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Stock Rating
Overweight

Industry View
Attractive

Pusan Bank

Another Solid Quarter – Reiterate Overweight Rating

What's Changed	
Price Target	**W18,000 to W19,500**
07E / 08E MW EPS	**Up 3.3% / Up 1.9%**

Conclusion: Following the best results among Korean banks in 4Q06 and 1Q07, Pusan Bank (PSB) reported another impressive result in 2Q07. The bank's NIM has improved for three consecutive quarters, and its commission income has continued to increase in every quarter since 1Q05 except 4Q05. On top of its benign asset quality, the bank's tight cost management makes us more confident in the visibility of its earnings. In our view, PSB is too cheap to ignore, especially considering its strong progress in core earnings. We reiterate our Overweight rating on the stock.

25+% PPOP Growth but Trading at Lower than ex-Growth Multiple: On the back of 1) NIM recovery for consecutive three quarters, 2) strong lending growth (8.1%q-q), and 3) tight cost control, PSB's PPOP growth reached 27%y-y. Furthermore, its core PPOP (NII + net commissions & fees, excluding trading-related income) is growing at 34%y-y. However, the stock is trading at a lower price-to-book ratio than ex-growth multiple, which is difficult to justify, in our view.

New NPL Formation Remains at 8bp Per Quarter: The bank's asset quality remained benign in 2Q07, with NPL ratio of 0.68% and NPL coverage of 180%. More importantly, its new NPL formation remains very stable at 8 basis points per quarter (as % of total loans), which indicates that the bank's asset quality will likely continue to be strong in the near future.

Raise Price Target to W19,500: After reflecting 2Q07 results, we raise 07E/08E MW EPS by 3.3%/1.9%, respectively. Accordingly, we revise up our price target to W19,500, implying 25% upside from the current price.

Key Ratios and Statistics

Reuters: 005280.KS Bloomberg: 005280 KS
S. Korea Financial Services

Price target	W19,500
Shr price, close (Jul 18, 2007)	W15,650
Mkt cap, curr (bn)	W2,296
52-Week Range	W16,050-10,850
ROE (07e) (%)	21.3
Shrs out, basic, per-end (07e) (mn)	147
S'hldr eqty (07e) (bn)	W1,485

Fiscal Year (Dec)	2006	2007e	2008e	2009e
ModelWare EPS (W)*	1,271	1,857	1,852	2,012
Prior ModelWare EPS (W)	-	1,797	1,817	1,931
EPS, basic, rpt'd (W)	1,253	1,840	1,835	1,995
Prior EPS, basic, rpt'd (W)	-	1,781	1,802	1,915
ModelWare net inc (W bn)	186	272	272	295
Net inc, rpt'd (W bn)	184	270	269	293
P/E	9.1	8.4	8.5	7.8
P/BV	1.3	1.5	1.4	1.2
Div yld (%)	3.6	3.8	3.8	4.5

***** = Please see explanation of Morgan Stanley ModelWare later in this note.
e = Morgan Stanley Research estimates

Pusan Bank: Financial Summary

Profit and Loss Statements Won billions, Year ending Dec 31	2004	2005	2006	2007E	2008E
Avg Earning Assets	14,901	16,593	18,463	21,321	23,870
Net Interest Margin (%)	3.44	3.34	3.08	3.04	3.00
Interest Income	965	1,016	1,173	1,416	1,578
Interest Expense	415	423	555	708	797
Net Interest Income (NII)	550	593	617	708	780
Loan Loss Prov Exp (LLPE)	129	100	60	55	100
NII After LLPE	421	492	557	653	681
Non-interest Income					
Fees and Commissions	70	79	80	101	115
Dividend Income	0	0	0	1	1
Forex Income	16	22	50	5	0
Other trading income	3	(5)	(28)	11	12
Other Income	(37)	(33)	(32)	(42)	(57)
Total Non-interest Income	53	63	71	77	71
Non-interest Expense					
Salaries & Benefits	195	215	216	232	255
Net Occupancy & Equipment	4	4	5	5	5
Other Expenses	96	101	143	113	121
Total Non-interest Expense	294	321	363	349	381
Pre-tax Operating Profit	179	234	264	381	371
Associate Profit/Loss	10	16	(7)	(7)	1
Profit Before Tax	189	250	257	373	371
Effective Tax	57	71	74	103	102
Minority Interests	-	-	-	-	-
Preference Dividend	-	-	-	-	-
Net Profit	132	179	184	270	269
EPS - Reported (Won)	899	1,220	1,253	1,840	1,835
EPS - ModelWare (Won)	924	1,241	1,271	1,857	1,852

Selective Balance Sheet Data Won billions, Year ending Dec 31	2004	2005	2006	2007E	2008E
Total Assets	17,134	19,050	21,711	24,505	26,836
RWA	10,673	11,962	14,947	16,816	18,416
Total Liquid Assets	5,395	6,325	6,267	6,617	6,678
Gross Customer Loans	11,234	12,375	15,153	17,715	20,073
Total Customer Deposits	12,016	12,923	13,133	13,921	14,756
Certificates of Deposits	629	597	1,265	1,568	1,850
Other Interest Bearing Liability	2,468	3,570	5,031	6,332	7,337
EOP Shareholders' Equity	1,026	1,147	1,279	1,485	1,666
Avg Loans	10,528	11,804	13,764	16,434	18,894
Avg Total Assets	16,744	18,092	20,380	23,108	25,671
Avg Total Deposits	12,578	13,233	14,110	15,113	16,238
Avg Shareholders' Equity	981	1,086	1,213	1,382	1,575
Avg Equity/Avg Assets (%)	5.86	6.00	5.95	5.98	6.14
Avg EA/Avg Assets (%)	88.99	91.71	90.59	92.27	92.99
Avg Loans/Avg EA (%)	70.65	71.14	74.55	77.08	79.15

Asset Quality Won billions, Year ending Dec 31	2004	2005	2006	2007E	2008E
Non-performing Loans (NPL)	146	117	128	160	201
Gross NPL Ratio (%)	1.30	0.94	0.83	0.90	1.00
Loan Loss Reserve (LLR)	156	190	224	279	351
LLR/NPL (%)	106.79	162.41	175.11	174.40	174.26
LLR/Total Credit (%)	1.39	1.52	1.46	1.56	1.74
Specific Reserve	54	60	75	87	98
Specific Reserve/NPLs (%)	37.04	51.77	58.41	54.27	48.66
General Reserve	102	129	149	192	253
General Reserve/NPLs (%)	69.75	110.63	116.69	120.13	125.60
Net Charge-offs (NCO)	129	87	39	14	40
NCO/Avg Total Credit (%)	1.23	0.73	0.28	0.08	0.21
LLPE/Avg Loans (%)	1.22	0.85	0.44	0.33	0.53

Note: we have applied accounting change re reclassification of credit card income.
E = Morgan Stanley Research estimates
Source: Company data, Morgan Stanley Research

Per Share Data and Valuations Won billions, Year ending Dec 31	2004	2005	2006	2007E	2008E
Book Value Per Share (Won)	6,993	7,816	8,718	10,121	11,356
Price/Book (x)	2.24	2.00	1.80	1.55	1.38
ROAA (%)	0.81	1.01	0.91	1.18	1.06
ROAE (Reported, %)	13.44	16.47	15.16	19.54	17.09
ROAE (ModelWare, %)	13.81	16.76	15.37	19.71	17.25
MW EPS Growth (%)	8.18	34.30	2.42	46.09	(0.25)
Current P/MW EPS	16.94	12.61	12.31	8.43	8.45
Gross Dividends	44	59	62	88	88
Gross DPS (Won)	300	405	420	600	600
Dividend Yield (Current Price, %)	1.92	2.59	2.68	3.83	3.83
Dividend Payout Ratio (%)	33.36	33.20	33.51	32.60	32.70
Issued Shares (m)	146.7	146.7	146.7	146.7	146.7
Market Cap (Wonbn)	2,296	2,296	2,296	2,296	2,296
Market Cap (US$mn)	2,416	2,416	2,416	2,416	2,416

PERFORMANCE RATIOS Won billions, Year ending Dec 31	2004	2005	2006	2007E	2008E
Growth (%)					
Net Interest Income	3.0	7.9	4.2	14.6	10.3
Non-interest Income	22.5	18.5	12.9	8.8	(7.8)
Non-interest Expense	10.7	9.0	13.2	(3.9)	9.0
Recurrent Net Profit After Tax (FD)	(4.2)	34.0	12.6	45.8	(2.4)
Net Profit	8.7	35.7	2.8	46.8	(0.3)
Gross Customer Loans	14.4	10.2	22.5	16.9	13.3
Total Deposits	3.7	6.7	6.6	7.6	7.3
Avg Earning Assets		11.4	11.3	15.5	12.0
Total Interest-bearing Liab		10.0	10.8	15.4	9.8
Risk-weighted Assets	13.5	12.1	25.0	12.5	9.5
Revenue Breakdown (%)					
NII/Operating Income	91.2	90.5	89.7	90.2	91.7
Non-interest Inc/Opg Income	8.8	9.5	10.3	9.8	8.3
Forex Income/Operating Income	2.6	3.3	7.3	0.7	-
Efficiency (%)					
Cost/Income	48.9	49.0	52.8	44.5	44.7
Expenses/Avg Assets	1.8	1.8	1.8	1.5	1.5
Rev Per Employee	0.30	0.33	0.35	0.40	0.42
Exp Per Employee	0.15	0.16	0.19	0.18	0.19
Rev Per Branch	3.8	4.1	4.2	4.6	4.8
Exp Per Branch	1.9	2.0	2.2	2.0	2.1
Net Profit Per Branch	0.8	1.1	1.1	1.6	1.5
Net Interest Margin Analysis (%)					
Int Income/Avg EA	6.36	6.01	6.20	6.47	6.44
Int Exp/Avg Int Bearing Liab.	2.98	2.75	3.23	3.55	3.64
Net Interest Spread	3.39	3.26	2.96	2.91	2.80
Contribution From Free Funds	0.06	0.09	0.11	0.13	0.20
Net Interest Margin	3.44	3.34	3.08	3.04	3.00
Liquidity (%)					
Avg Loans/Avg EA	70.65	71.14	74.55	77.08	79.15
Avg Liquid Assets/AEA	38.24	35.32	34.10	30.22	27.85
Avg Loans/Avg Deposits	83.70	89.20	97.55	108.74	116.36
Avg Loans/Avg Depo & Equity	80.38	87.08	96.65	110.23	118.73
Period-End Loans/Deposits	87.74	90.57	104.09	113.06	119.43
Capital Information					
Tier 1 Ratio (%)	8.99	9.05	8.08	8.27	8.54
Tier 2 Ratio (%)	1.88	3.22	2.98	3.67	3.69
Total CAR (%)	10.87	12.27	11.07	11.94	12.23

Investment Case

Summary & Conclusions

Outstanding Results Again in 2Q07

In our view, Pusan Bank's results in 4Q06 and 1Q07 were the best among Korean banks, especially based on core operating trends. Surprisingly, PSB reported another impressive result in 2Q07. Its net profit of W79bn exceeded our estimate of W57bn and I/B/E/S consensus of W59bn. More importantly, its greater-than-expected net profit was driven purely by its core operations, and every line of the bank's 2Q07 results was positive. Hence, we think it is time for investors to become more confident about the bank's visibility on earnings, and we reiterate our bullish stance on the stock.

Strong Lending Growth: PSB increased its lending by 8.1%q-q, which was substantially higher than our estimate of 3.2%q-q. According to the management, strong industrial activity in the Pusan area (shipbuilding and auto parts) has been a key reason for its outstanding growth in lending. PSB's management highlighted that the bank has become able to focus more on margin than lending growth from 2H07.

Net Interest Margin Improved for Third Consecutive Quarter: PSB is the only bank in Korea that has improved its net interest margin (NIM) for three consecutive quarters. As a result, its NIM will likely show y-y increase from 3Q07, which would accelerate the bank's net interest income growth along with strong lending activities.

Non-Interest Income: Pusan Bank's non-interest income remained flattish in 2Q07 versus 1Q07. However, this was mostly due to one-off gains of W8.3bn in 1Q07 (reversal from bad credit clearing fund). More importantly, its commission & fee income rose 22%q-q. Since 1Q05, PSB has continued to increase commission income in every quarter except 4Q05.

Asset Quality Remained Benign: PSB continued to show solid asset quality in 2Q07, with NPL ratio of 0.68% and NPL coverage of 180%. More importantly, in our view, the bank's quarterly new NPL formation remains very stable at 8bp (new NPL formation / total credit), which indicates that its asset quality will likely remain strong going forward.

Tight Cost Management: 2Q07 results also show the extent to which the bank is focusing on cost management. Despite its strong business results, PSB's SG&A expenses remain flattish versus 2Q06 and 1Q07. As a result, its cost-to-income ratio fell to 40.3% in 2Q07 versus 41.4% in 1Q07 and 46.8% in 2Q06.

Exhibit 1

Pusan Bank: Summary of 2Q07 Results

(W billions)	2Q07	2Q06	Chg (y-y)	1Q07	Chg (q-q)
Net Op Revenue	197.9	175.3	12.9%	189.5	4.4%
Net interest income	173.1	150.4	15.1%	163.8	5.7%
Non-interest income	24.8	24.9	-0.3%	25.7	-3.4%
SG&A expenses	79.7	82.0	-2.8%	78.5	1.6%
PPOP	118.2	93.3	26.7%	111.0	6.5%
Prov. Expenses	5.8	10.3	-43.7%	4.8	20.8%
Operating profits	112.4	83.0	35.5%	106.2	5.8%
Net profits	78.9	62.0	27.3%	76.2	3.5%
Key indicators					
Net interest margin	3.06%	3.09%	-0.03%	3.04%	0.02%
Cost-to-income	40.3%	46.8%	-6.52%	41.4%	-1.14%
NPL ratio	0.68%	0.89%	-0.21%	0.79%	-0.11%
NPL coverage	180%	172%	8.56%	174%	6.72%
Tier 1 ratio (%)	8.1%	9.2%	-1.03%	8.4%	-0.24%

Source: Company data, Morgan Stanley Research

Raise EPS Estimates and Price Target

After reflecting Pusan Bank's 2Q07 results, we raise 07E/08E MW EPS by 3.3% and 1.9%, respectively. Accordingly, we revise up our price target from W18,000 to W19,500, which implies 25% upside from the current share price. At our price target, Pusan Bank would trade at 1.7x 08E P/B with an ROE of 17.2% and at 10.5x 08E P/E. Our target is based on a residual income model using an 11.6% cost of equity (risk-free rate: 5%, beta: 1.1, risk premium: 6%) and a terminal growth rate of 4%. A potential downside risk to our price target could come from a greater-than expected deterioration in consumer asset quality. Any delay in Korea's ongoing economic recovery could result in further SME delinquency problems and a bursting of the real estate bubble.

MORGAN STANLEY ModelWare	**Morgan Stanley ModelWare is a proprietary analytic framework that helps clients uncover value, adjusting for distortions and ambiguities created by local accounting regulations.** For example, ModelWare EPS adjusts for one-time events, capitalizes operating leases (where their use is significant), and converts inventory from LIFO costing to a FIFO basis. ModelWare also emphasizes the separation of operating performance of a company from its financing for a more complete view of how a company generates earnings.

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(as of June 30, 2007)

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	Coverage Universe		Investment Banking Clients (IBC)		
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	**892**	**39%**	**316**	**43%**	**35%**
Equal-weight/Hold	**1017**	**45%**	**320**	**44%**	**31%**
Underweight/Sell	**356**	**16%**	**94**	**13%**	**26%**
Total	**2,265**		**730**		

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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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More volatile (V) - We estimate that this stock has more than a 25% chance of a price move (up or down) of more than 25% in a month, based on a quantitative assessment of historical data, or in the analyst's view, it is likely to become materially more volatile over the next 1-12 months compared with the past three years. Stocks with less than one year of trading history are automatically rated as more volatile (unless otherwise noted). We note that securities that we do not currently consider "more volatile" can still perform in that manner.

Unless otherwise specified, the time frame for price targets included in this report is 12 to 18 months.

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Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.

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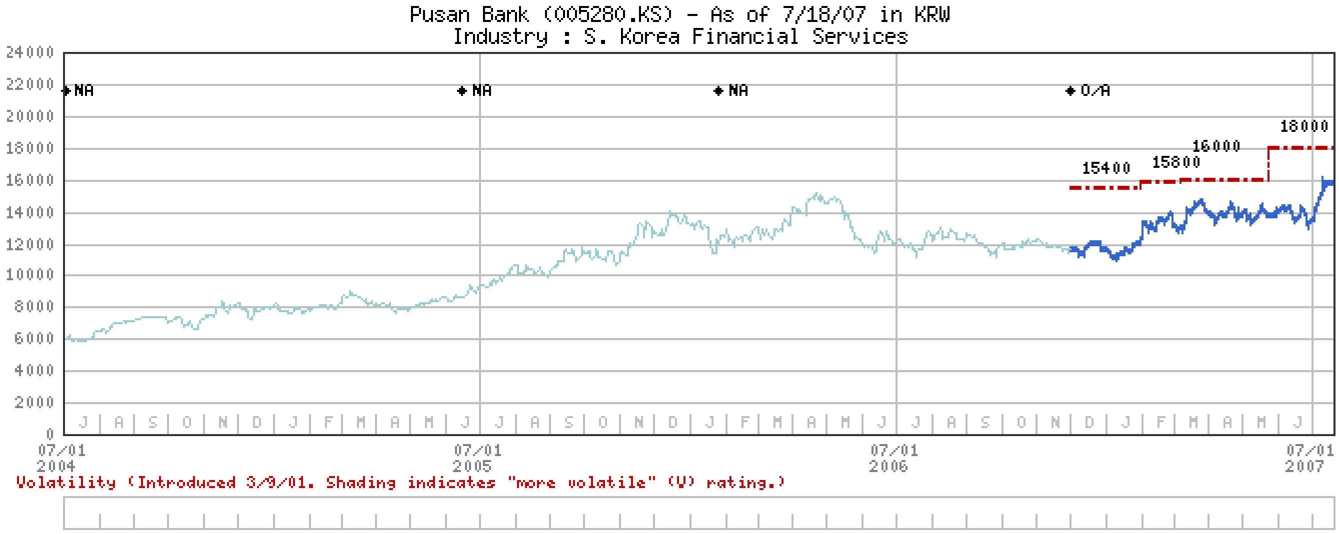
Stock Price, Price Target and Rating History (See Rating Definitions)



Stock Rating History: 7/2/04 : NA; 6/15/05 : NA; 1/26/06 : NA; 12/1/06 : O/A
Price Target History: 12/1/06 : 15400; 1/31/07 : 15800; 3/7/07 : 16000; 5/23/07 : 18000

Source: Morgan Stanley Research Date Format : MM/DD/YY Price Target No Price Target Assigned (NA)
Stock Price (Not Covered by Current Analyst) Stock Price (Covered by Current Analyst)
Stock Ratings abbreviated as below (Effective 3/18/02, ratings appear as Stock Ratings/Industry View) ♦
Stock Ratings as of 3/18/02: Overweight (O) Equal-weight (E) Underweight (U) More Volatile (V) No Rating Available (NAV)
Stock Ratings prior to 3/18/02: Strong Buy (SB) Outperform (OP) Neutral (N) Underperform (UP) No Rating Available (NAV)
Industry View: Attractive (A) In-line (I) Cautious (C) No Rating (NR)

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Industry Coverage:S. Korea Financial Services

Company (Ticker)	Rating (as of)	Price (07/18/2007)
Chan Hwang		
Daegu Bank (005270.KS)	E (12/01/2006)	W18,600
Hana Financial Group (086790.KS)	O (06/27/2007)	W49,000
Industrial Bank of Korea (024110.KS)	O (03/07/2007)	W20,100
Kookmin Bank (060000.KS)	O (01/29/2004)	W81,900
Korea Exchange Bank (004940.KS)	O (05/30/2006)	W14,400
Pusan Bank (005280.KS)	O (12/01/2006)	W15,650
Shinhan Financial Group (055550.KS)	O (10/25/2005)	W62,400
Woori Finance Holdings (053000.KS)	O (01/26/2006)	W23,950

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