

CONCERNS ON NIM, CAPITAL AND DIVIDEND

The key concerns for the market in HSBC's 2009 results were the weak NIM in H2 2009 and higher than expected loan losses in some divisions, (albeit not for the group as a whole). However, we believe going forward that the key incremental negative will be the market coming to the view that the Core Tier 1 ratio under Basel III is rather low. We see it at only 6.3% at year-end 2012. Importantly for income funds, capital constraints mean that dividend growth is likely to be limited, and may indeed be negative at some point as capital preservation becomes key. We believe management is already aware of this, declaring a dividend for Q1 2010 of only \$0.08, which is flat on Q1 2009. We reduce our target price to 750p from 800p. Although we maintain our HOLD rating on HSBC, we believe it will be a structural underperformer against Standard Chartered (also rated HOLD).

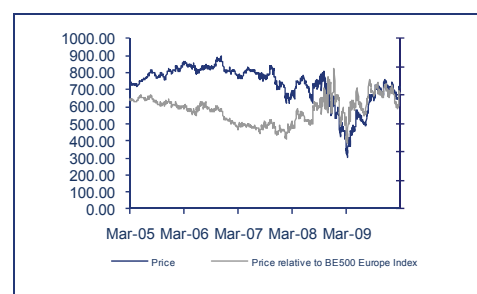
- NIM.** The negative development in the net interest margin is somewhat of a surprise. The FY 2009 NIM was 2.94% (HSBC's basis of calculation), falling from 3.05% in H1 2009. This implies that the H2 2009 NIM was some 2.83%, a fall of 11bps HoH. This is disappointing as HSBC had previously demonstrated a robust NIM despite falling base rates. Our view is that the NIM can stabilise at this level. Management indicates that NIM expansion should be driven by a rising US base rate, but we do not expect this until after year-end 2010.
- Capital adequacy.** We believe there were increased concerns at the conference call over how HSBC will fare under Basel III. Our own analysis shows that HSBC's Core Tier 1 ratio is quite low under the proposed regime. Despite the 2009 results showing the Basel III Core Tier 1 ratio has improved 30bps by our analysis to 6.4%, it is likely the market will become incrementally negative on HSBC's capital adequacy as it catches up with our view.
- Dividend.** We believe management realises that the new Basel regulations are likely to affect HSBC more than its peers. Indeed, management highlighted that regulatory change was a key reason why it was maintaining the dividend at \$0.08 for Q1 2010, which is flat on Q1 2009 and represents an annualised yield of 3.1%. Income funds are likely to be disappointed by this.
- Impairments.** In our view the market is overly concerned with the perceived negative development of asset quality. There was indeed a severe deterioration in the Middle East, and HSBC Finance suffered a modest increase in impairments to \$3.2bn in Q4 2009 from \$3.0bn in Q3 2009, following consistent improvement over 2009. However, on a group basis, the loan loss rate was better than we were expecting and importantly, there was an improvement from H1 to H2 2009. The NPL ratio was stable HoH.

Research

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Rating	HOLD
Target price (p)	750
Yesterday's closing price (p)	682
Upside / Downside	10%
Market cap (£b)	119
Market cap (€b)	131
Sector	Pan-European Banks

USD/(USDm)	2009A	2010E	2011E
Net interest income	40,730	39,845	40,462
Net fees & commissions	17,664	18,703	19,816
Trading profits/losses	9,863	7,217	6,815
Other revenue	-815	2,544	4,738
Total operating revenues	67,442	68,309	71,831
Operating costs	-34,395	-33,614	-33,140
Operating profit	33,047	34,695	38,691
Total provisions	-26,488	-21,048	-17,658
Pre-tax profit	7,079	14,031	21,417
ROA	0.24%	0.39%	0.58%
ROE	5.26%	7.25%	10.60%
ROTNV	7.09%	9.48%	13.85%
Cost/Income	-50.61%	-48.93%	-45.89%
Net interest margin	2.94%	2.76%	2.73%
LLC % gross loans	-2.82%	-2.27%	-1.88%
NPL ratio	3.32%	3.00%	2.00%
NPL coverage ratio	83.45%	92.50%	97.50%
Loans % deposits	77%	77%	77%
Core tier 1 ratio	9.38%	9.50%	10.03%
EPS	0.38	0.53	0.81
DPS	0.34	0.34	0.34
Payout ratio	101%	63%	41%
P/TNAV	1.90	1.86	1.74
Div yield	4.72%	4.72%	4.72%



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Further Detail

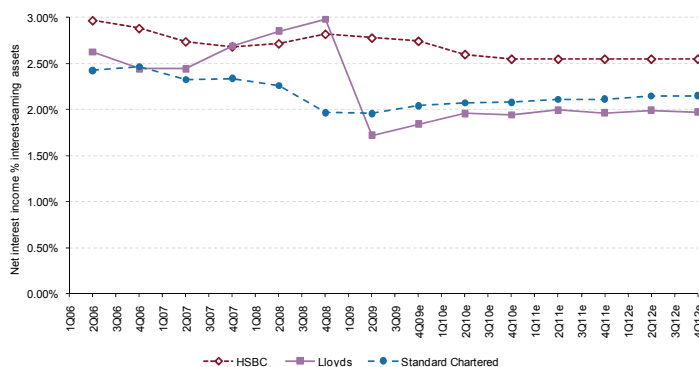
Earnings were lower than consensus expectations for FY 2009 due to a number of reasons: lower than expected NII, underpinned by a weak NIM in H2 2009; low trading profits; a weak insurance result; and a larger-than-expected fair value reversal on own debt. Of these, the weak NIM is likely to cause most concern among analysts. Impairments were also a concern in some regions and businesses, but we note that for the group overall, impairments and asset quality were in-line with consensus expectations and better than in H1 2009.

Net Interest Margin Weak in H2 2009

The negative development in the NIM is somewhat of a surprise. The FY 2009 NIM was 2.94% (HSBC's basis of calculation), falling from 3.05% in H1 2009. This implies that the H2 2009 NIM was some 2.83%, a fall of 11bps HoH. This is disappointing as HSBC had previously demonstrated a robust NIM despite the fall in base rates. The conference call did not really enlighten us as to the reasons why this fall occurred, but management alluded to the fact that balance sheet restructuring may have had an effect. Management indicated that the key driver for NIM expansion going forward should be an increasing US base rate, but we do not expect this for a long time (at least until after the end of 2010).

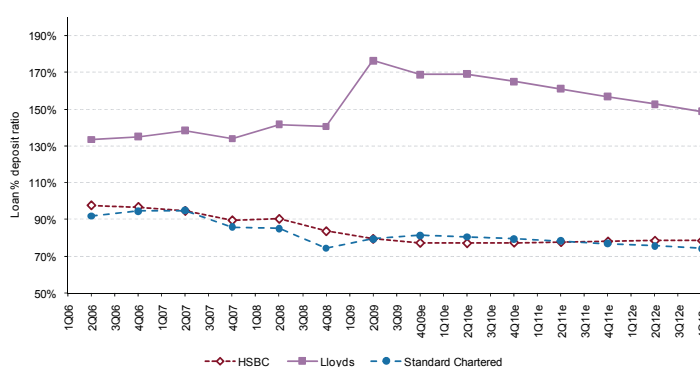
We model a stabilisation in the NIM for H1 2010 and thereafter (in the absence of an expected increase in base rates). We note that the loan-to-deposit ratio has improved further to 77% from 80% at H1 2009, which should have a positive mix effect on the NIM, on the basis that cheap customer deposits will fund high margin loan growth.

Figure 1: Net Interest Margin for UK banks



Source: Matrix Corporate Capital Research

Figure 2: Loan-to-Deposit ratio for UK banks



Source: Matrix Corporate Capital Research

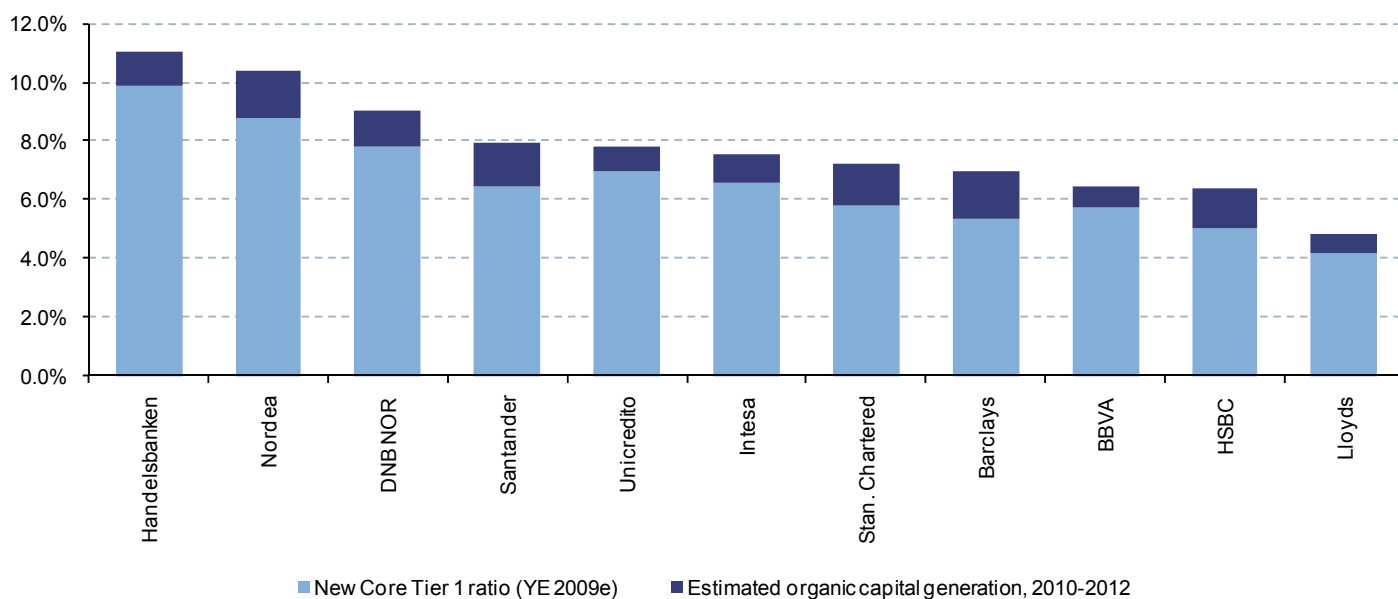
Capital Adequacy is Weak

The 2009 results showed an improvement in the Core Tier 1 ratio to 9.4% from 8.8% at H1 2009, underpinned by \$4.8bn of positive foreign exchange effects aiding dollar-denominated equity, and a 2.3% HoH fall in RWA.

We have re-run our Basel III analysis and arrive at a new Core Tier 1 ratio at year-end 2012 of 6.4%. This is better than our previous estimate of 6.0%, but still very weak compared to peers and only slightly better than a regulatory minimum of 6.0% that we would expect.

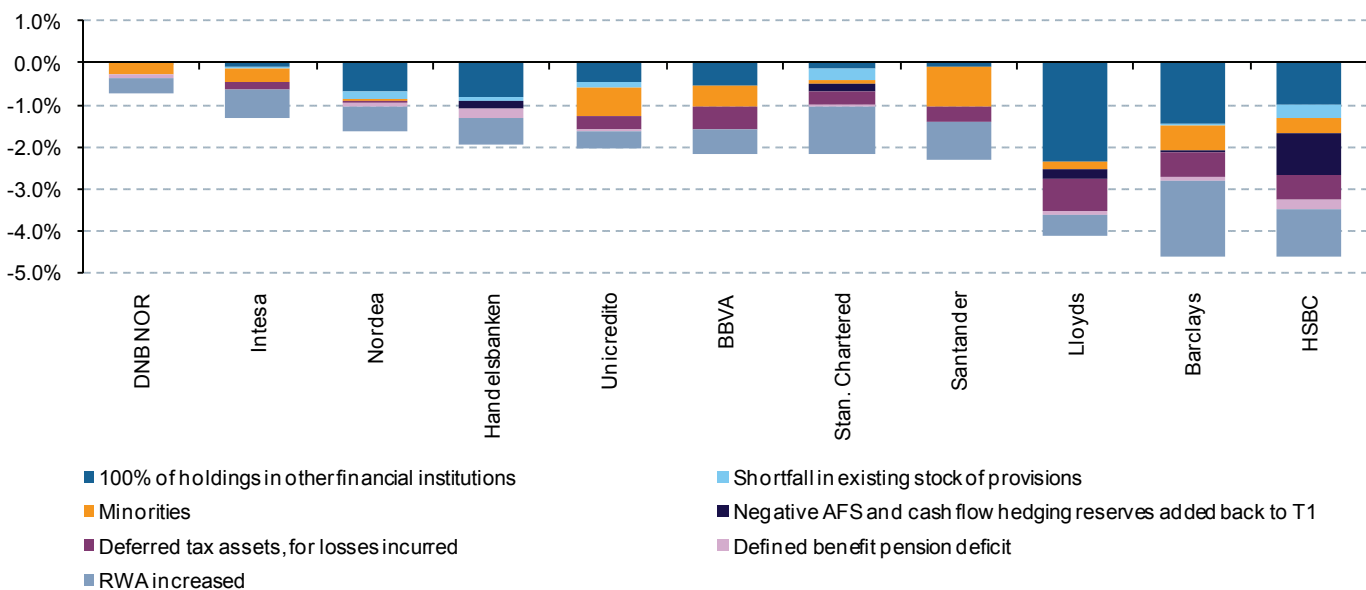
We estimate that to reach a Core Tier 1 ratio of 7.5% under Basel III (just below the average for the peer group) would require an increase in capital of approximately \$13bn, which is roughly 9% of expected shareholders' funds in 2012

Figure 3: Banks Ranked by Expected Core Tier 1 Ratio at Year-end 2012



Source: Matrix Corporate Capital Research

Figure 4: Banks Ranked by Estimated Change in Core Tier 1 Ratio under Basel III



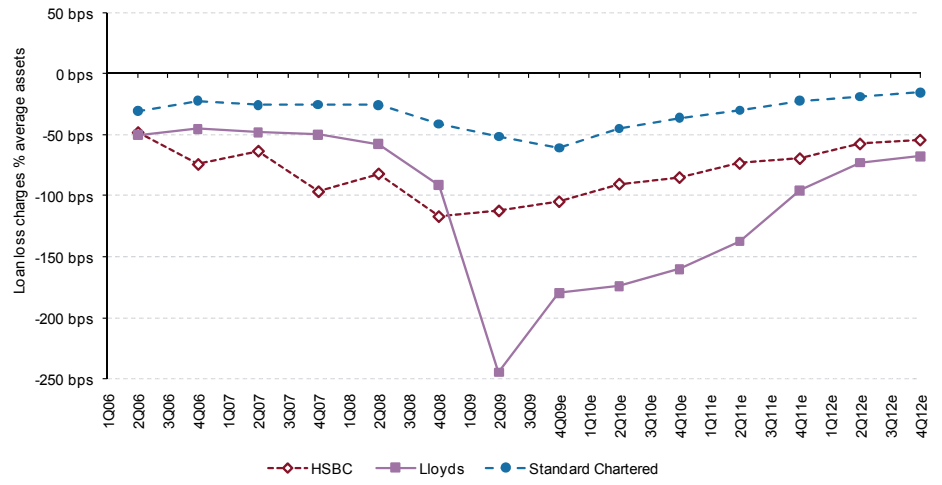
Source: Matrix Corporate Capital Research

Impairments

We believe the market is overly concerned with the perceived negative development of asset quality. There is indeed a severe deterioration in the Middle East business, and HSBC Finance has shown a very modest increase in impairments to \$3.2bn in Q4 2009 from \$3.0bn in Q3 2009, following consistent improvement over 2009. However, on a group basis, loan losses were lower than we were expecting (and in-line with consensus forecasts). Importantly, there was an improvement from H1 to H2 2009, when seasonally there are usually larger loan losses in the second half of the year. We therefore view the loan loss experience as positive on the whole and are encouraged that 2010 should be marked by a significant improvement.

However, we believe this is already accounted for in consensus expectations, so do not see this as an incremental positive.

Figure 5: LLC % Average Total Assets for UK Banks



Source: Matrix Corporate Capital Research

Figure 6: HSBC Earnings Table

HSBC HLDGS PLC	FY 2008	FY 2009E	FY 2009	FY 2010E	FY 2011E	FY 2012E
INCOME STATEMENT (US\$m)						
Net interest income	42,563	40,818	40,730	39,845	40,462	41,454
Net fees & commissions	20,024	17,913	17,664	18,703	19,816	21,008
Trading profits/losses	6,560	11,413	9,863	7,217	6,815	6,454
Other revenue	13,999	3,890	-815	2,544	4,738	4,329
Total operating revenues	83,146	74,035	67,442	68,309	71,831	73,245
Operating costs	-38,535	-34,399	-34,395	-33,614	-33,140	-32,990
Operating profit	44,611	39,636	33,047	34,695	38,691	40,255
Total provisions	-24,937	-29,169	-26,488	-21,048	-17,658	-14,227
Investment income	197	500	520	384	384	384
Impairments on other assets	0	0	0	0	0	0
Goodwill impairment	-10,564	0	0	0	0	0
Pre-tax profit	9,307	10,967	7,079	14,031	21,417	26,412
Taxes	-2,809	-3,068	-385	-3,508	-5,354	-6,603
Minorities	-770	-947	-860	-1,105	-1,687	-2,080
Other non-operating items	0	-1	0	0	0	0
Net profit	5,728	6,950	5,834	9,418	14,376	17,729
ASSETS (US\$m)						
Loans to customers	932,868	919,241	896,231	906,439	932,504	955,977
Interbank loans	153,766	184,089	179,781	183,395	187,081	190,841
Total securities	756,097	860,561	845,183	862,305	897,142	933,386
Intangible assets	27,357	29,396	29,994	31,206	32,466	33,778
Total assets	2,527,465	2,518,508	2,364,452	2,434,204	2,511,120	2,593,683
Net interest-earning assets	1,439,265	1,549,050	1,529,683	1,561,833	1,610,653	1,657,726
LIABILITIES (US\$m)						
Interbank borrowings	130,084	131,734	130,606	135,882	141,372	147,084
Customer deposits	1,295,020	1,380,833	1,323,393	1,353,330	1,384,003	1,415,433
Total shareholders' equity	93,591	119,973	128,299	131,527	139,714	151,253
Tangible net asset value	66,234	90,577	98,305	100,322	107,247	117,475
IMPORTANT FINANCIAL RATIOS						
ROA	0.23%	0.32%	0.24%	0.39%	0.58%	0.69%
ROE	5.17%	7.62%	5.26%	7.25%	10.60%	12.19%
ROTNV	7.41%	10.37%	7.09%	9.48%	13.85%	15.78%
Cost/income	-46.24%	-45.43%	-50.61%	-48.93%	-45.89%	-44.81%
Tax rate	-30.18%	-25.26%	-5.44%	-25.00%	-25.00%	-25.00%
Payout	134.58%	71.30%	101.16%	62.85%	41.17%	33.38%
Net interest margin	2.90%	0.00%	2.94%	2.76%	2.73%	2.72%
LLC % gross loans	-2.55%	-3.06%	-2.82%	-2.27%	-1.88%	-1.48%
Non-performing loans % gross loans	2.65%	4.00%	3.32%	3.00%	2.00%	1.50%
NPL coverage ratio	94.31%	87.00%	83.45%	92.50%	97.50%	97.50%
Loans % deposits	83.64%	75.25%	77.33%	76.67%	77.32%	77.70%
Tier 1 ratio	8.30%	10.17%	10.78%	10.87%	11.37%	12.13%
Core tier 1 ratio	6.99%	8.84%	9.38%	9.50%	10.03%	10.82%
Equity % total assets	3.70%	4.76%	5.43%	5.40%	5.56%	5.83%
RWA % total assets	45.42%	46.49%	47.93%	47.49%	46.96%	46.38%

Source: Matrix Corporate Capital Research

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