BVPS	9,454	9,496	10,696	10,835	12,048	12,299
Change (%)		0.4		1.3		2.1

Source: Daiwa forecast

Valuation

Target price was raised up to W17,900

We have raised our six-month target price (Target price as of 4Q07) by 10.5% from W16,200 to W17,900. The valuation method we used to derive our 4Q07 target price is as follows: we multiplied our FY07 BVPS forecast (W9,496) by our target PBR (1.88x) and derived our FY07 year-end target price (W17,866). Our target PBR was obtained by dividing (ROAE {20.06%} - long-term growth rate) by (cost of equity - long-term growth rate). We assume a cost of equity for Pusan Bank of 12.3% and a long-term growth rate of 3.5%.

Total return of 18.3% is expected with a 6-month time horizon

The stock is currently trading at 1.65x of FY07F BVPS and 1.44x of FY08F BVPS and also trading at 8.6x and 7.8x of FY07F and FY08F earnings, respectively. Assuming that the bank maintains the payout ratio of 35% in FY07 as well, per share cash dividend is expected to be W612, which means that the dividend yield based on the current share price would be 3.9% in FY07. Therefore, we are expecting a total return of 18.3% with a 6-month time horizon (14.4% of capital gains plus 3.9% of dividend yield). We maintain our 2 (*Outperform*) rating on the counter.

Pusan Bank – financial summary

Profit forecasts and breakdown (Wbn)					
Year to 31 December	2005	2006	2007F	2008F	2009F
	W'bn	W'bn	W'bn	W'bn	W'bn
Interest income	1,015.6	1,172.6	1,384.6	1,561.9	1,701.4
Interest expense	(422.9)	(555.2)	(696.0)	(795.1)	(875.4)
Net interest income	592.7	617.4	688.6	766.9	826.0
Fees & commissions	55.0	64.4	82.3	93.5	100.5
Other non-interest inc	8.6	(44.5)	(20.7)	(31.6)	(27.5)
Total non-interest income	63.6	19.9	61.6	61.9	72.9
Operating income	656.3	637.2	750.2	828.8	898.9
Operating expense	(320.9)	(329.0)	(334.2)	(361.5)	(390.8)
Operating profit	335.4	308.2	415.9	467.3	508.2
Provisions	(85.9)	(50.7)	(44.8)	(58.4)	(61.0)
Pre-tax profit	249.6	257.4	371.1	408.9	447.2
Taxation	(70.6)	(73.6)	(103.2)	(113.7)	(124.4)
Net profit	178.9	183.9	267.9	295.2	322.8
Growth	34.8	2.8	45.7	10.2	9.4

NPLs and provisions					
	2005	2006	2007F	2008F	2009F
Credit quality					
NPLs (% of total credit)	0.9	0.8	0.7	0.6	0.6
Precautionary and below (% of total credit)	2.9	2.7	2.0	1.9	1.9
Coverage ratios					
Total provisions (% of NPLs)	162.9	175.8	170.0	170.0	160.5
Total provisions (% of precautionary & below)	52.1	53.3	59.0	55.2	51.3

Balance sheet (Wbn)					
As at 31 December	2005	2006	2007F	2008F	2009F
	W'bn	W'bn	W'bn	W'bn	W'bn
Cash	378.7	386.0	464.2	495.1	531.7
Placements w/ banks	779.3	643.4	1,193.1	1,272.6	1,366.7
Net loans & advances	12,186.1	14,932.4	17,481.0	18,961.1	20,363.4
Securities & investments	4,871.1	4,918.2	4,990.1	5,655.1	6,073.3
Other assets	487.2	474.5	1,018.0	1,158.8	1,477.9
Fixed assets	347.4	356.4	399.5	435.9	471.8
Total assets	19,049.9	21,710.8	25,546.0	27,978.6	30,284.9
Growth	11.2	14.0	17.7	9.5	8.2
Customer deposits	13,662.5	14,557.7	15,594.1	16,632.5	17,862.7
Borrowings	3,161.5	4,162.9	5,302.0	5,875.5	6,359.8
Debentures	408.7	867.6	1,620.3	2,028.4	2,195.7
Other liabilities	670.7	843.7	1,636.7	1,852.8	2,062.7
Total net assets	1,146.5	1,278.8	1,392.9	1,589.3	1,804.0
Share capital	733.4	733.4	733.4	733.4	733.4
Reserves	413.1	545.4	659.5	855.9	1,070.6
Shareholders' funds	1,146.5	1,278.8	1,392.9	1,589.3	1,804.0
Growth	11.8	11.5	8.9	14.1	13.5

Ratios (%)					
	2005	2006	2007F	2008F	2009F
Return on assets	0.94	0.85	1.05	1.06	1.07
Return on equity	15.6	14.4	19.2	18.6	17.9
Net interest margin	3.51	3.22	3.12	3.10	3.08
Net int inc / operating inc	90.3	96.9	91.8	92.5	91.9
Expense / operating inc	48.9	51.6	44.6	43.6	43.5
Net loans & advances growth	10.0	22.5	17.1	8.5	7.4
Earning asset growth	12.2	14.9	15.5	9.4	7.4
Deposit growth	6.7	6.6	7.1	6.7	7.4
Loan / deposit	89.2	102.6	112.1	114.0	114.0
Equity / assets	6.0	5.9	5.5	5.7	6.0
Capital adequacy, BIS	12.2	11.0	11.4	11.6	11.7
Dividend payout	33.2	33.5	33.5	33.5	33.5
Book NAV - Common share	7,816	8,718	9,496	10,835	12,299

Source: Company, Daiwa forecasts

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"1": the security could outperform the KOSPI by more than 15% over the next six months.

"2": the security is expected to outperform the KOSPI by 5-15% over the next six months.

"3": the security is expected to perform within 5% of the KOSPI (better or worse) over the next six months.

"4": the security is expected to underperform the KOSPI by 5-15% over the next six months.

"5": the security could underperform the KOSPI by more than 15% over the next six months.

"Positive" means that the analyst expects the sector to outperform the KOSPI over the next six months.

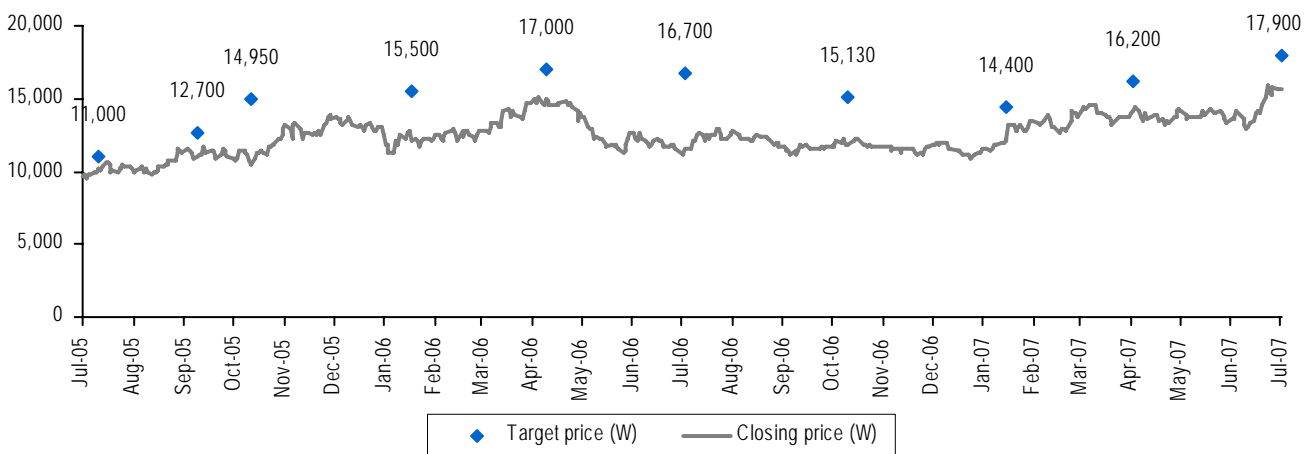
"Neutral" means that the analyst expects the sector to be in-line with the KOSPI over the next six months

"Negative" means that the analyst expects the sector to underperform the KOSPI over the next six months

Additional information may be available upon request.

Pusan Bank: share-price and Daiwa recommendation trend

Date	2007-07-19	2007-04-19	2007-01-31	2006-10-27	2006-07-20
Target price (W)	17,900	16,200	14,400	15,130	16,700
Rating	2	2	2	2	2



Source: Daiwa

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