

Korea Banks

Will Korea banks enter a 'Lost Decade'?

Equities

Korea
Banks, Ex-S&L

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Operating conditions remain challenging

We maintain our cautious view on Korea banks. We expect limited momentum due to: 1) the slowdown of loan growth; 2) NIM to be negatively affected again by rate cuts in 2015E; and 3) the bottoming of provisioning after a seven-year low in 2014 to be partly offset by; 4) improving SG&A. As a result, we cut our 2015, 2016 and 2017 sector earnings estimates 4%, 12% and 12%, and our price targets 13% on average. Our cautious view should not be a surprise as the sector has stagnated for over three years. We think Korea bank investors need to consider whether the stagnation will last even longer as has been the case for Japan's banks since the 1990s.

A comparison of Japan's Lost Decade with present-day Korea

We believe Korea's economy resembles that of Japan's with an 18-20 year lag in terms of: 1) demographic structure; 2) similar conditions prior to the formation of the respective property bubbles; and 3) similar responses after the bubbles burst. However, we also note fundamental differences in the two economies, such as Korea's 1) more export-led economy; 2) smaller property bubble; and 3) large underground economy.

We believe the major concern is micro rather than macro

We believe Japan's Lost Decade should be understood in the context of: 1) eroding competitiveness; 2) the failure of government intervention; and 3) the lack of restructuring, as claimed by Michael Porter in his 2000 publication, "Can Japan Compete?" rather than solely by macro factors. We believe these factors are adaptable to today's Korean economy. Japanese banks have been consistent underperformers as they lacked competitiveness; they also contributed to the property bubble formation and delayed restructuring. We think Korea banks are in a similar position and are thus at risk of following the same path.

Lessons from Japan since the 1990s

1) Japan banks had six major rebounds in 1990s, but eventually underperformed in the longer term; 2) higher yield stocks outperformed; and 3) Orix and Suruga Bank were significant outperformers with profitability-driven niche business models. Our top picks in Korea are KB FG and Shinhan FG based on higher earnings and capital bases to qualify as yield stocks. We upgrade DGB Financial Group from Neutral to Buy and Woori Bank from Sell to Neutral based on a heavily discounted valuations.

Changes to ratings, price targets and EPS (in order of preference)

	Price (Won)	Rating		Price target				EPS (2015E)			EPS (2016E)			P/BV (2015E)		PE (2015E)	
	2-Mar-15	Old	New	Old	New	Chg	Upside	Old	New	Chg	Old	New	Chg	Current	Target	Current	Target
KB Financial Group	37,600	Buy	Buy	43,000	43,000	0%	14%	4,171	4,255	2%	4,377	4,220	-4%	0.53x	0.60x	8.8x	10.1x
Shinhan Financial Group	42,200	Buy	Buy	54,000	52,000	-4%	23%	4,685	4,680	0%	5,238	4,763	-9%	0.67x	0.83x	9.0x	11.1x
DGB Financial Group	11,650	Neutral	Buy	16,000	14,000	-13%	20%	1,785	1,587	-11%	2,004	1,622	-19%	0.57x	0.68x	7.3x	8.8x
Industrial Bank of Korea	13,150	Neutral	Neutral	18,000	14,500	-19%	10%	1,778	1,682	-5%	1,944	1,645	-15%	0.52x	0.58x	7.8x	8.6x
BS Financial Group	14,600	Neutral	Neutral	17,000	15,500	-9%	6%	1,938	1,871	-3%	2,134	1,823	-15%	0.66x	0.70x	7.8x	8.3x
Hana Financial Group	29,400	Neutral	Neutral	40,000	32,000	-20%	9%	4,301	4,007	-7%	4,589	3,822	-17%	0.39x	0.42x	7.3x	8.0x
Woori Bank	9,300	Sell	Neutral	12,000	10,000	-17%	8%	1,395	1,212	-13%	1,571	1,236	-21%	0.34x	0.36x	7.7x	8.3x
Korea Banks						-12%	13%			-5%			-14%	0.53x	0.60x	8.0x	9.0x

Source: Reuters, UBS estimates

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Executive Summary

The Korean bank index (KRX Banks) finished 2014 down 17%, underperforming the KOSPI, which was down 5% and regional banks (FTSE Asia Banks), which was up 6%. We believe the weak performance supports our cautious stance on the Korea bank sector (the majority of banks we cover are rated Neutral), which is premised on: 1) structural challenges undermining the recovery of the household sector; 2) the continued decline in bank asset yields; and 3) the lack of dividends due to regulations and the lack of management dedication to maximising shareholder returns.

We believe the weak performance supports our cautious stance on the Korea bank sector

We remain cautious on the sector in 2015 despite lower valuations, as we believe operating conditions will remain challenging. We believe banks' key earnings drivers are at risk of further deterioration with: 1) NIM to be negatively affected by our assumption of a 25bp rate cut during 2015; 2) loan growth slowing down from a high base in 2014, despite lower rates (supported by cautious growth guidance by banks who are more aware of credit risk as well as pressure on the loan-to-deposit [LDR] and capital ratios); and 3) a sequential rise in provisioning. We expect SG&A to be a positive exception due to cost management efforts.

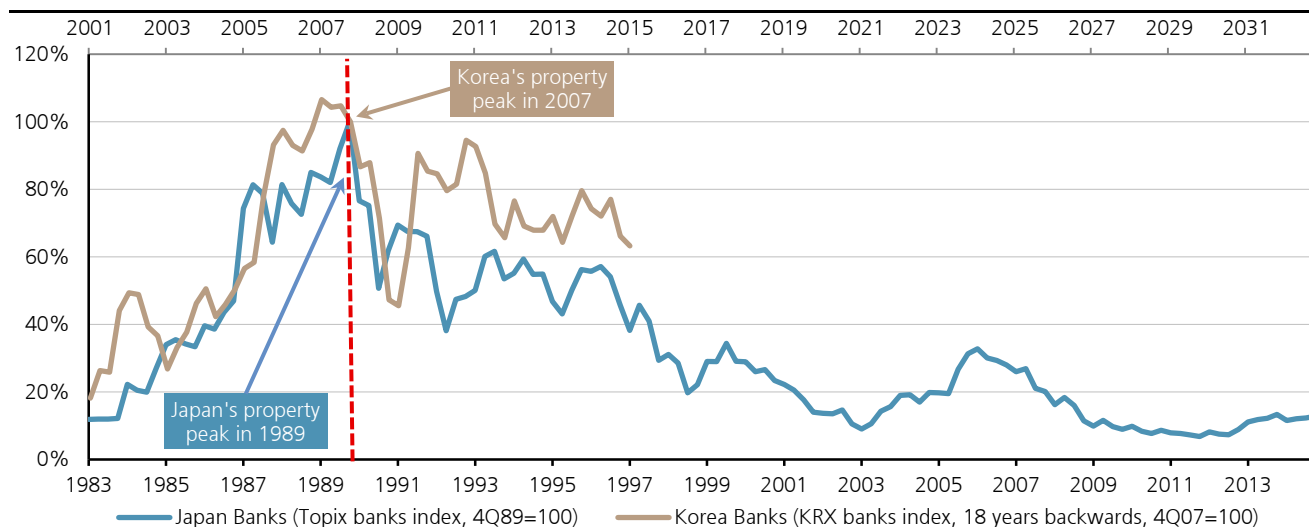
Based on the above, we cut our 2015, 2016 and 2017 sector earnings estimates 3%, 12% and 12%; our new estimates are 8% and 6% below 2016 and 2017 consensus. We also lower our price targets for our coverage stocks by 13% on average.

We cut our 2015, 2016 and 2017 sector earnings estimates 3%, 12% and 12%

Our cautious outlook and estimates for the next one to two years are not new, and should not be a surprise for a sector that has stagnated for over three years. Will slightly better assumptions than ours justify a sector re-rating? We think not. We believe the big question is whether the stagnation of Korea banks will continue as was the case in Japan in the 1990s.

Put more simply, our concerns are expressed in the chart below that shows close correlation in share prices between Japan and Korea banks since their respective property peaks in 1989 and 2007.

Figure 1: Coincidence or fate? Similar bank share price trends post property peaks in Japan and Korea



Source: Bloomberg

We therefore compare present-day Korea with Japan in the 1990s from both a macro and micro viewpoint. We note Michael Porter's 2000 publication, *Can Japan Compete?*, in which he argues the root cause of Japan's Lost Decade was microeconomic factors such as eroding competitiveness and inefficient business structures, and not the typical macroeconomic factors such as a property bubble, currency movements, or demographics. In our view, the key causes of Japan's difficulties that Porter pointed out 15 years ago are comparable to the present-day Korean economy. Our two key conclusions are:

Conclusion No. 1: macroeconomic factors are not complete evidence that Korea will experience a Lost Decade; there are similarities, but many differences as well

We note several similarities between Korea and Japan, including:

Demographics. Korea faces a similar demographic challenge that Japan faced around 20 years ago (the percentage of the economically active population peaked in 1992 in Japan and in 2012 in Korea). Korea may face higher long-term pressure given its lower fertility rate at 1.21 since 2000 versus 1.34 for Japan.

Similarities during the formation of the property bubbles

- a. The property bubble started to form when the home purchasing age group (35-44 years) neared the peak in Japan and Korea, and burst when that age group started to decrease. Korea may face more pressure given the smaller contribution from the so-called 'echo boomers' (second-generation baby boomers) to the home purchasing age group (essentially a result of faster falling fertility rates).
- b. The high asset portion per household (Korea: 68% in 2014; Japan: 70% in 1989) implies a substantial negative wealth effect when property prices fall.
- c. Currency appreciation and low interest rates prior to the bubble formation, which stimulated investment sentiment for real estate.
- d. Property undersupply prior to the bubble formation and a continued increase in supply after the bubble burst.

Policy responses. Since the property bubble burst, Japan has initiated multiple policy responses including rate cuts, monetary easing and expansionary budget spending. These led to short-term stock market rebounds along with Japan Post and the Government Pension Investment Fund investing in equities during the rebounds. However, the policy response failed to reverse the downturn. Moreover, an increasing expenditure burden (stimulus package + welfare) induced the Japanese government to raise taxes and initiate healthcare insurance reform in 1997, which led to a significant drop in GDP growth from 1998. Tax rate hikes are now a key area of discussion in Korea.

The differences that we note include:

A more export-led economy. Korea's economy is more export-led than Japan with exports accounting for 50% of GDP compared to 15% in Japan, according to Statistics Bureau of Japan and the Bank of Korea. This usually implies a more elastic recovery when growth in external economies improves. The Korean currency's volatile nature as a non-key currency allows exporters to benefit from a weaker Won; again allowing the Korean economy to recover faster post economic troughs. Along with the emergence of globally competitive companies like Hyundai Motor and Samsung Electronics after the bubble peak, the KOSPI performed better during 2008-14 compared to the TOPIX during 1990-96.

Differences during the property bubble formation:

- a. **Size of the bubble:** the price-to-income ratio in Tokyo was 18x and 12x in Korea at the peak.
- b. **Difference in leverage:** during the bubble, Japanese banks allowed a loose LTV (loan-to-value ratio) of 110-120%, while it was capped at 50% in Korea, implying relatively higher quality collateral value and relatively lower NPL risk.

'Underground' economy. Korea's underground economy is estimated to be one of the largest among developed economies (26% of GDP versus 11% in Japan, according to the OECD), possibly due to the high proportion of SME and self-employed businesses. While difficult to quantify, the large underground economy is one factor that should be considered when assessing Korea's property and household debt issues.

Conclusion No. 2: we see more similarities in Korea for microeconomic factors that Porter flagged as the key causes of Japan's failure in the 1990s. Eroding competitiveness, failing government intervention, and a lack of restructuring are the factors we are concerned about

Eroding competitiveness. Almost no new export industries have emerged in Japan since the 1980s; reflecting a gradual erosion of the nation's overall competitiveness. This has been driven by competitors adopting Japan's productivity enhancement measures. In Korea we see similar signs of competitive erosion in key industries (IT, autos, shipbuilding and steel) that have led exports.

Failure of the Japanese government model. Ironically most of the industries in Japan (eg, chemicals, software and finance) that were protected and nurtured by the government eventually failed to achieve global competitiveness and remained unproductive. On the other hand, the most competitive companies came from industries that were exposed to open competition, notably automobiles. Unfortunately banks are in the former category in Japan and Korea.

Lack of restructuring. In Japan, the restructuring of uncompetitive companies has been delayed due to the forbearance of banks and regulators. This has led to a significant increase in so-called 'zombie' companies, or companies that survived only via maturity extensions or interest payment exemptions on loans. Such practices have led to a prolonged period of economic depression. In Korea, we note similar trends with: 1) the percentage of zombie companies reaching levels close to Japan (15.6% in 2013 for Korea versus 16.2% in 1996 for Japan); 2) the portion of companies with less than 1x interest coverage sustained at above 2008-09 crisis levels; and 3) the number of companies applying for debt workouts is decreasing despite the factors mentioned above.

The above factors combined with several examples of large corporate restructuring in Korea (where banks had to extend loans to unprofitable companies under the creditor bank group system) leads us to assume it is sensible to factor in conservative credit cost assumptions for Korea banks.

Considering the factors mentioned above, we conclude that Japan's long depression is at least a possible scenario for Korea banks, albeit at a smaller magnitude considering the differences (eg, a smaller property bubble, more of an export-led economy and stricter LTV) between the two economies.

We conclude that Japan's long depression is at least a possible scenario for Korea banks

We note that we are more negative than market consensus, and that changes could reverse the trend that we envisage. However, we believe that change should not only depend on better macro assumptions, but also structural reforms that could enable the Korean economy and Korea banks to improve competitiveness while breaking through the barriers capping fundamental upside.

We believe Korea banks should undertake significant changes to improve competitiveness, for example: 1) the adequate pricing of loans and fees under the law of competition instead of regulatory and public pressure; 2) the pursuit of new business opportunities cross-border and cross-sector; 3) the restructuring of zombie companies without delay; and 4) flexible cost management in a changing business environment. We note that most Japanese banks that were unable to achieve a structural improvement in competitiveness became unattractive investments for investors.

We believe the history of Japan's stock market and the performance of the financial sector in 1990s have three implications for Korea's bank sector.

Three implications for Korea's bank sector

The sector eventually underperformed in the long term despite significant short-term rebounds. During the 1990s, the Japanese bank sector underwent six rebounds, which led to an average 47% appreciation over a 10-month period on average. These rebounds generally took place along with: 1) expansionary stimulus policies; 2) a (temporary) earnings recovery on lower credit costs; and 3) improving global/Japanese GDP growth. However looking at the longer term trend, the rebounds were temporary and eventually did not reverse a long depression. In the case of Korea, the primary determinant of the rebounds was an improvement in external economies combined with low valuations, historically at 6.5x PE (1 standard deviation below the historical average), and which is now 18% below current levels.

Yield stocks outperformed. Due to their relative attractiveness in a low-rate environment, high-yield stocks have been outperformers in Japan, as noted by UBS's Japan Strategist Tomohiro Okawa and Korea Strategist Young Chang (for more detail, please refer to the report, *Korea Strategy: Korea's competitiveness is fading— what to do?* Young Chang, 16 January 2015). We believe Korea banks on average have had difficulties paying high dividends given insufficient capital buffers and low profitability; however, we think KB and Shinhan are better positioned given their sufficient capital buffers and higher earnings bases.

Profitability-driven, niche business models significantly outperformed; competitiveness matters. UBS Japan bank analyst, Shinichi Ina, notes that the most successful financial stock in Japan since the 1990s has been Orix (8591.T) a diversified financial services firm that was established as a small leasing business and rapidly grew via a flexible business model while avoiding regulatory pressure by focusing on the non-banking business. As a pure bank, Suruga Bank (8358.T) has significantly outperformed by uniquely positioning itself as a higher risk/higher return personal loan lender since 1987.

Our stock ratings and preferences are largely unchanged even after reflecting our lower earnings estimates and price targets. We continue to prefer the two large-cap banks (KB Financial Group and Shinhan Financial Group) based on a better dividend outlook. Among the Neutral-rated stocks (Hana Financial Group, Industrial Bank of Korea [IBK], BS Financial Group and DGB), we upgrade DGB to Buy due to heavily discounted valuations after a large stock price correction in H214. Finally, we upgrade Woori Bank from Sell to Neutral after the share price corrected to well below our previous price target.

Our preferred picks are KB and Shinhan

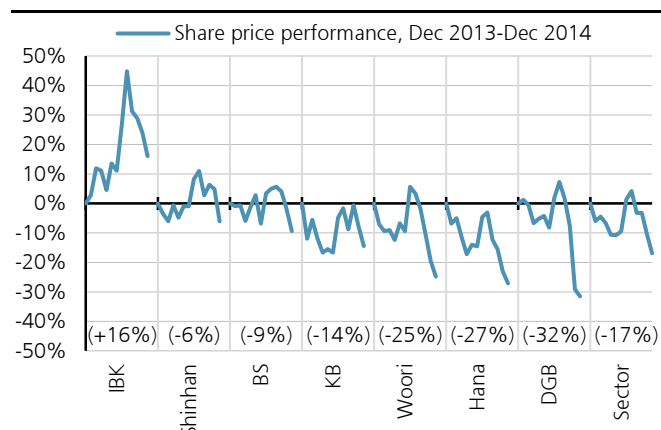
A challenging outlook for 2015-16

A review of 2014

The Korean bank index (KRX Banks) closed down 17% in 2014, underperforming Korea (KOSPI, down 5%) and the regional banks (FTSE Asia Banks, up 6%). The weak performance supports our cautious stance on the sector (with the majority of our covered stocks rated Neutral) premised on: 1) structural challenges undermining a household sector recovery; 2) a continued decline in asset yields, and; 3) a lack of dividends due to regulations and a lack of management dedication to paying dividends.

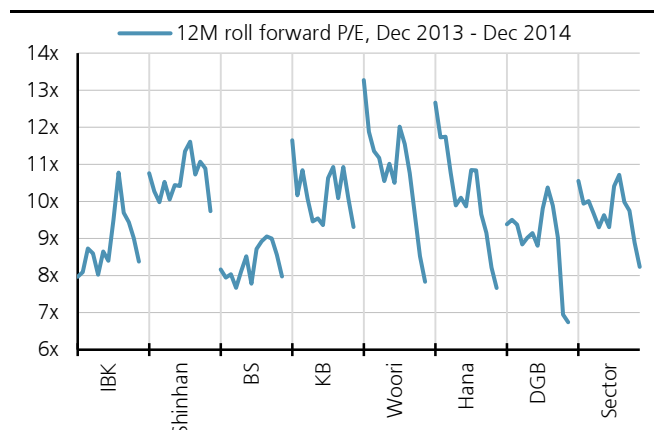
The weak performance supports our cautious stance on the sector

Figure 2: Korea banks' share price performance in 2014



Source: Reuters

Figure 3: PE trends in 2014



Source: Reuters

Apart from the overall weak performance, several other outcomes met our expectations.

Companies with better shareholder return prospects outperformed. Since July 2014, dividends have become a central theme for Korea, driven by the Finance Minister's focus on dividends as one measure to improve household income. IBK and Shinhan outperformed the bank sector average by 33% and 11% in 2014, respectively.

Progress in SG&A savings. Despite our cautious view on the sector, we have highlighted before that SG&A savings would be a structural positive factor, as the highly senior-skewed employee demographic could be gradually resolved, driven by the increasing retirement of baby boomers. From H214, we note that bank industry headcount has been gradually decreasing.

Improved credit costs. We have highlighted several factors to support an optimistic view on credit costs such as: 1) the lowest system loan growth in Asia ex-Japan; 2) reduced risk from problematic (construction and shipbuilding) industries after years of restructuring; 3) concentration of low-end household bankruptcy risk in non-bank financial companies; and 4) stabilisation of collective mortgage loan delinquencies. As a result, credit costs remained at 59bp, in line with our previous estimate of 61bp and meaningfully lower than 2008-10 (108bp) and 2011-13 (77bp).

On the other hand, the key factors that did not meet our expectations were:

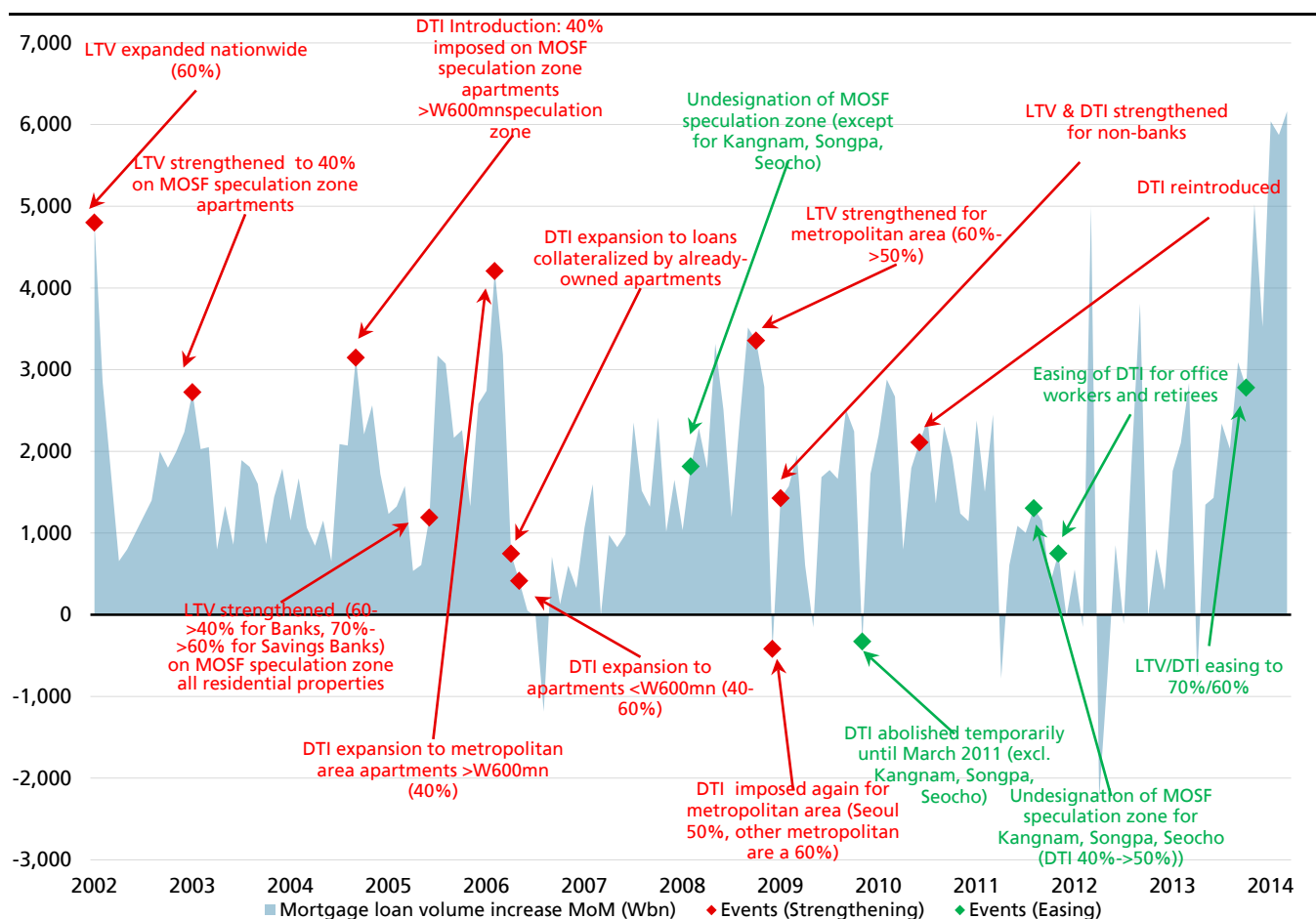
Much higher-than-expected household loan growth. Initially we expected low household loan growth based on Korea's high household debt leverage and stagnant household income growth. However, household loan growth rose sharply during H214 and closed at 12% YoY in December 2014. This was largely attributable to the announcement of the loan-to-value (LTV) and debt-to-income (DTI) easing in July 2014, followed by two policy rate cuts in August (2.50% to 2.25%) and October (2.25% to 2.00%). We think the higher LTV and DTI limits stimulated demand for property on the one hand, but more importantly encouraged high debtors check to switch out of expensive non-bank loans to bank mortgages to lower the interest burden.

Figure 4: Bank loan growth trends by segment

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Overall loan growth	15.6%	27.4%	10.2%	5.3%	8.3%	14.3%	13.8%	12.4%	7.8%	3.7%	6.6%	4.4%	4.6%	8.4%
Household	38.6%	38.0%	13.8%	8.9%	10.7%	13.4%	5.1%	6.9%	5.2%	5.5%	5.6%	2.5%	3.0%	8.5%
Mortgage	N/A	N/A	16.9%	11.0%	12.1%	14.2%	2.0%	8.2%	10.6%	7.6%	7.5%	3.5%	3.5%	11.8%
Non-Mortgage	N/A	N/A	9.3%	5.7%	8.4%	12.1%	10.4%	4.8%	-3.5%	1.6%	1.7%	0.4%	1.8%	1.2%
Corporate	7.5%	20.3%	14.3%	1.7%	5.7%	15.3%	23.1%	17.6%	10.1%	2.2%	7.6%	5.9%	5.9%	8.3%
SME	11.9%	24.5%	18.3%	3.8%	4.7%	17.7%	22.4%	12.7%	7.6%	-0.2%	2.6%	1.3%	5.9%	7.1%
Large Corp	-9.6%	0.4%	-9.2%	-15.1%	15.9%	-4.6%	30.5%	66.6%	27.0%	15.7%	31.8%	23.5%	5.8%	12.3%

Source: Bank of Korea

Figure 5: Monthly mortgage loan balance change vs. key events



Note: MOSF (Ministry of Strategy and Finance). Source: Bank of Korea, UBS

The dividend theme overheats. We expect only select banks to be able to increase dividends on a sustainable basis given the low recurring sector average level ROE of c6%, which is just enough to cover asset growth of c5-6% (higher dividends would erode the capital ratio). However, we believe the Finance Minister's focus on dividends brought about an excessive anticipation that all banks (as the industry with the highest political and regulatory pressure) would increase dividends and re-rate. As a result, the bank sector rose 18% from July to early September 2014, but corrected soon after as the sector valuation surpassed 11x PE (+1.4 STD above the historical average of 8.4x) and was deemed too expensive.

Better-than-expected NIM. While sector NIM fell in 2014, reflecting the two rate cuts in August and October, the magnitude of the fall was lower than we had expected (an 8bp NIM decline versus a 43bp decline in average lending rates). Contributing factors were: 1) an aggressive expansion in low-cost deposits during the year; and 2) the redemption of high-yield debentures issued during the global financial crisis.

On balance, despite the challenging conditions we believe the banks' overall operational performance was moderately better than our conservative expectations, leading to 9% earnings growth in 2014E.

We expect only select banks will be able to increase dividends on a sustainable basis

Overall operational performance was moderately better than our conservative expectations

We lower our expectations for 2015-16

We believe operating conditions will remain challenging for the sector, and that most of the key earnings drivers will be sequentially weaker compared to 2014 (which was a better-than-expected year in terms of operations).

Operating conditions will remain challenging for the sector

Our revised estimates are premised on four major assumptions: 1) one policy rate cut of 25bp in 2015; 2) loan growth to slow from a higher base in 2014; 3) a sequential rise in provisioning after near-term stability in 2015; and 4) better-than-expected cuts in SG&A. As a result, we cut our 2015, 2016 and 2017 sector earnings estimates 4%, 12% and 12%, which is in line with consensus in 2015 and 8% and 6% lower in 2016 and 2017.

Figure 6: We cut our 2015/16/17 sector earnings estimates 4%/12%/12%

(Won bn)	Old			New			Difference		
	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E
Net Interest Income	37,028	39,082	41,253	37,036	37,829	39,547	0.0%	-3.2%	-4.1%
Loan growth (%)	5.4%	6.0%	6.0%	5.2%	5.1%	5.1%	-0.2%pt	-0.9%pt	-0.9%pt
NIM (%)	2.39%	2.40%	2.40%	2.38%	2.32%	2.32%	-1	-8	-8
Non Interest Income	623	678	731	-82	154	344	-113.1%	-77.3%	-52.9%
Total Income	37,651	39,760	41,984	36,954	37,983	39,891	-1.9%	-4.5%	-5.0%
YoY growth (%)	9.8%	5.6%	5.6%	7.8%	2.8%	5.0%	-203	-282	-57
SG&A	19,671	20,377	21,156	19,167	19,469	19,823	-2.6%	-4.5%	-6.3%
YoY growth (%)	5.4%	3.6%	3.8%	2.7%	1.6%	1.8%	-2.7%pt	-2.0%pt	-2.0%pt
Cost-Income (%)	52.2%	51.3%	50.4%	51.9%	51.3%	49.7%	-0.4%pt	0.0%pt	-0.7%pt
Pre-provisioning profit	17,981	19,383	20,828	17,787	18,514	20,067	-1.1%	-4.5%	-3.7%
Provisioning	7,087	7,504	7,947	7,153	7,933	8,620	0.9%	5.7%	8.5%
Provisioning Yield (bps)	59	59	59	60	63	65	1	4	6
Pre-tax profit	10,894	11,879	12,881	10,634	10,581	11,448	-2.4%	-10.9%	-11.1%
Net profit	7,936	8,672	9,420	7,632	7,592	8,245	-3.8%	-12.5%	-12.5%
YoY growth (%)	23.8%	9.3%	8.6%	19.0%	-0.5%	8.6%	-4.7%pt	-9.8%pt	0.0%pt
ROE	6.7%	7.0%	7.1%	6.5%	6.1%	6.3%	-0.2%pt	-0.8%pt	-0.8%pt

Source: UBS estimates

Figure 7: Our revised earnings estimates are 8%/6% below consensus in 2016-17E

(Won bn)	Consensus			UBS (Reported basis)			UBS vs. Consensus		
	2015	2016	2017	2015E	2016E	2017E	2015	2016	2017
KB	1,631	1,730	1,664	1,644	1,631	1,748	1%	-6%	5%
Shinhan	2,212	2,392	2,518	2,281	2,321	2,522	3%	-3%	0%
DGB	270	302	325	268	274	300	-1%	-9%	-8%
IBK	1,125	1,224	1,267	1,080	1,057	1,135	-4%	-14%	-10%
BS	449	498	531	439	427	453	-2%	-14%	-15%
Hana	1,129	1,264	1,448	1,162	1,108	1,211	3%	-12%	-16%
Woori	997	1,085	1,279	968	984	1,085	-3%	-9%	-15%
Sector	7,813	8,495	9,032	7,842	7,802	8,455	0%	-8%	-6%

Source: Bloomberg, UBS estimates

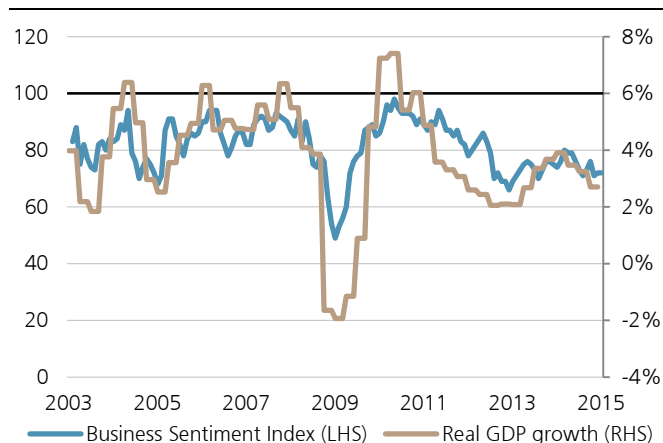
NIM to continue to fall

We lower our NIM assumptions (previously flat) 1bp in 2015 and 8bp in 2016, premised on: 1) a 25bp policy rate cut in 2015 offset by; 2) a further increase in low-cost deposits in the near-term.

We lower our NIM assumptions

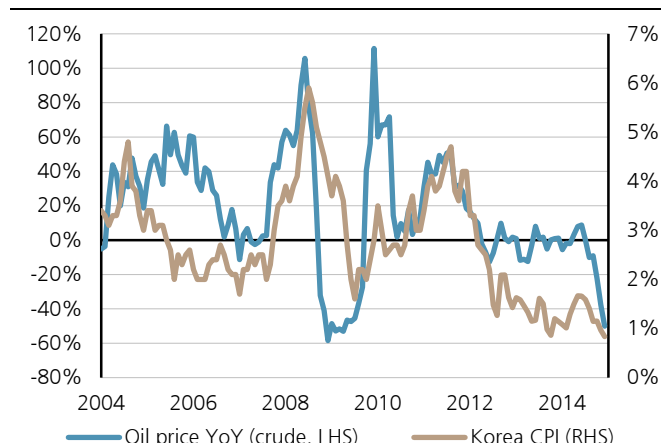
1) Based on delayed economic growth and low inflation, we assume Bank of Korea cuts the policy rate at least once (25bp) in 2015 from 2.0% to 1.75%, in line with consensus. A 25bp cut would imply a c8bp impact on sector NIM, and also correspond with a 14x sector asset/equity and 25% low-cost funding portion.

Figure 8: Business sentiment index and GDP growth



Source: Bank of Korea

Figure 9: Low inflation supported by lower oil prices



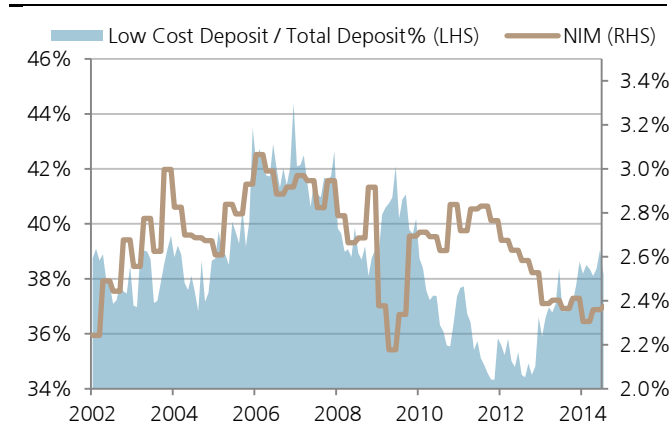
Source: Bloomberg, Bank of Korea, UBS

2) Fast low-cost deposit expansion in 2014 was a key factor limiting the downside impact on NIM against falling rates. According to *Newspim*, the trend continued until Q414—four major banks' (Shinhan, KB, Woori and Hana) low-cost deposit balances grew 14.5% in 2014E, partly offsetting the impact of the rate cuts in August and October 2014.

We believe this trend will continue in the short run, although the pace will likely slow down compared to 2014. With a flattening yield curve and a lack of alternative investment options (property as well as mutual funds in 2006-07 and Wrap accounts in 2008-12), attracting low-cost deposit accounts (eg, salary and transaction accounts) continues to be a key objective for nearly all banks.

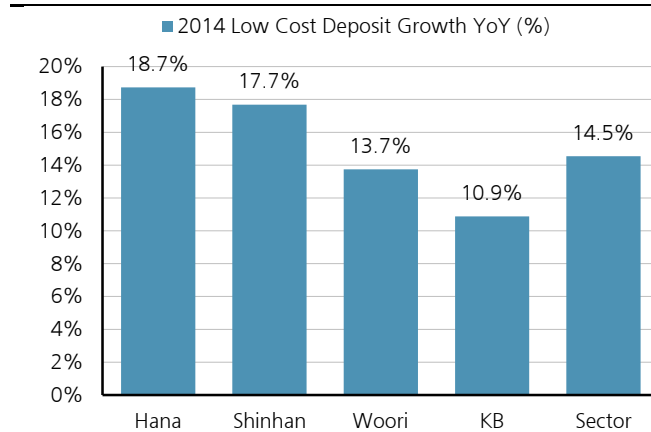
We believe this trend will continue in the short run

Figure 10: Rising low-cost deposits offset NIM erosion



Source: Bank of Korea, UBS estimates

Figure 11: Major banks' low-cost deposit growth in 2014E



Source: Company data, UBS estimates

Moderate loan growth versus a high base in 2014E

We moderately cut our 2015-16 loan growth assumption from 6.0% to 5.1%, largely due to a high base effect in 2014. The key driver of the higher-than-expected loan growth in 2014 was household mortgage loans, which accelerated in H214 after the easing of LTV and DTI regulations and ended 2014 at 11.8%.

We moderately cut our 2015-16 loan growth assumption from 6.0% to 5.1%

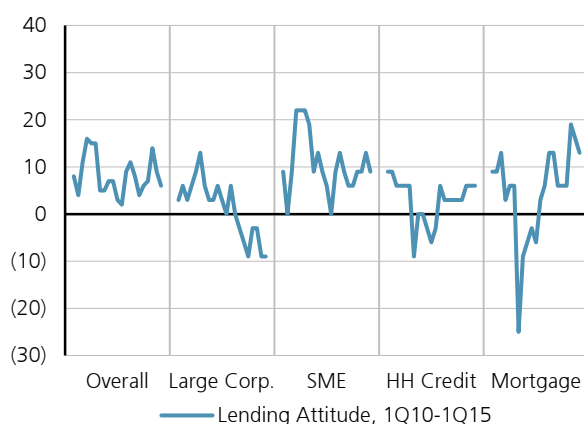
We believe the majority of incremental mortgage demand post the LTV and DTI easing came from relatively low credit quality borrowers who switched from expensive non-bank loans to bank mortgages in order to fulfil living expenses and SME needs instead of purchasing homes. According to the FSS, over half (55.6%) of incremental mortgage loans in August and September 2014 (after the easing) were extended for such needs, which supports our view.

For the financial system as a whole, the move from non-bank to bank loans in order to lower the interest burden/debt service and leading to lower default risk is positive for system asset quality, in our view. However, from the banks' perspective, we believe they are aware of the risk of too many low-quality borrowers switching from non-bank loans.

A loan survey conducted by the Bank of Korea also supports our view, as it highlights signs of loan supply and demand sequentially slowing amid increased awareness of credit risk.

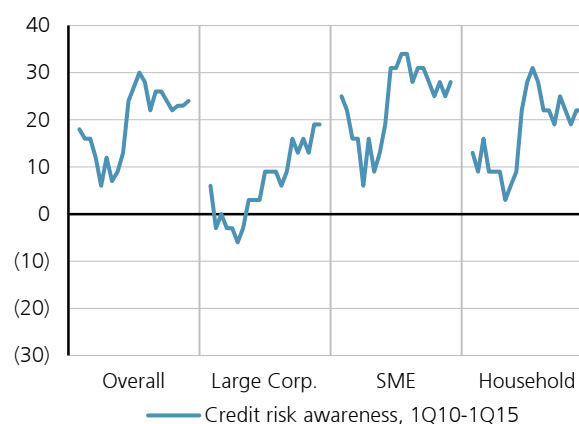
Signs of loan supply and demand sequentially slowing

Figure 12: Banks' attitude to lending weakened in Q115



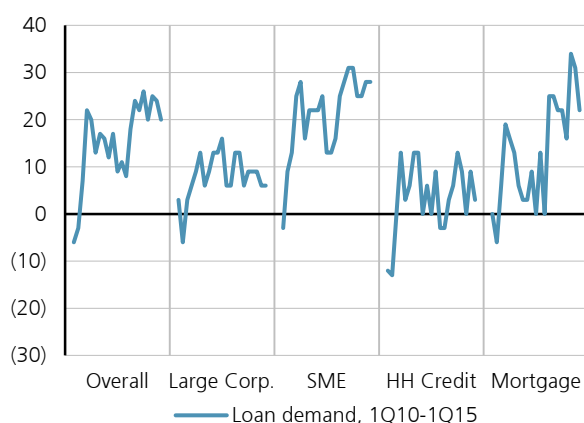
Source: Bank of Korea

Figure 13: Credit risk awareness remained high



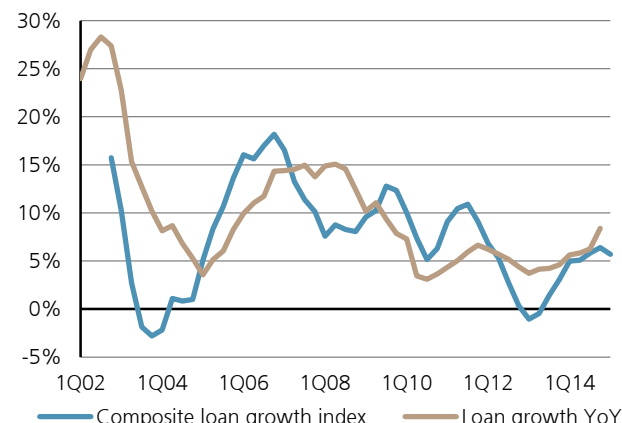
Source: Bank of Korea

Figure 14: Loan demand slowed in Q115



Source: Bank of Korea, UBS

Figure 15: We believe loan growth slowed

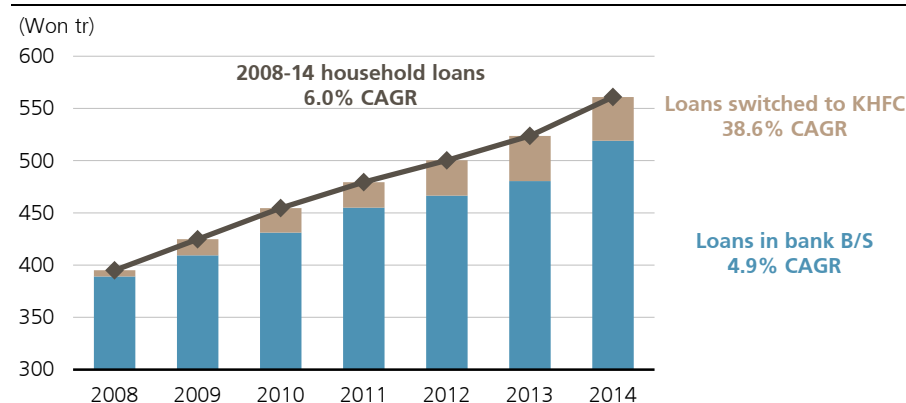


Source: Bank of Korea, KOSIS, UBS estimates

Finally, we believe the increasing role of the Korea Housing Finance Corporation (KHFC, the Korean version of Fannie Mae/Freddie Mac) will be a risk to the banks' traditional household lending role. Since 2008, the KHFC has rapidly penetrated the household mortgage market, and increased the loan balance from Won6trn in 2008 to Won42trn in 2014 (a 39% CAGR in 2008-14), or 22% of incremental household loans extended during the period. As a result, loans booked on banks' balance sheets grew less than actual demand: a 4.9% CAGR over 2008-14 versus 6.0%, factoring in the KHFC loans.

We think the planned introduction of a Loan Conversion Program by the KHFC on 24 March will accelerate the trends: the conversion loans are designed to encourage existing bank mortgage borrowers (with floating rate and/or interest-only redeeming mortgages) to switch to KHFC loans (fixed rate and interest + principal redemption) at lower interest rates. Considering the significant size of the programme (a Won20trn maximum in 2015E, which could be expanded further), household loan growth for banks may be limited despite expected strong housing supply and demand this year.

Figure 16: Increasing role of KHFC to limit banks' household loan growth



Source: Bank of Korea, KHFC

Rate cut may not be significant for loan growth and provisioning, while negative for NIM

Another of our key assumptions is that we do not expect loan growth to accelerate significantly despite assuming an additional rate cut; this contradicts the typical consequence of a rate cut (higher loan growth, lower NIM, and lower provisioning). Our key observations from previous policy rate cuts (2001, 2003, 2005, 2009 and 2013) are as follows:

Four (2001, 2003, 2005 and 2009) out of five cuts were followed by a significant outperformance by the bank sector versus the KOSPI, while bank sector outperformance was insignificant during the most recent cycle (2013).

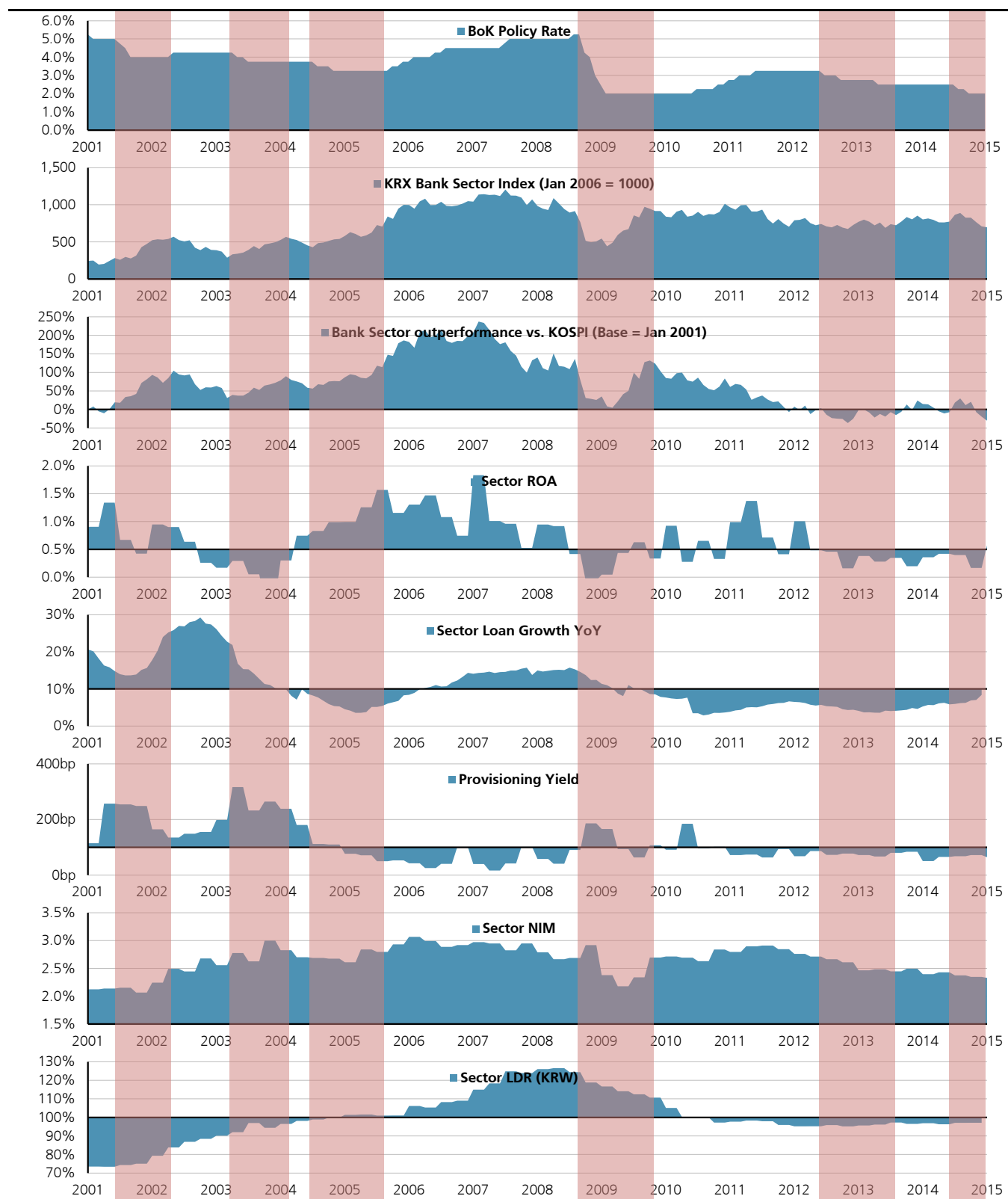
We note that loan growth did not accelerate during the previous rate cut cycles, generally because the rate cut cycles took place during economic downturns. Instead banks' ROA and share price performance improved due to: 1) changes in the balance sheet mix (higher loan-to-deposit ratio); 2) an improvement in credit costs; and 3) the growth in credit card transaction volume in the early 2000s.

We do not expect loan growth to accelerate significantly despite assuming an additional rate cut

- a. Loan-to-deposit ratio (LDR). Contrary to expectations, NIM did not contract during the three early (2001, 2003, 2005) policy rate cut cycles. We believe a key reason for the disparity was a low LDR during the period; banks were able to improve asset yields by increasing the loan portion (from lower yield bonds) on the back of improving asset quality to sustain NIM during previous rate cut cycles. This was not the case in 2013 when sector LDR was 96% and sector NIM fell sharply.
- b. The four earlier policy rate cut cycles were followed by a sizeable fall in credit costs. Provisioning yields fell during the 2013 cycle too, but to a much smaller extent given a lower base.
- c. The emergence of credit cards in the early 2000s. Credit card purchase volume rose 10x in 2005 to Won258trn compared to 1999 at Won24trn, due to the introduction of tax benefits on credit card use in 2000. The increasing portion of credit card business supports NIM as credit card asset yields are higher (15-20%) versus loans (4-6%).

We believe any positive impact would be limited as was the case in 2013, taking into account the current LDR of 97%, a low credit cost base and the lack of a positive NIM impact from credit cards.

Figure 17: Bank of Korea policy rate changes vs. bank fundamentals and performance during rate cut cycles



Source: Bank of Korea, FISIS, Bloomberg, UBS

SG&A to improve further, partly offsetting downward pressure on revenues

To reflect the cost-saving efforts of 2014, we update our proprietary SG&A model and lower our 2015 and 2016 estimates by 2.6% and 4.5%.

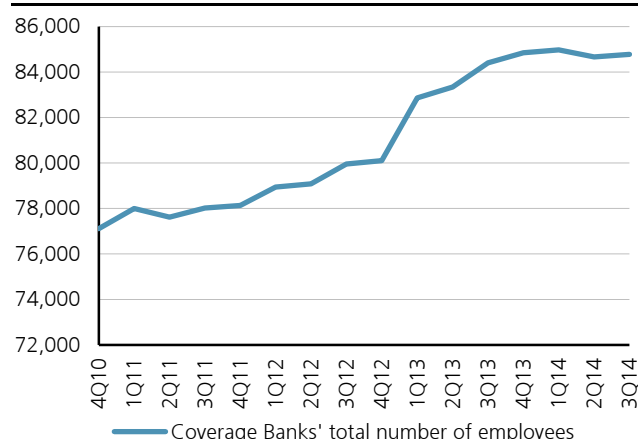
We lower our SG&A forecasts for 2015 and 2016

Our data suggest that banks with a more senior-skewed employee structure (with higher average service years) have higher cost improvements in the form of reduced headcount. We believe this trend will continue, especially as banks may pre-emptively reduce their workforce ahead of the revised retirement age law (retirement age to rise from 58 to 60 years) effective from 2016. Given the low base in 2014 and assuming extra labour restructuring costs are reflected in 2015 for several banks, our YoY growth forecasts are relatively higher in 2015 than for 2016.

Separately the number of bank branches also decreased in 2014 as a result of branch restructuring efforts by major banks such as Shinhan and KB. This trend will likely continue based on further branch reduction and integrated branch formation plans announced by the banks.

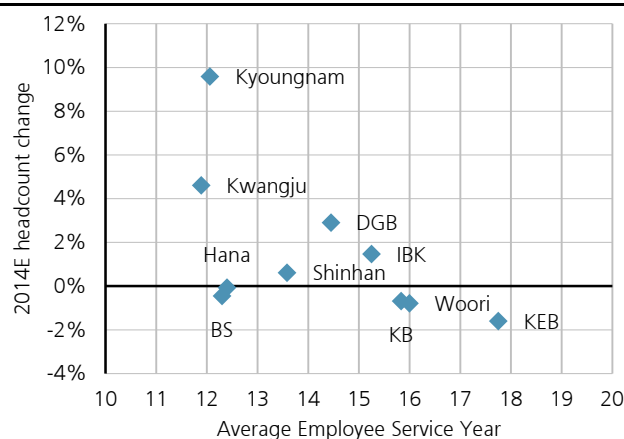
Bank branches decreased in 2014

Figure 18: Number of employees started to decrease...



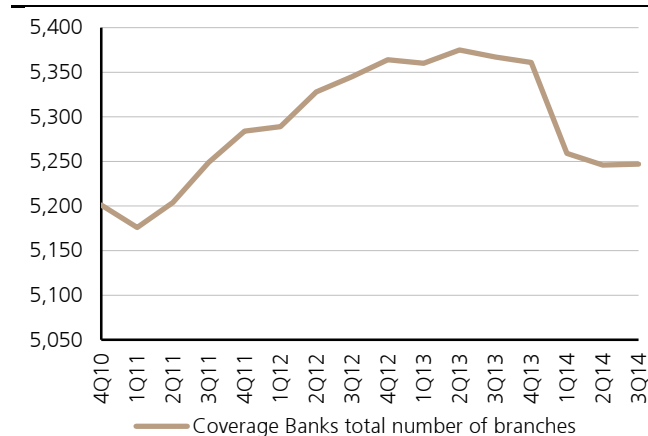
Note: Bank employees only. KEB's headcount adjusted for credit card spin-off in Q314. Source: FISIS, UBS

Figure 19: ...at senior employee-skewed banks



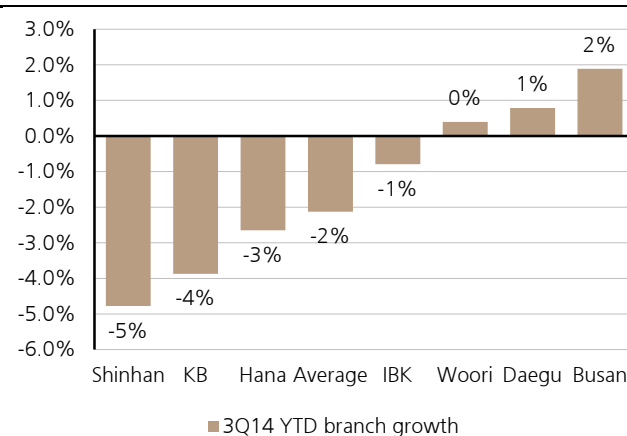
Note: Bank employees only. KEB's headcount adjusted for credit card spin-off in Q314. Source: FISIS, UBS

Figure 20: Number of branches also started to decrease...



Source: FISIS, UBS

Figure 21: ...mainly at large banks



Source: FISIS, UBS

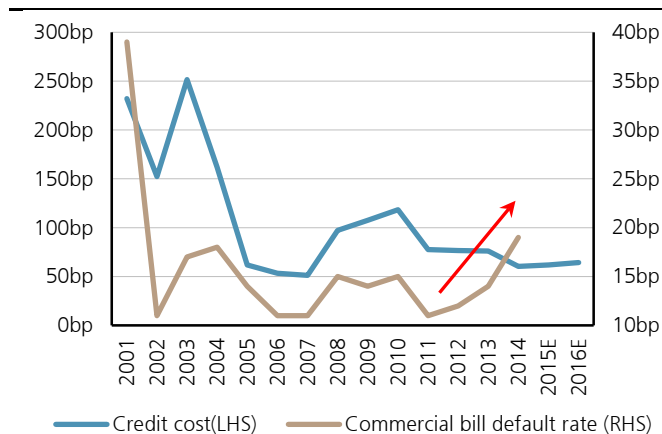
We expect marginal upside risk for provisioning

We moderately raise our provisioning cost estimates for 2015, 2016 and 2017

We moderately raise our provisioning cost estimates for 2015, 2016 and 2017 by 1%, 6% and 8%, implying a 1-6bp higher credit cost of 60-65bp from 59bp previously. Directionally, our assumption contradicts the expected rate cut in 2015E, which should be generally positive for credit costs. However, after reaching a credit cost of 59bp in 2014 (the lowest since 2008), we believe risks are marginally skewed to the upside considering:

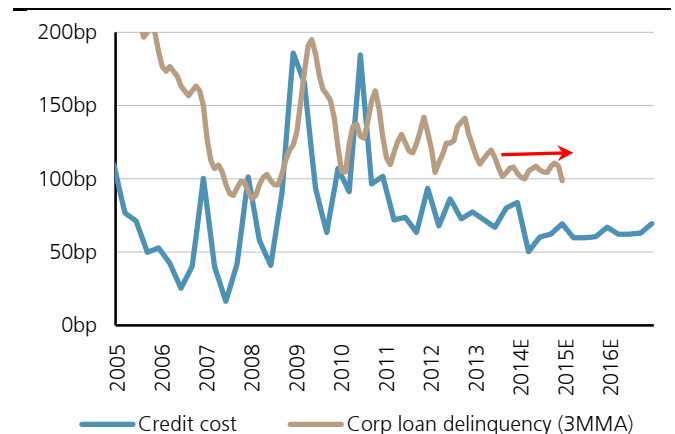
Leading indicators imply near-term upside including: 1) a rise in default rates during 2014, 2) a slowing improvement in delinquency trends; 3) higher credit risk awareness by banks; and 4) higher-than-expected loan growth (adjusted for lending rates to factor in a lower interest burden from falling interest rates).

Figure 22: Credit cost vs. CB default rate



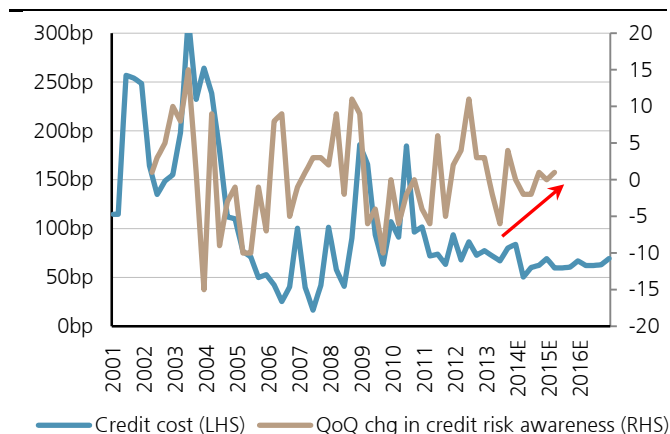
Source: KOSIS, UBS estimates

Figure 23: Credit cost vs. loan delinquency



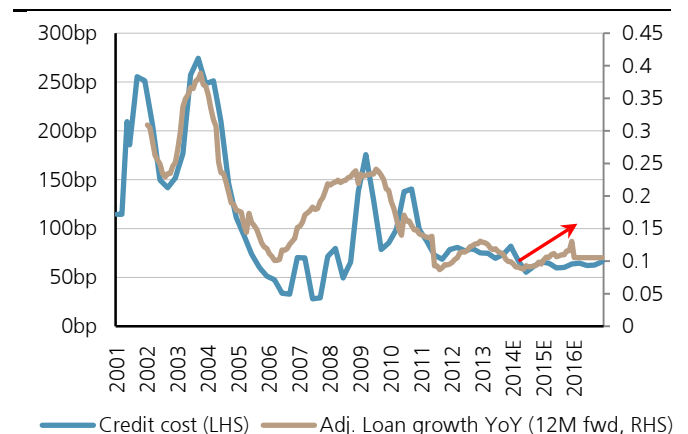
Source: FSS, UBS estimates

Figure 24: Credit cost vs. credit risk awareness index



Source: Bank of Korea, UBS estimates

Figure 25: Credit cost vs. adj. loan growth (12M fwd)



Note: Adjusted loan growth = $[(1 + \text{Loan growth}) \times (1 + \text{Average loan rate}) - 1]$ to reflect lending rate impact on credit costs; estimates are based on our loan growth and lending rate assumptions factoring in a 50bp policy rate cut.
Source: Bank of Korea, UBS estimates

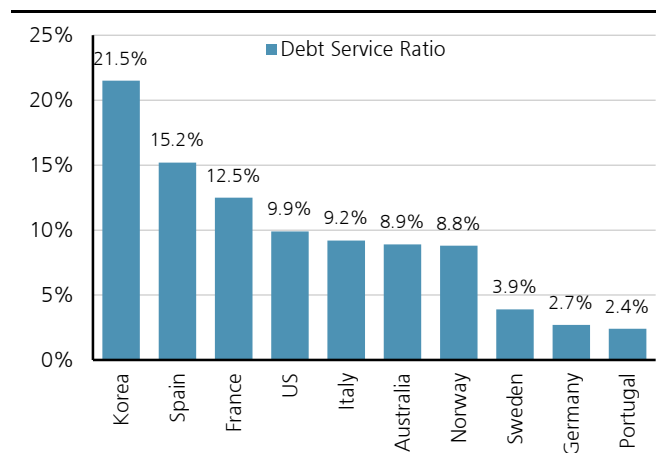
We have a longer-term cautious stance on overall household asset quality. Korean household's debt service ratio (DSR) has gradually increased since 2009 and now stands at 21.5%, one of the highest in the world. Looking at the trends: 1) interest payments are decreasing due to lower rates; but 2) total DSR is rising due to increased principal redemptions, which we attribute to government efforts since 2011 to reform Korea's mortgage loan structure by requiring banks to reduce lump-sum redemption loans and instalment redemption loans with interest-only periods (which can be easily extended), and increasing the portion of loans with no interest-only periods to 40% by 2017. While such structural changes would help Korean households to gradually reduce leverage in the long run, we expect near-term burdens for borrowers without sufficient and/or stable incomes. The gradual retirement of baby boomers (who account for over 50% of mortgage loans) may become a problem.

Moreover, total household debt levels have not decreased despite the increase in DSR during 2009-13, implying that customers leveraged up due to the debt service burdens. As the share of lower-tier lenders increased during that time, we believe current household debt risk should not be viewed as comfortable.

We believe current household debt risk should not be viewed as comfortable

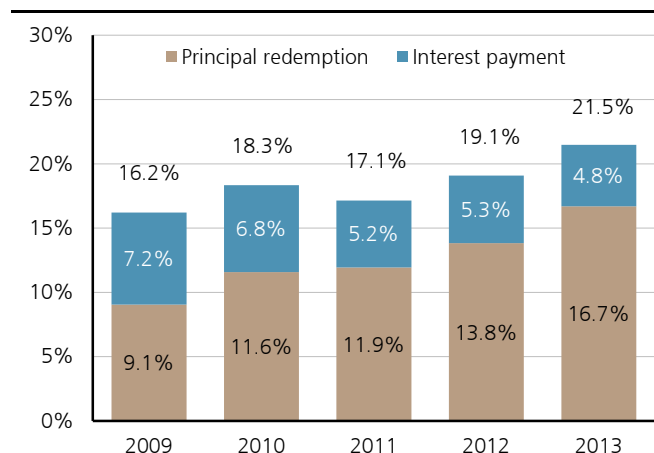
However, we believe the LTV and DTI easing in August 2014 partly lowered the risk by allowing lower credit quality borrowers to switch out of expensive non-bank loans to bank mortgages, supporting our assumption of a moderate (rather than a significant) increase in credit cost. However, this may not justify positive expectations (ie, credit costs falling significantly) unless there are signs of improvements in employment and income.

Figure 26: Debt service ratio is high in Korea...



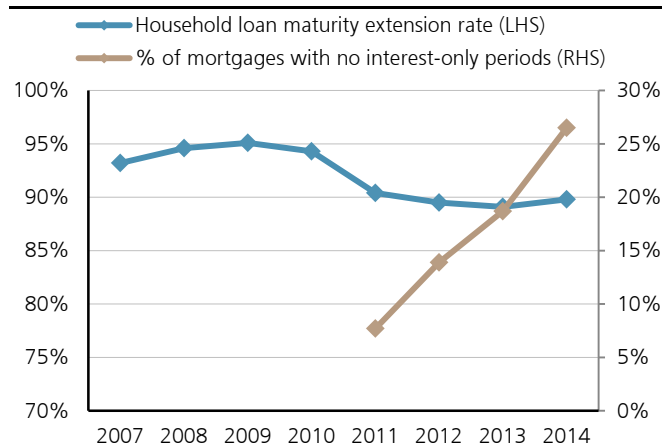
Source: KOSTAT, IMF Financial Soundness Indicators (2014), *Maekyung*

Figure 27: ...due to rising principal redemptions...



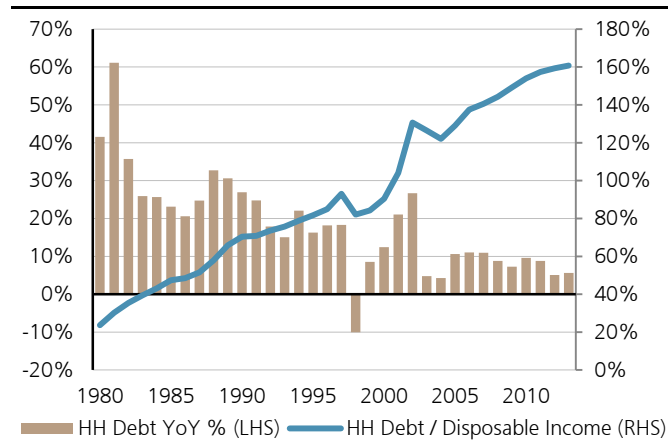
Source: KOSTAT, Bank of Korea, UBS estimates for 2009-10

Figure 28: ...partly driven by structural changes in loans, particularly mortgages



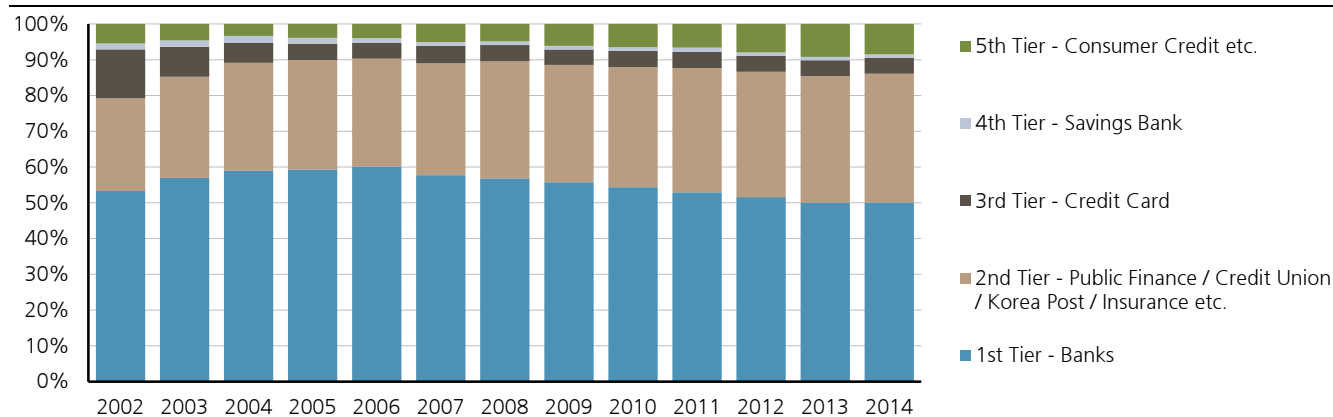
Source: FSC, FSS, UBS

Figure 29: However, household debt levels are not falling



Source: Bank of Korea, UBS

Figure 30: Worsening household debt structure is also a concern

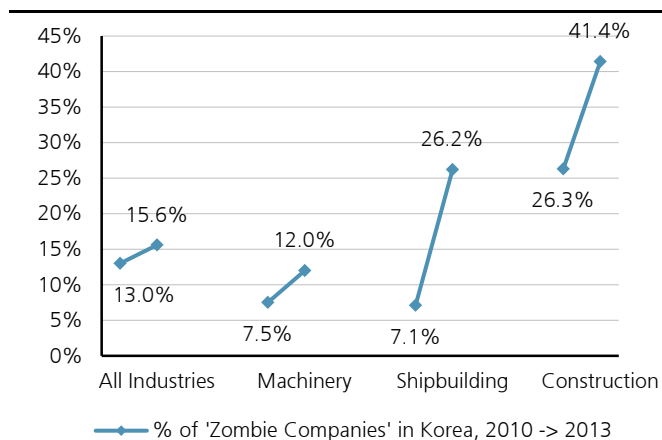


Note: 2014 data based on Q314 balance. Source: Bank of Korea, UBS

Separately, we remain cautious on corporate asset quality in the long term based on the increase in zombie companies that have only survived via maturity extensions or interest exemptions on loans. We will discuss this issue further in the following section.

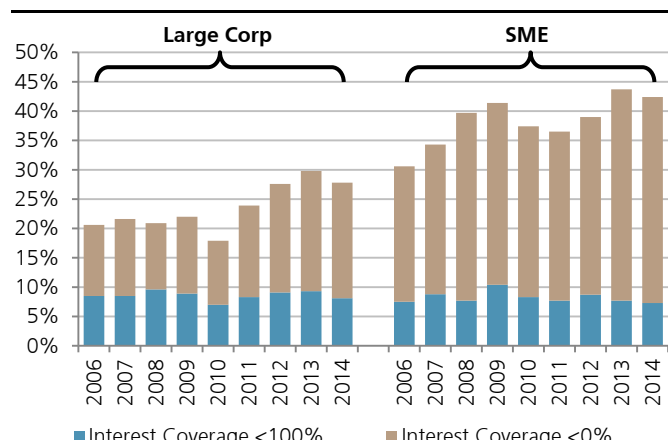
We remain cautious on corporate asset quality

Figure 31: Zombie companies in Japan



Source: Korea Development Institute, Maekyung

Figure 32: Companies with low interest coverage



Source: Bank of Korea, UBS

Valuation and basis for our price targets

Our price targets are based on an ROE-g/COE-g implied target P/BV model. We determine sustainable ROE based on the rounded three-year forecast average of 5-8%. We use a COE of 8.1-10.3% based on our risk-free rate assumption of 2.8% and a market risk premium assumption of 5.0%. We assign a beta of 1.1 for the largest two banks in terms of market cap and total assets (Shinhan and KB), 1.2 for the mid-sized banks (Hana, IBK and Woori), and 1.5 for regional banks (DGB and BS). Lastly, we assume a terminal growth rate of 3.0%.

Figure 33: Valuation scenarios

	KB			Shinhan			DGB			IBK			BS			Hana			Woori		
	Base	Upside	Downside	Base	Upside	Downside	Base	Upside	Downside	Base	Upside	Downside	Base	Upside	Downside	Base	Upside	Downside	Base	Upside	Downside
ROE	6.0%	7.0%	5.3%	7.2%	8.3%	6.6%	7.8%	9.0%	7.0%	6.3%	7.5%	5.2%	8.1%	9.4%	7.1%	5.4%	6.6%	4.5%	5.4%	7.3%	4.7%
2014A	5.4%	5.4%	5.4%	7.4%	7.4%	7.4%	8.2%	8.2%	8.2%	6.9%	6.9%	6.9%	8.9%	8.9%	8.9%	4.6%	4.6%	4.6%	2.6%	2.7%	2.7%
2015E	6.1%	6.8%	5.3%	7.7%	8.5%	7.0%	8.4%	9.3%	7.5%	6.8%	7.7%	5.6%	8.8%	9.9%	7.8%	5.4%	6.3%	4.6%	5.2%	6.8%	4.5%
2016E	5.8%	6.7%	5.0%	7.3%	8.5%	6.7%	7.6%	8.8%	6.8%	6.3%	7.5%	5.1%	8.0%	9.3%	6.9%	5.0%	6.1%	4.0%	5.1%	7.0%	4.4%
2017E	5.9%	7.1%	5.2%	7.5%	8.9%	6.9%	7.8%	9.3%	7.0%	6.4%	7.8%	5.2%	7.8%	9.4%	6.8%	5.2%	6.5%	4.2%	5.4%	7.6%	4.8%
COE	8.1%	8.1%	8.1%	8.1%	8.1%	8.1%	10.3%	10.3%	10.3%	8.8%	8.8%	8.8%	10.3%	10.3%	10.3%	8.8%	8.8%	8.8%	8.8%	8.8%	8.8%
Rf	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%	2.8%
Beta	1.1	1.1	1.1	1.1	1.1	1.1	1.5	1.5	1.5	1.2	1.2	1.2	1.5	1.5	1.5	1.2	1.2	1.2	1.2	1.2	1.2
MRP	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
g	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
Target P/B	0.60x	0.79x	0.45x	0.83x	1.04x	0.72x	0.66x	0.83x	0.55x	0.58x	0.77x	0.37x	0.70x	0.88x	0.56x	0.42x	0.62x	0.27x	0.41x	0.75x	0.30x
Adjusted Target P/B	0.60x	0.79x	0.45x	0.83x	1.04x	0.72x	0.68x	0.82x	0.54x	0.58x	0.79x	0.36x	0.70x	0.90x	0.55x	0.42x	0.62x	0.27x	0.42x	0.75x	0.30x
2015E BVPS	71,329	71,854	70,799	62,932	63,439	62,532	20,574	20,755	20,404	25,101	25,342	24,798	22,017	22,255	21,788	75,464	76,125	74,829	23,780	24,155	23,616
Fair Value Per Share	42,515	56,554	31,642	52,339	66,156	44,711	13,666	17,158	11,245	14,455	19,535	9,208	15,382	19,622	12,137	31,747	47,250	19,869	9,840	18,077	7,010
Valuation (rounded)	43,000	57,000	32,000	52,000	66,000	45,000	14,000	17,000	11,000	14,500	20,000	9,000	15,500	20,000	12,000	32,000	47,000	20,000	10,000	18,000	7,000
2015E EPS	4,255	4,780	3,726	4,680	5,187	4,280	1,587	1,768	1,417	1,659	1,901	1,354	1,871	2,112	1,635	4,007	4,669	3,373	1,212	1,587	1,048
Implied P/E	10.1x	11.9x	8.6x	11.1x	12.7x	10.5x	8.8x	9.6x	7.8x	8.7x	10.5x	6.6x	8.3x	9.5x	7.3x	8.0x	10.1x	5.9x	8.3x	11.3x	6.7x
Current Price	38,200	38,200	38,200	43,350	43,350	43,350	11,850	11,850	11,850	13,500	13,500	13,500	15,300	15,300	15,300	29,500	29,500	29,500	9,510	9,510	9,510
Current P/BV	0.54x	0.53x	0.54x	0.69x	0.68x	0.69x	0.58x	0.57x	0.58x	0.54x	0.53x	0.54x	0.69x	0.69x	0.70x	0.39x	0.39x	0.39x	0.40x	0.39x	0.40x
Current P/E	8.98x	7.99x	10.25x	9.26x	8.36x	10.13x	7.47x	6.70x	8.36x	8.14x	7.10x	9.97x	8.18x	7.24x	9.36x	7.36x	6.32x	8.75x	7.85x	5.99x	9.08x
Upside (%)	13%	49%	-16%	20%	52%	4%	18%	43%	-7%	7%	48%	-33%	1%	31%	-22%	8%	59%	-32%	5%	89%	-26%

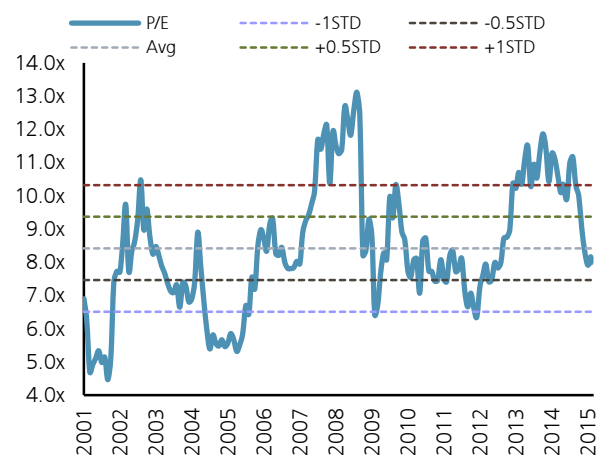
Note: Priced as of 2 February 2015. Source: Bloomberg, UBS estimates

Figure 34: Valuation summary

Company name	Rating	Local Price	Mkt Cap	Price	Upside	P/BV (x)			P/E (x)			ROE (%)			Net Profit (Won bn)			Yield (%)		
		2-Mar-15	(Won tn)	Target		2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E
KB Financial Group	Buy	37,600	14.5	43,000	14%	0.53x	0.50x	0.48x	8.84x	8.91x	8.31x	6.1%	5.8%	5.9%	1,644	1,631	1,748	2.3%	2.2%	2.4%
Shinhan Financial Group	Buy	42,200	20.0	52,000	23%	0.67x	0.63x	0.59x	9.02x	8.86x	8.13x	7.7%	7.3%	7.5%	2,219	2,259	2,460	2.2%	2.3%	2.5%
DGB Financial Group	Buy	11,650	1.5	14,000	20%	0.57x	0.53x	0.50x	7.34x	7.18x	6.56x	8.4%	7.7%	7.8%	268	274	300	1.6%	1.7%	1.8%
Industrial Bank of Korea	Neutral	13,150	8.6	14,500	10%	0.52x	0.50x	0.47x	7.82x	7.99x	7.45x	6.9%	6.4%	6.5%	1,095	1,071	1,149	2.7%	2.7%	3.0%
BS Financial Group	Neutral	14,600	2.8	15,500	6%	0.66x	0.62x	0.58x	7.80x	8.01x	7.55x	8.8%	8.0%	7.9%	439	427	453	2.1%	2.1%	2.2%
Hana Financial Group	Neutral	29,400	8.5	32,000	9%	0.39x	0.37x	0.36x	7.34x	7.69x	7.04x	5.4%	5.0%	5.2%	1,162	1,108	1,211	1.6%	1.6%	1.7%
Woori Bank	Neutral	9,300	6.3	10,000	8%	0.34x	0.33x	0.31x	7.67x	7.52x	6.72x	4.5%	4.4%	4.7%	820	836	936	2.2%	2.2%	2.7%
Korea Banks			62.3		13%	0.53x	0.50x	0.47x	7.98x	8.02x	7.39x	6.8%	6.4%	6.5%	7,646	7,606	8,259	2.1%	2.1%	2.3%

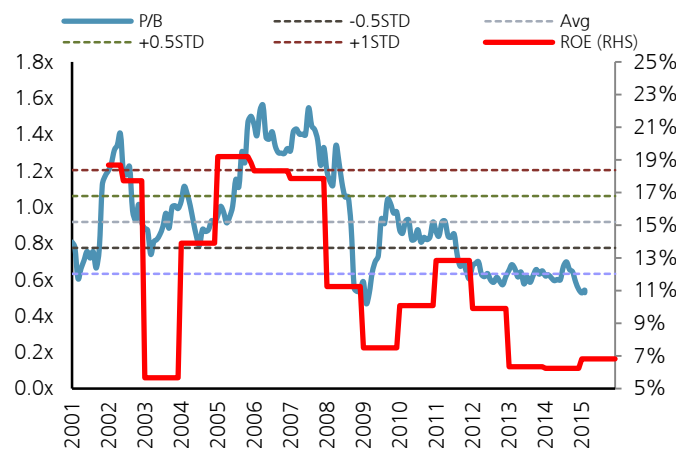
Source: Bloomberg, UBS estimates

Figure 35: Sector PE



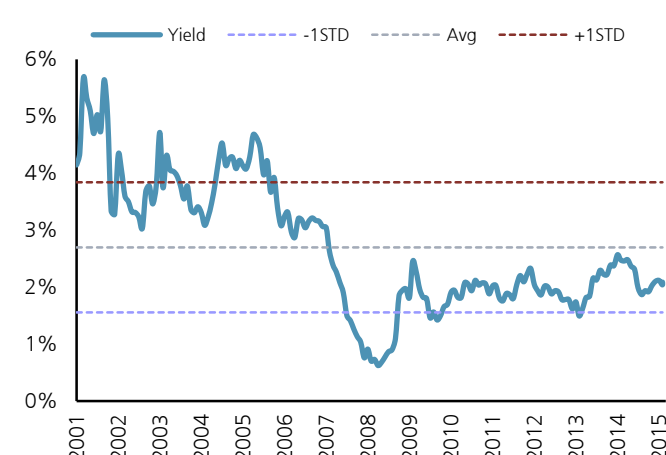
Source: Company data, UBS estimates

Figure 36: Sector P/BV vs. ROE



Source: Company data, UBS estimates

Figure 37: Sector dividend yield



Source: Company data, UBS estimates

Japan's Lost Decade: inevitable for Korea banks?

Our sector view is conservative compared with consensus, and our outlook and estimates for the next one to two years should not surprise investors. We believe cautious market sentiment is well reflected in valuations, and the slightly positive assumptions for loan growth, NIM and provisioning will not be a game-changer for a sector that has stagnated at below 0.7x P/BV for over three years.

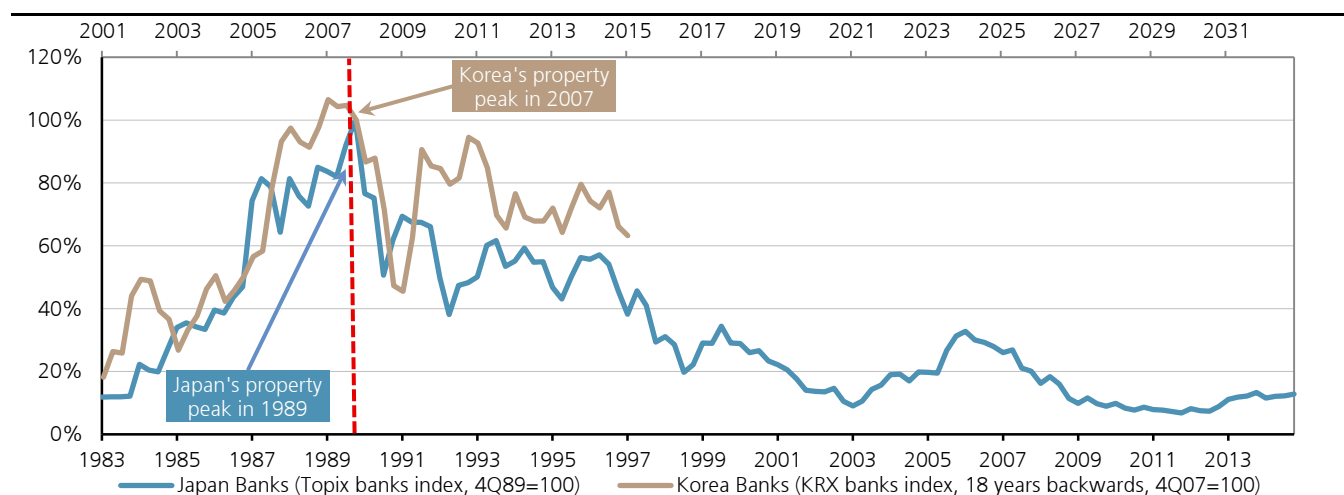
Our sector view is conservative compared with consensus

Instead, we believe it is time to think about longer-term trajectories, especially considering increased concerns about a prolonged stagnation as was the case for Japan banks during the 1990s.

Put more simply, our concerns are expressed in the chart below that shows a close correlation in share prices between Japan and Korea banks since their respective property peaks in 1989 and 2007.

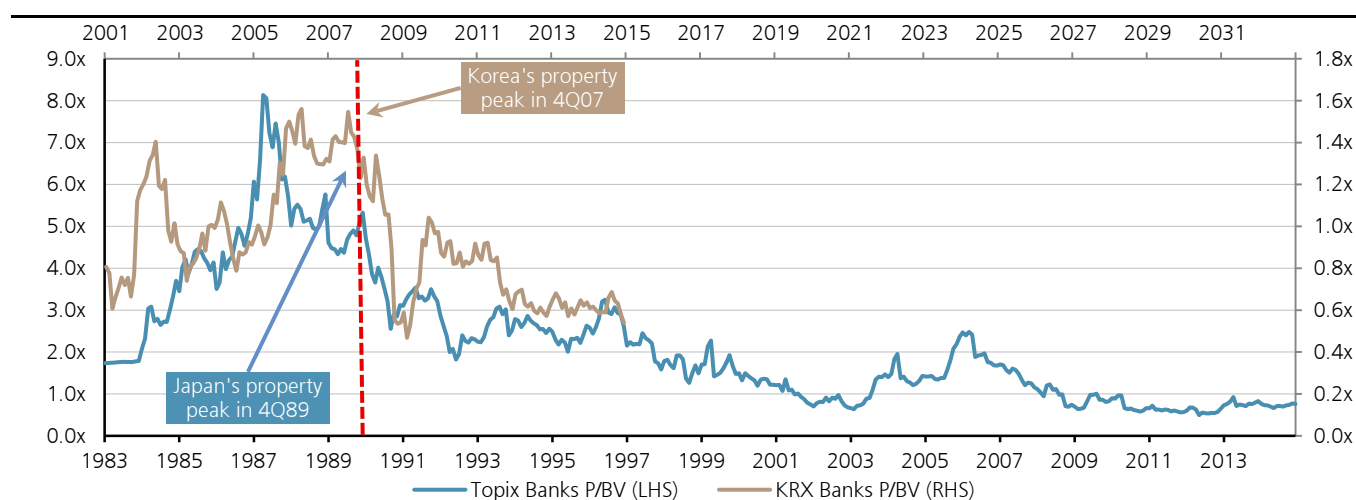
Close correlation in share prices between Japan and Korea banks since their respective property peaks

Figure 38: Coincidence or fate?



Source: Bloomberg, UBS

Figure 39: P/BV suggests a large gap in peak valuations (8x in Japan vs. 1.6x in Korea) , but trajectories are similar



Note: Japan P/BV before July 1993 are estimates. Source: Datastream, Bloomberg, Bank of Japan, company data, UBS estimates

We therefore compare present day Korea with Japan in the 1990s from both a macro and micro viewpoint. We note Michael Porter's 2000 publication, *Can Japan Compete?*, in which he sets out the root cause of Japan's decade-long depression using an insightful bottom-up microeconomic approach across different industries in Japan, which is different from the typical focus on macro factors such as property bubble or demographics. In our view, the key causes of Japan's difficulties that Porter pointed out 15 years ago seem adaptable to today's Korean economy.

We conclude that: 1) macroeconomic factors do not perfectly predict that Korea will experience a Lost Decade; there are similarities but many differences as well; and 2) we see more similarities in the microeconomic factors that Porter flagged as the key causes of Japan's failure in the 1990s. Eroding competitiveness, failing government intervention and the lack of restructuring are the factors we need to be concerned about.

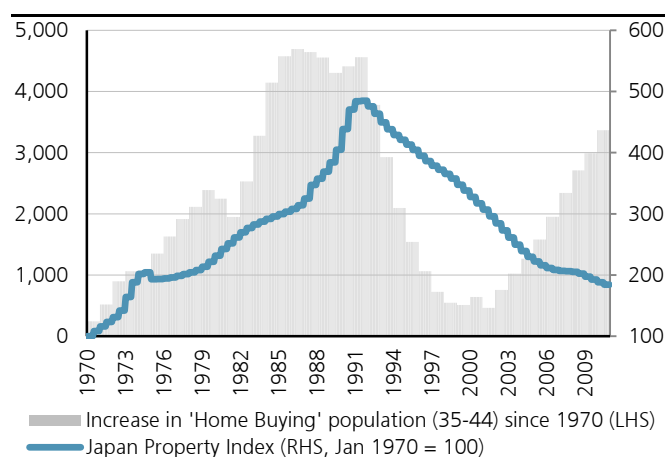
We compare present day Korea with Japan in the 1990s from both a macro and micro viewpoint

Eroding competitiveness, failing government intervention and the lack of restructuring

Macro factors suggest some similarities between Japan and Korea

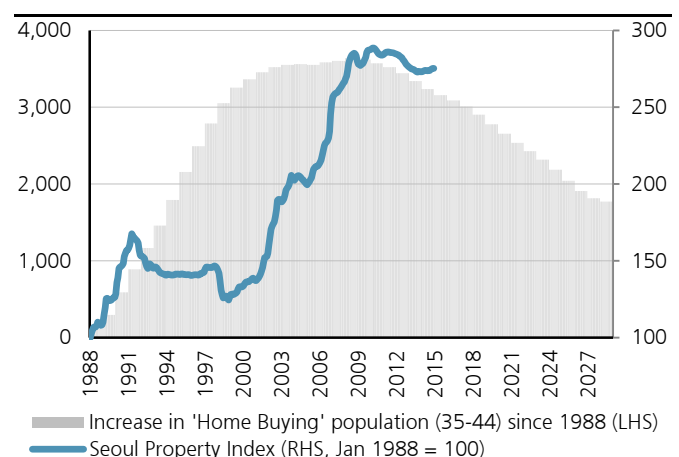
- **Demographics.** We believe Korea faces a similar demographic challenge that Japan faced around 20 years ago (the percentage of the economically active population peaked in 1992 in Japan and in 2012 in Korea). Korea may face more long-term pressure given its lower fertility rate at 1.21 since 2000 versus 1.34 for Japan.
- **Property bubble formation** started in 1985 for Japan and 2002 in Korea around when the home purchasing age group (35-44 years) neared the peak in Korea and Japan, and burst when that age group started to decrease. Korea may face more pressure given the smaller contribution from the so-called echo boomers (second-generation baby boomers) to the home purchasing age group (essentially a result of faster falling fertility rates).

Figure 40: Japan demographics vs. property prices



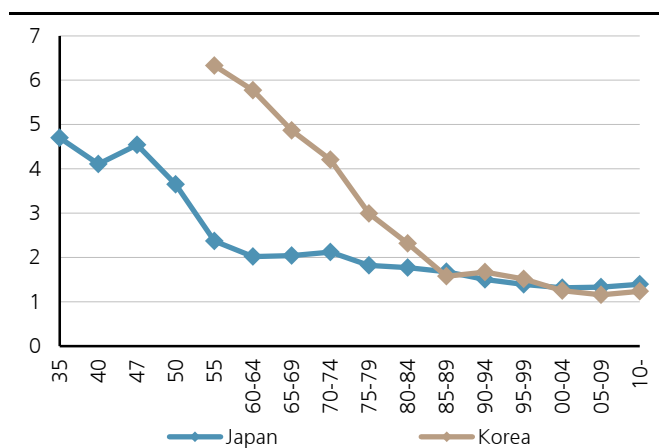
Source: Statistics Bureau of Japan, CEIC

Figure 41: Korea demographics vs. property prices



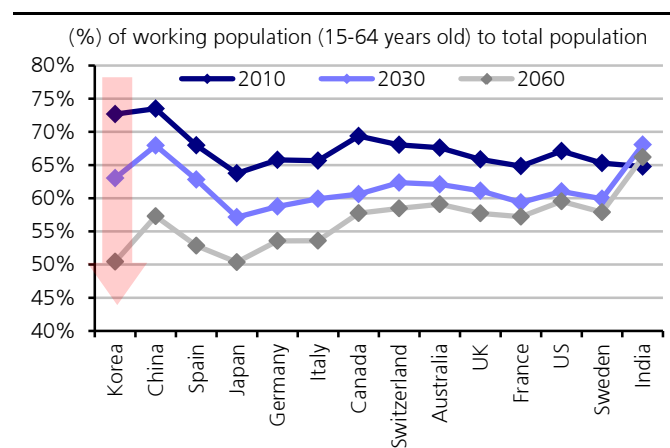
Source: KOSIS, Kookmin Bank, UBS

Figure 42: Japan vs. Korea fertility rates



Source: CEIC

Figure 43: Korea is rapidly aging

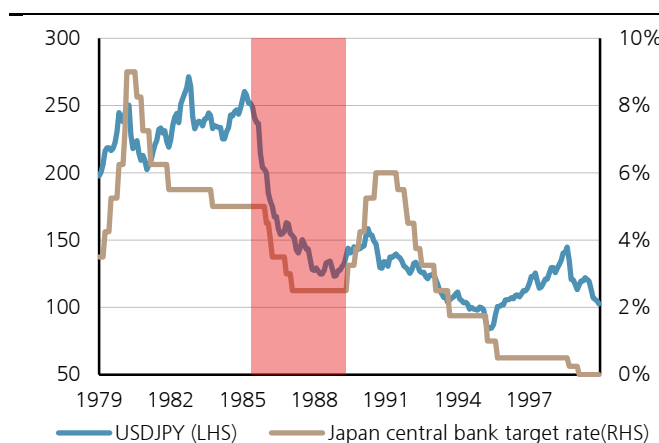


Source: World Population Prospects: The 2012 Revision, UN

The high asset portion per household (Korea: 68% in 2014; Japan: 70% in 1989), implying a substantial negative wealth effect when property prices fall.

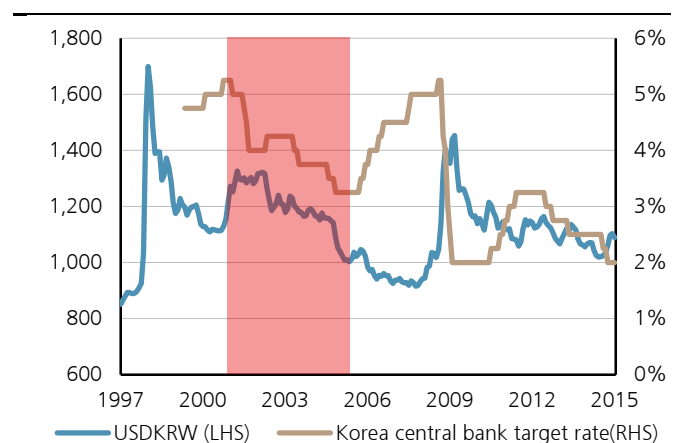
Currency appreciation and low interest rates prior to the property bubble formation, which were favourable for property investment. Following the appreciation of the Yen driven by the Plaza Agreement in 1985 and subsequent challenges faced by exporters in Japan, the Bank of Japan lowered the target interest rate from 5.0% in 1985 to 2.5% in 1987. Similarly, the Won appreciated against the US\$ from the early 2000s, and the Bank of Korea lowered the target interest rate from 5.25% in 2001 to 3.25% in 2005, which stimulated investment sentiment for real estate in Korea.

Figure 44: Currency and interest rates in Japan



Source: Bloomberg, UBS

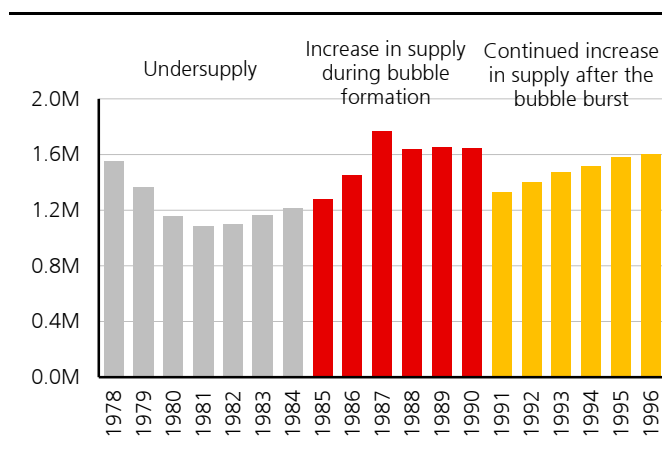
Figure 45: Currency and interest rates in Korea



Source: Bloomberg, UBS

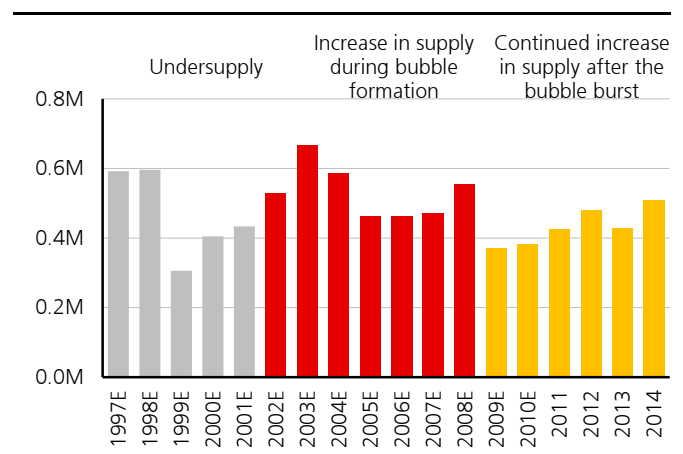
Property undersupply prior to the bubble formation and continued increase in supply after the bubble burst. Japan's housing supply increased during the bubble formation from 1985, following a period of undersupply during the early 1980s. After the bubble burst, housing supply temporarily decreased in 1991 but soon started to increase until 1996, which we attribute to expectations of a market recovery and multiple stimulus packages that supported the construction industry (which eventually delayed the recovery by providing support to the troubled construction sector). The trend is similar in Korea: housing supply has continued to increase since 2009.

Figure 46: Japan housing starts



Source: Bloomberg, UBS

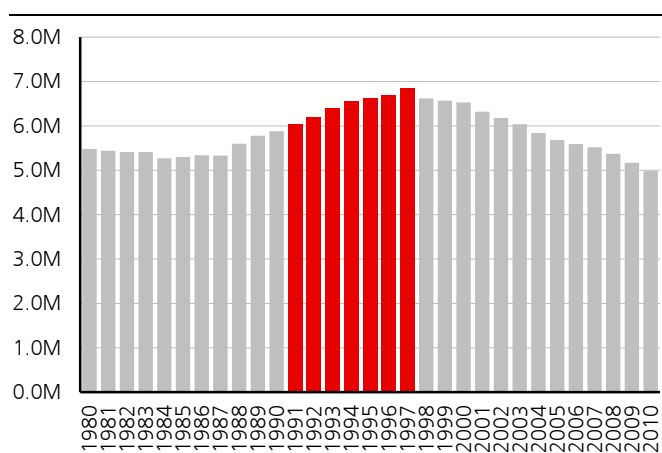
Figure 47: Korea housing starts



Note: Estimates based on historical permit data. Source: Ministry of Land, Infrastructure, and Transportation

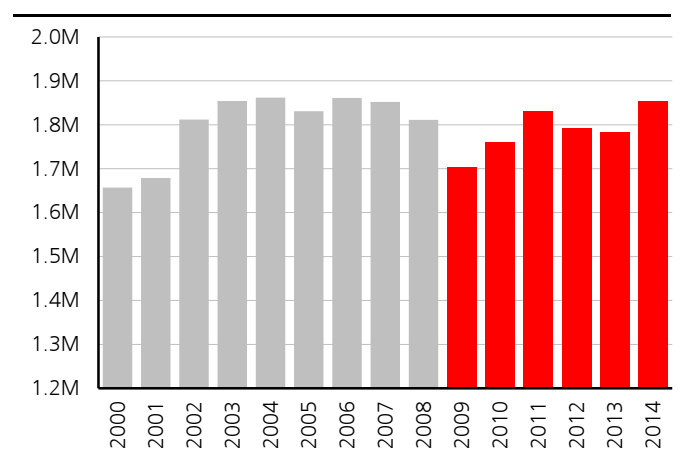
Trends in construction sector employment are similar as well. In Japan, the construction sector labour force expanded after the bubble burst up to 1997 when Japan halted construction industry stimulus packages. In Korea, construction sector employment has gradually increased since 2009, supported by increased SOC investments and affirmative policy measures.

Figure 48: Construction sector employment in Japan



Source: Statistics Japan, UBS

Figure 49: Construction sector employment in Korea



Source: KOSIS, UBS

Policy responses. Since the property bubble burst, Japan has initiated multiple policy responses including rate cuts, monetary easing and expansionary budget spending. These led to short-term stock market rebounds along with Japan Post and the Government Pension Investment Fund investing in equities during the rebounds. However, the policy response failed to reverse the downturn. Moreover, an increasing expenditure burden (stimulus package + welfare) induced the Japanese government to raise tax and initiate healthcare insurance reform in 1997 which led to a significant drop in GDP growth from 1998. Tax rate hikes are a key area of discussion in Korea at present.

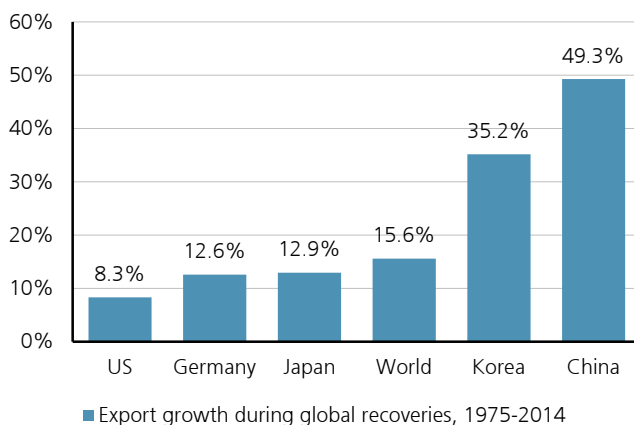
The policy response failed to reverse the downturn

However, there are differences as well

- **A more export-led economy.** Korea's economy is more export-led than Japan with exports accounting for 50% of GDP compared to 15% in Japan. This usually implies a more elastic recovery when growth in external economies improves. The Korean currency's volatile nature as a non-key currency allows exporters to benefit from a weaker Won; again allowing the Korean economy to recover faster post economic troughs. Along with the emergence of globally competitive companies like Hyundai Motor and Samsung Electronics after the bubble peak, the KOSPI performed better in during 2008-14 compared to the TOPIX during 1990-96.

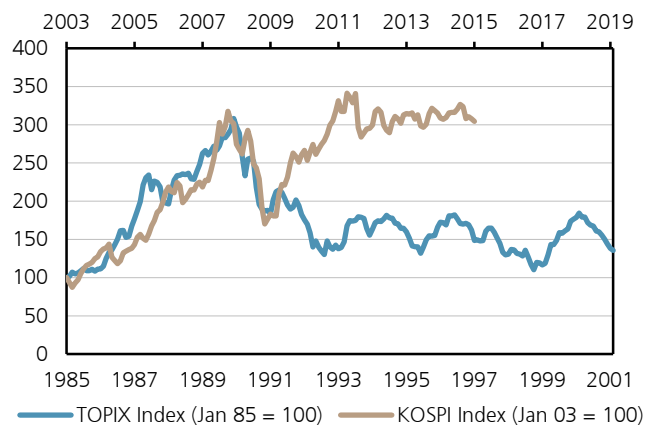
The KOSPI performed better in during 2008-14 compared to the TOPIX during 1990-96

Figure 50: Elastic recoveries during global recovery phase



Source: KITA

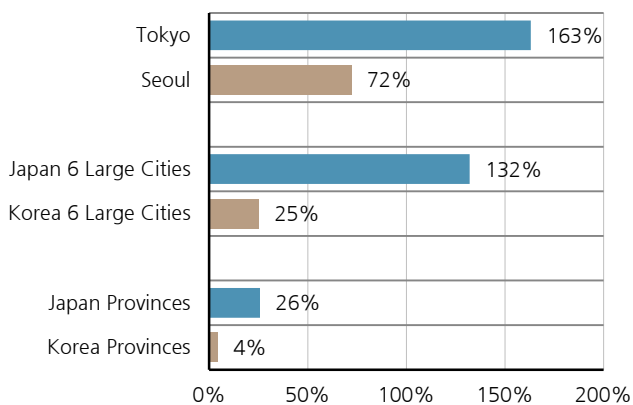
Figure 51: KOSPI vs. TOPIX



Source: Bloomberg

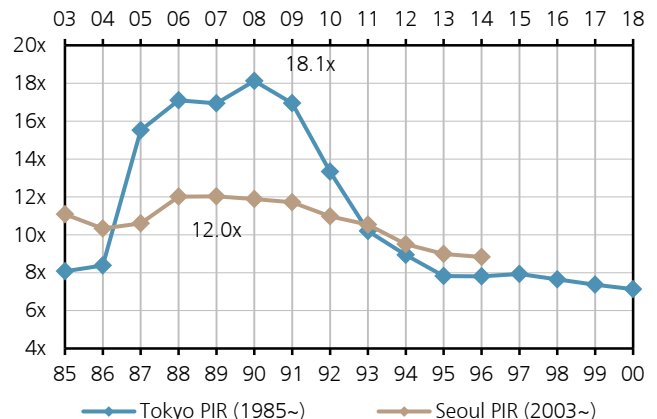
- **The size of the bubble was smaller in Korea.** 1) Korea's property bubble was largely limited to Seoul (prices up 72%) and to a smaller extent compared with Tokyo (up 163%). Other regions in Korea were largely unaffected by the bubble. 2) The price-to-income (PIR) ratio in Tokyo and Seoul was measured at 18x during the peak in Tokyo and 12x in Seoul. 3) Property value/GDP rose to 6.6x from an average 4.3x before the bubble formation (up 54%) in Japan; while in Korea it was 5.6x from an average 4.3x in 2001-02 (up 30%).

Figure 52: Appreciation during the bubbles



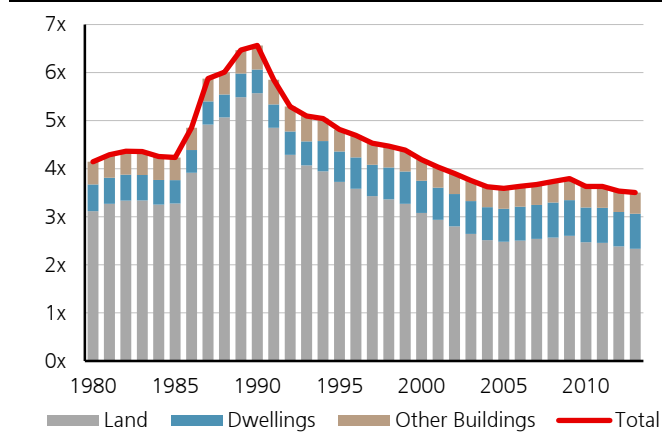
Source: Kookmin Bank, MOLIT (Japan), Real Estate Institute, UBS

Figure 53: Property price-to-income: Tokyo vs. Seoul



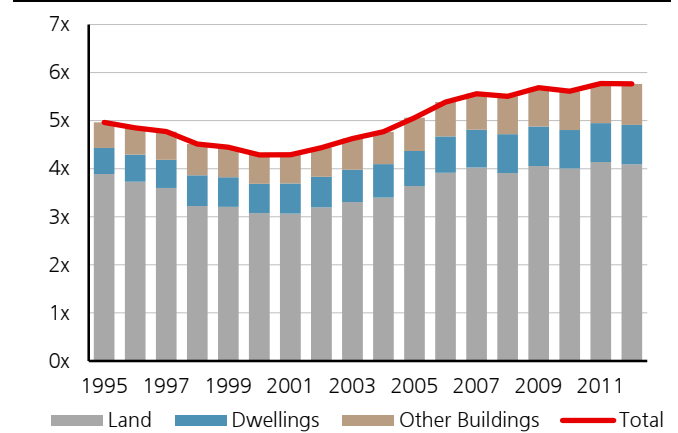
Source: Tokyo Kantai, Kookmin Bank, UBS estimates

Figure 54: Japan property value vs. GDP



Source: ESRI Japan

Figure 55: Korea property value vs. GDP

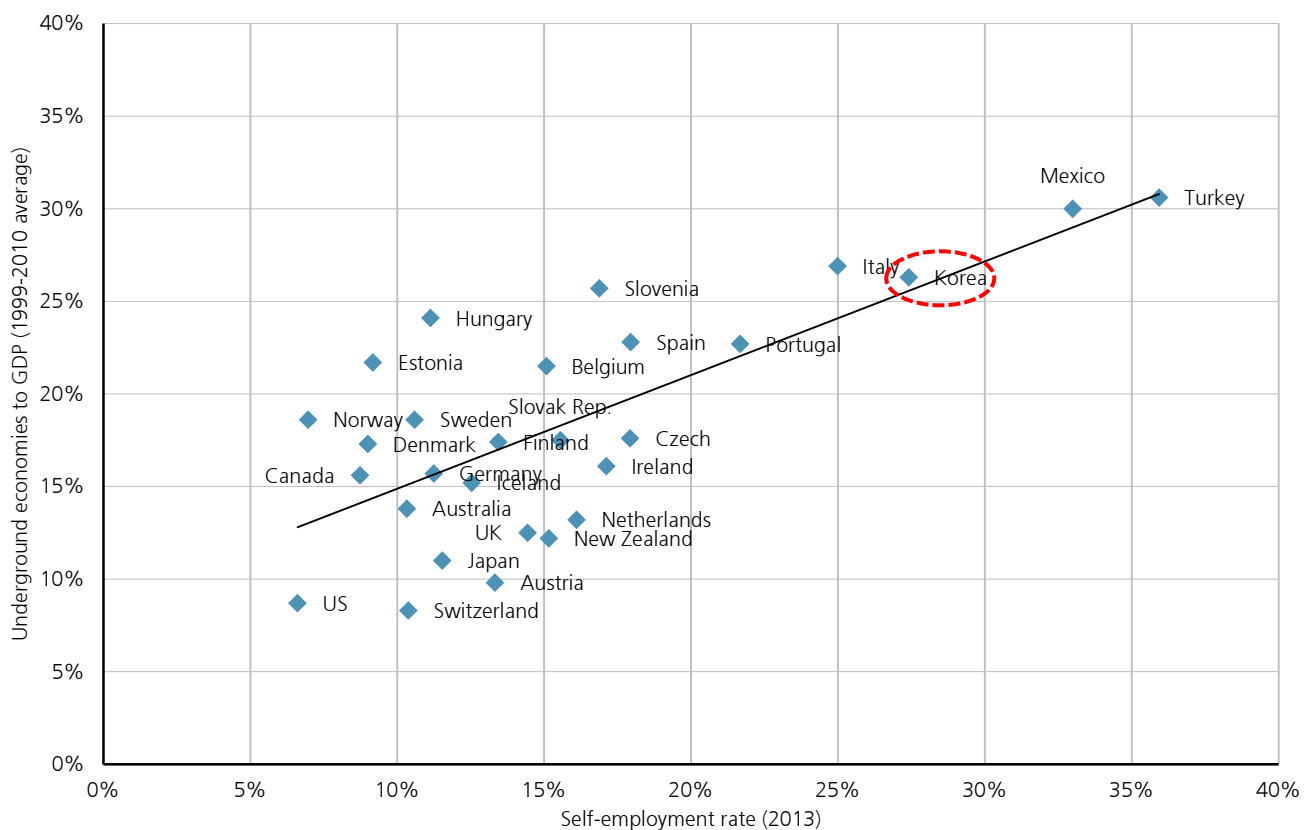


Source: KOSIS

Difference in leverage. During the bubble, Japanese banks allowed a loose LTV of 110-120%, while it was capped at 50% in Korea, implying relatively higher quality collateral value and relatively lower NPL risk. In addition, Korea had a DTI regulation in addition to the LTV, which limited excessive leverage compared to income levels.

Underground economy. Korea's underground economy is estimated to be one of the largest among developed economies (26% of GDP vs. 11% in Japan), and may be due to the high proportion of SME and self-employed businesses. While difficult to quantify, the large underground economy is one factor that should be considered when assessing Korea's property and household debt issues.

Figure 56: Self-employment rate and underground economy



Source: OECD, Friedrich Schneider et al., *Shadow Economies in Highly Developed OECD Countries: What are the Driving Forces?*

Michael Porter's, *Can Japan Compete?* revisited: can Korea banks compete?

In 2000 Michael Porter and his colleagues, Hirotaka Takeuchi and Mariko Sakakibara, argued in their book, *Can Japan Compete?* that Japan's decade-long depression during the 1990s was attributable more to microeconomic factors such as eroding competitiveness and inefficient business structures rather than the typical focus on macroeconomic factors such as the property bubble, currency, or demographics. We note that the key causes of Japan's difficulties that Porter pointed out 15 years ago appear comparable to the Korean economy now. We focus on three factors that will likely have implications for Korea banks.

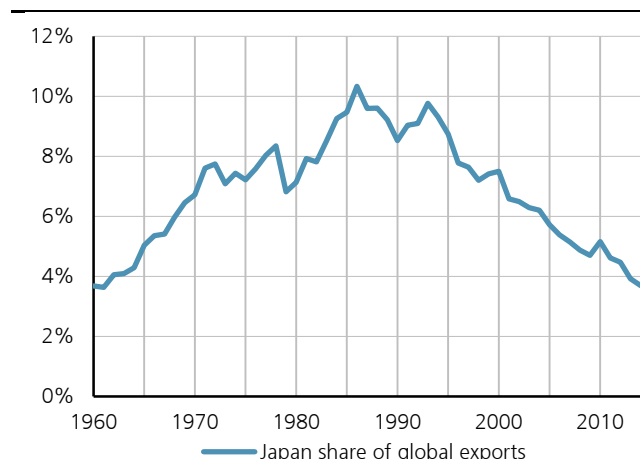
The key causes of Japan's difficulties appear comparable to the Korean economy now

1) Eroding competitiveness

Japan's global export market share peaked in the mid-1980s and has decreased ever since. While the weakness is typically explained by the appreciation of the Yen (driven by the Plaza Agreement in 1985), Porter points out that Japan experienced a gradual erosion of overall competitiveness in multiple sectors. This was driven by competitors adopting Japan's productivity enhancement measures. As a result, market shares declined for 87% of Japanese products in 1996 compared with the peak before 1990.

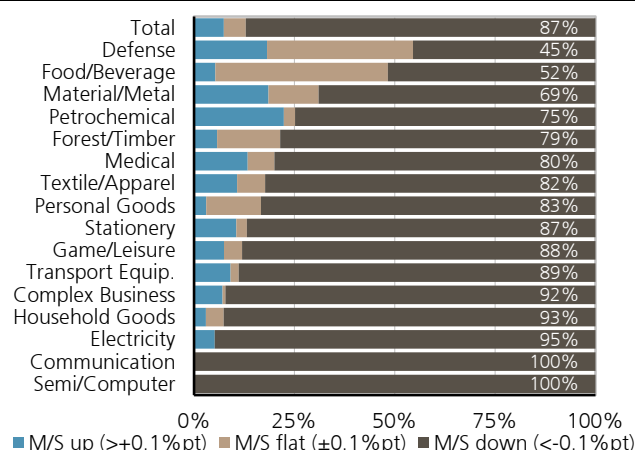
Japan's global export market share peaked in the mid-1980s

Figure 57: Japan's global export market share



Source: KITA

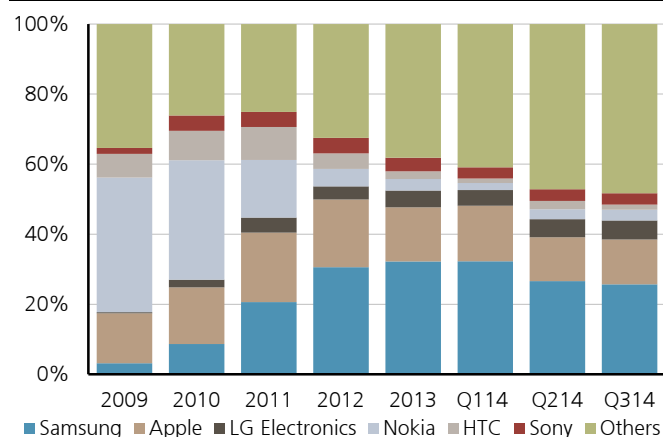
Figure 58: Market share declined for 87% of Japanese products in 1996 compared to the peak before 1990



Source: KITA

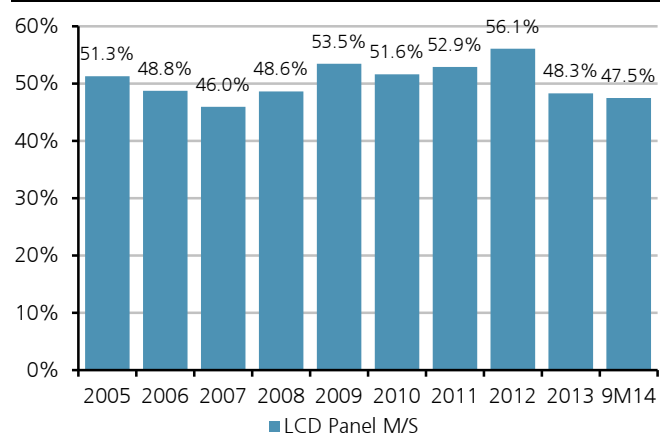
Early signs of similar trends taking place in Korea are noted by UBS Korea Strategist, Young Chang, in his report, *Korea Strategy: Korea's competitiveness is fading—what to do?* The global competitiveness of key leading industries appears to be fading, as evidenced by: 1) market share losses (smartphones, shipbuilding, autos, LCD); or 2) the gap in operating margin narrowing versus competitors (memory, autos).

Figure 59: Smartphone global market share



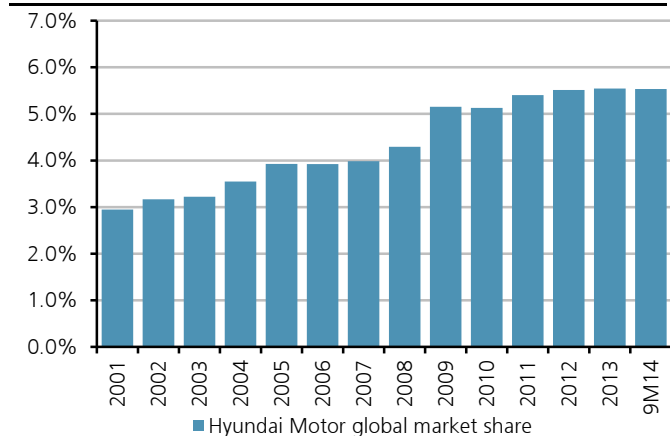
Source: Company data, UBS

Figure 60: LCD global market share



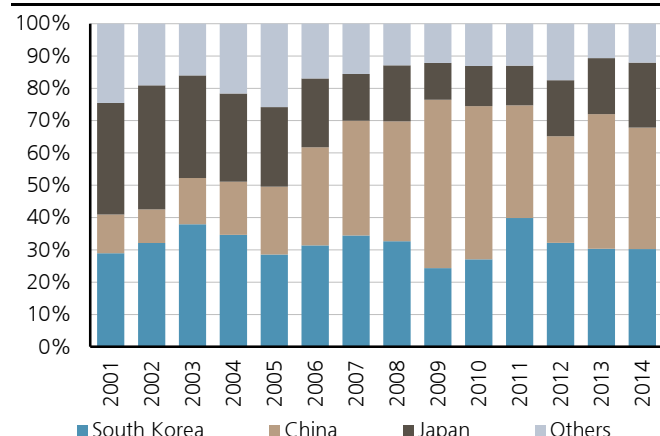
Source: Display Search, UBS

Figure 61: Hyundai Motor global market share



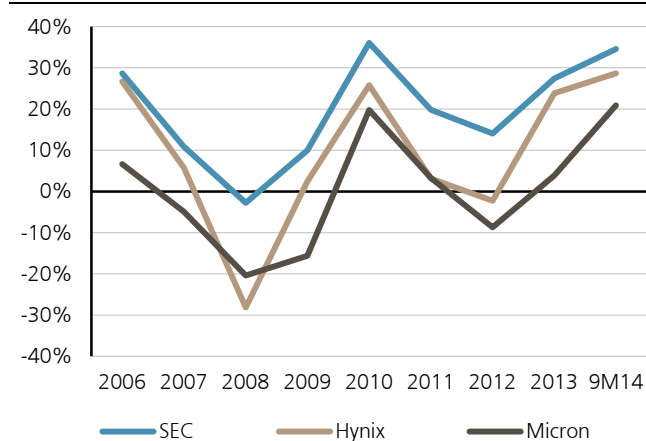
Source: Global Insight

Figure 62: Shipbuilding global market share



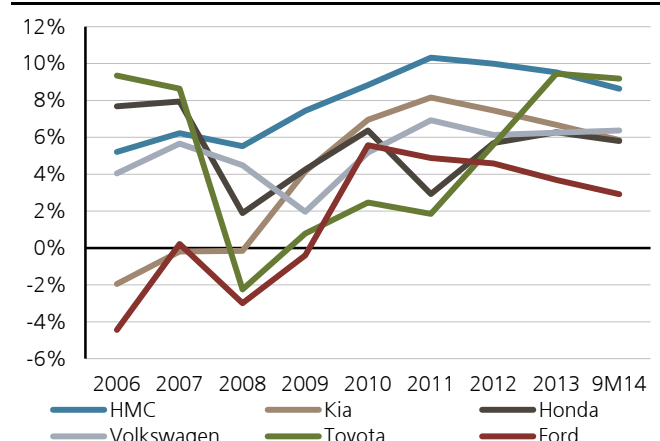
Source: Clarkson Research

Figure 63: Memory operating margin



Source: Company data, Bloomberg

Figure 64: Autos' operating margin



Source: Company data, Bloomberg

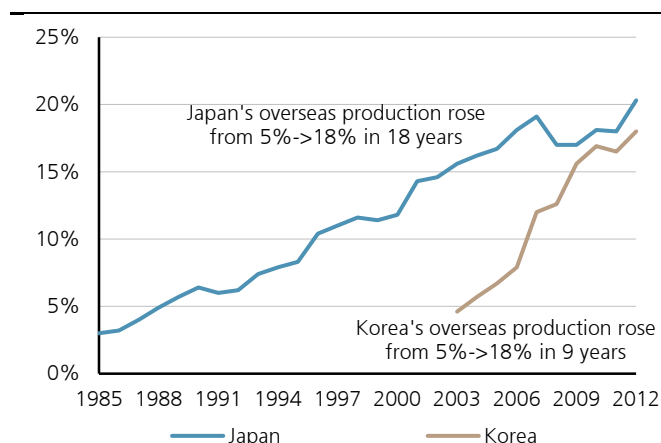
We also believe Korea's overall business environment adds to the burden of weakening competitiveness. For instance, an inflexible labour market (therefore difficult to restructure), strong unions and an aging workforce make it difficult to maintain competitiveness, especially in commodities and low-end products. These burdens eventually drive a rise in overseas production, which is increasing at a rate twice as fast as Japan. As a result Korea's global export market share started to moderately decline in 2010.

Figure 65: Korea's global export market share



Source: KITA, UBS

Figure 66: The proportion of overseas production is increasing twice as fast in Korea vs. Japan



Source: METI, KLSI, Seoul Finance, UBS

From a banking sector perspective, eroding competitiveness and rising overseas production of the corporate sector should be negative on growth as well as asset quality for both corporates and households (as employment will be limited at any case).

2) The two faces of Japan: the failure of the Japanese government model

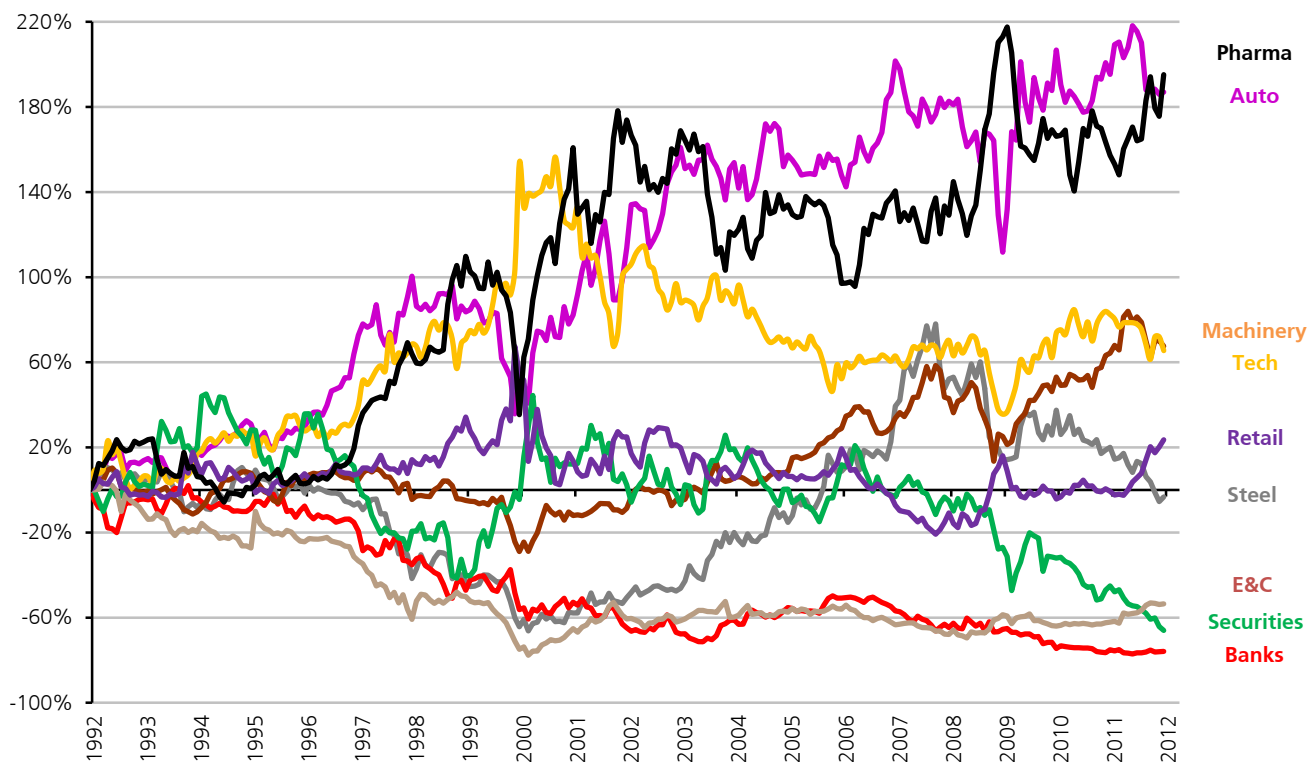
Another Japanese trend that Porter highlighted is the sharp contrast between globally competitive industries and extremely uncompetitive industries. Ironically, most of the industries in Japan that were protected from competition and nurtured by the government eventually failed to obtain global competitiveness and remained unproductive. These industries included chemicals, software and finance, including banks.

On the other hand, the most competitive companies came from industries that were exposed to open competition, notably automobiles that gained global competitiveness from the late 1990s. The historical share price performance in Japan shows that banks underperformed the market-and heavily underperformed leading sectors (pharmaceutical and autos).

In the case of Korea, we believe banks are protected and isolated from competition through high entry barriers with heavy restrictions on non-banks. particularly the *chaebol*, operating banks. However, we believe this environment contributed to Korean banks' heavily discounted valuations and ROE, as the high political and regulatory influence harmed profitability via intervention in lending rates and fees.

Most competitive companies came from industries that were exposed to open competition

Figure 67: Japan sector performance relative to TOPIX (1992-2012)

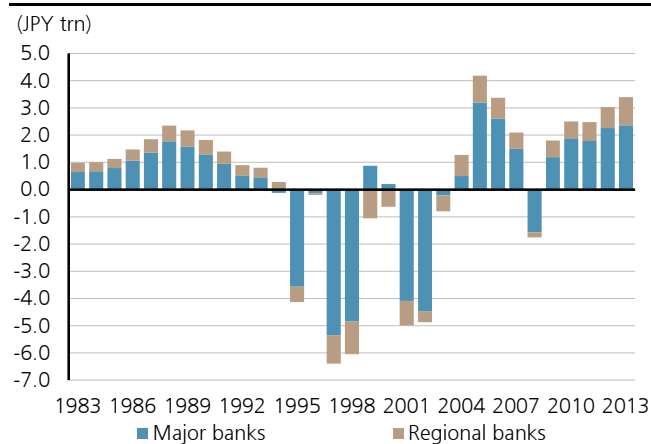


Source: Bloomberg, UBS

3) Lack of restructuring

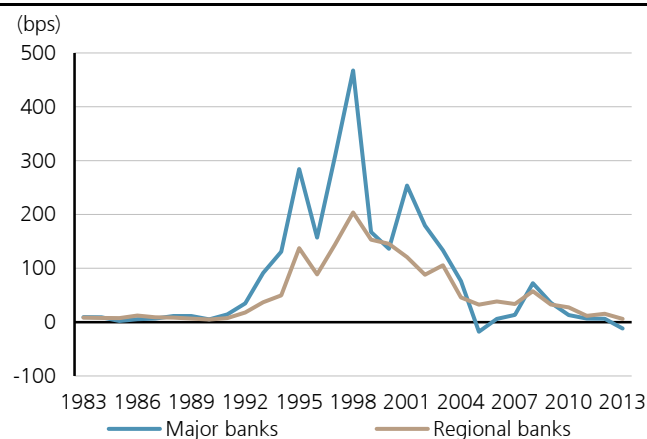
In Japan, the restructuring of uncompetitive companies has been delayed due to the forbearance of the banks and regulators. This led to a significant increase in zombie companies, which caused a prolonged period of economic depression and eventually an NPL clean-up during 1993-2004.

Figure 68: Japan banks' net earnings trends



Source: Bank of Japan, UBS

Figure 69: Japan banks' credit cost trends



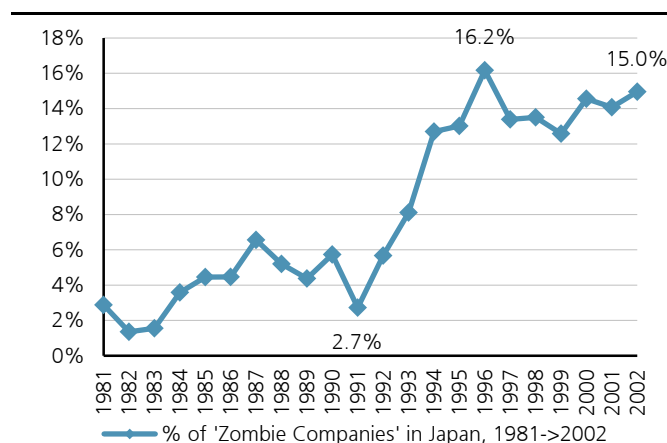
Source: Bank of Japan, UBS

In Korea, we note similar trends with: 1) the percentage of zombie companies reaching levels close to Japan's (15.6% in 2013 for Korea versus 16.2% in 1996 for Japan); 2) the proportion of companies with less than 1x interest coverage sustained at above 2008-09 crisis levels; and 3) the number of companies applying for debt workouts decreasing despite the factors mentioned above. The above factors combined with several examples of large corporate restructuring in Korea (where banks had to extend loans to unprofitable companies under the creditor bank group system) lead us to assume it is sensible to factor in conservative credit cost assumptions for Korea banks, despite the fact that falling rates are generally positive for credit costs.

Our base-case estimates for the sector assume credit costs rise from 59bp in 2014 to 60-65bp in 2015-17, assuming moderately higher restructuring; our bear-case scenario assumes credit costs to average 75bp in 2015-17E, close to the 2011-13 level of 77bp but lower than the 2008-10 level of 108bp.

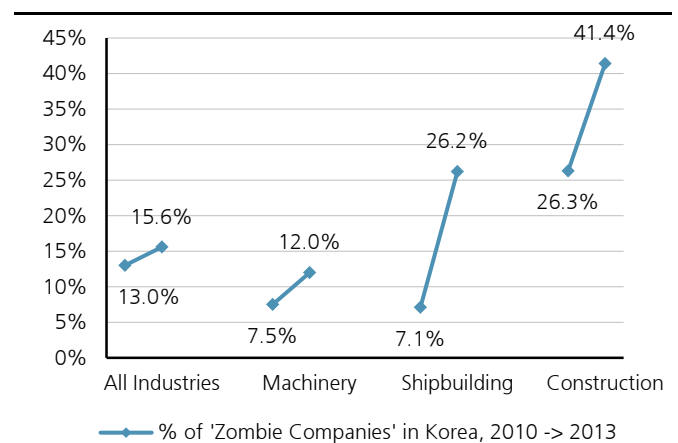
Our base-case estimates for the sector assume credit costs rise from 59bp in 2014 to 60-65bp in 2015-17

Figure 70: Zombie companies in Japan



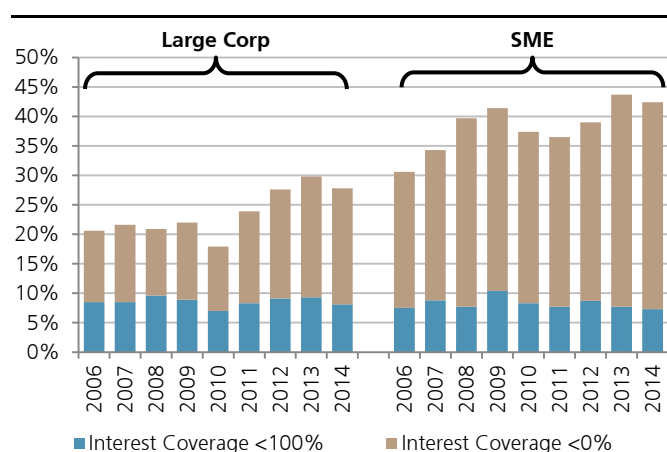
Source: Caballero et al., *Zombie Lending and Depressed Restructuring in Japan*

Figure 71: Zombie companies in Korea



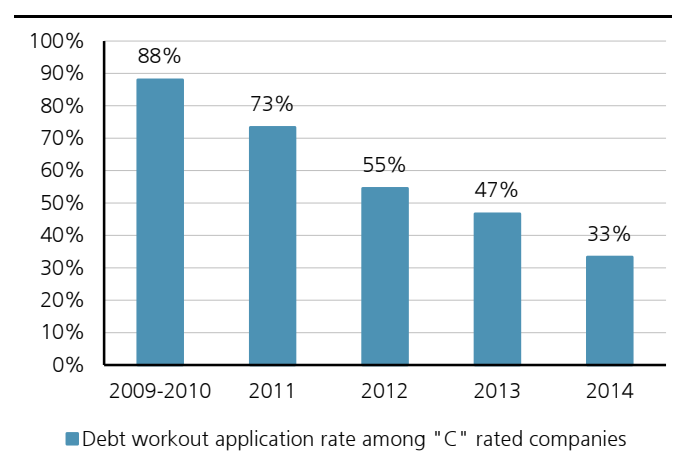
Source: Korea Development Institute, *Maekyung*

Figure 72: Companies with <100% interest coverage above crisis levels



Source: Bank of Korea, UBS

Figure 73: Restructuring delays in Korea



Note: Corporates with high insolvency risk are "C" rated under an annual corporate risk assessment by the FSS. Source: FSS, *Hankook Ilbo*, UBS

Japan's long depression is at least a possible scenario for Korea banks

Considering the factors mentioned above, we conclude that Japan's long depression is at least a possible scenario for Korea banks, albeit at a smaller magnitude considering the differences (eg, a smaller property bubble, more of an export-led economy and stricter LTV) between the two economies.

We note that we are at the negative end of market consensus, and that changes could reverse the trend that we envisage. However, we believe that change should not depend only on better macro assumptions, but also structural reforms that would enable the Korean economy and Korea banks to improve competitiveness while breaking through the barriers capping fundamental upside.

We believe Korea banks should actively undertake significant changes in business to improve competitiveness, for example: 1) the adequate pricing of loans and fees under the law of competition instead of regulatory and public pressure; 2) pursuit of new business opportunities cross-border and cross-sector; 3) restructuring of zombie companies without delay; and 4) flexible cost management in a changing business environment.

We believe Korea banks should actively undertake significant changes in business to improve competitiveness

Lessons from Japan

We believe the history of Japan's overall stock market and financial sector performance in the 1990s have three implications for Korea's bank sector.

Rebounds did not reverse the long downturn

Even during the long depression of the 1990s, Japanese banks underwent six major rebounds, which led to an average 47% appreciation over a 10-month period. These rebounds generally took place along with: 1) expansionary stimulus policies; 2) a (temporary) earnings recovery on lower credit costs; and 3) improving global/Japan GDP growth.

Figure 74: During the recovery phase, Japan banks appreciated 47% on average and outperformed the Topix

Start	End	Months	Bank performance	Topix performance	Bank outperformance	Stimulus	Earnings	GDP growth
Sep-90	May-91	9	44%	25%	19%	X	X	0
Jun-92	Aug-93	15	72%	37%	35%	0	X	X
Nov-93	May-94	7	19%	22%	-3%	0	X	0
Jun-95	Apr-96	11	33%	43%	-10%	0	0	0
Jan-97	Jun-97	6	21%	13%	8%	X	X	0
Sep-98	Oct-99	14	91%	50%	41%	0	0	0
Average		10	47%	32%	15%			

Source: Bloomberg, UBS

Figure 75: List of stimulus packages during 1990s

Stimulus Package	Announced Date	Size (Yen trn)
Comprehensive Economic Measures 1	Aug-92	10.7
Comprehensive Economic Measures 2	Apr-93	13.2
Emergency Economic Package	Sep-93	6.2
New Comprehensive Economic Measures	Feb-94	15.3
Comprehensive Emergency Economic Measures in Response to the Yen's Appreciation	Apr-95	7.3
The Present Economic Measure	Sep-95	14.2
Supplementary Budget	Feb-98	4.5
Comprehensive Economic Measures	Apr-98	16.0
Emergency Economic Package	Nov-98	17.0
Economic Measure to the New Life	Nov-99	17.0
New Development Plans for Japan's Rebirth	Oct-00	10.0
Total		131.4

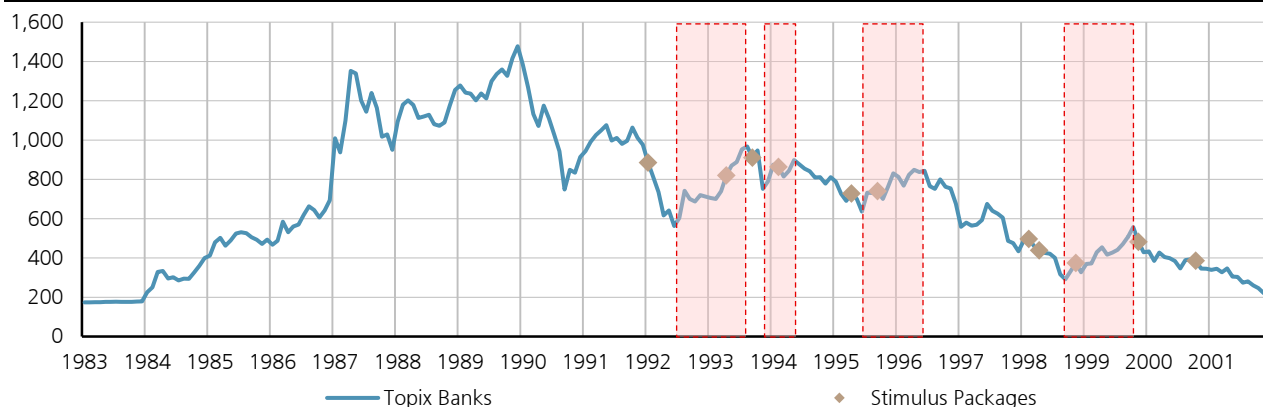
Source: Donga.com

However, looking at the longer term trends, such rebounds were temporary and eventually did not reverse the long depression. In particular:

- Japan's GDP growth temporarily recovered during 1995-97 reflecting the effect of stimulus packages; however, during that time banks underperformed the Topix as they had started recognising losses from NPLs since 1995 (as a result of delayed corporate restructuring), resulting in negative earnings for the sector until 1998.

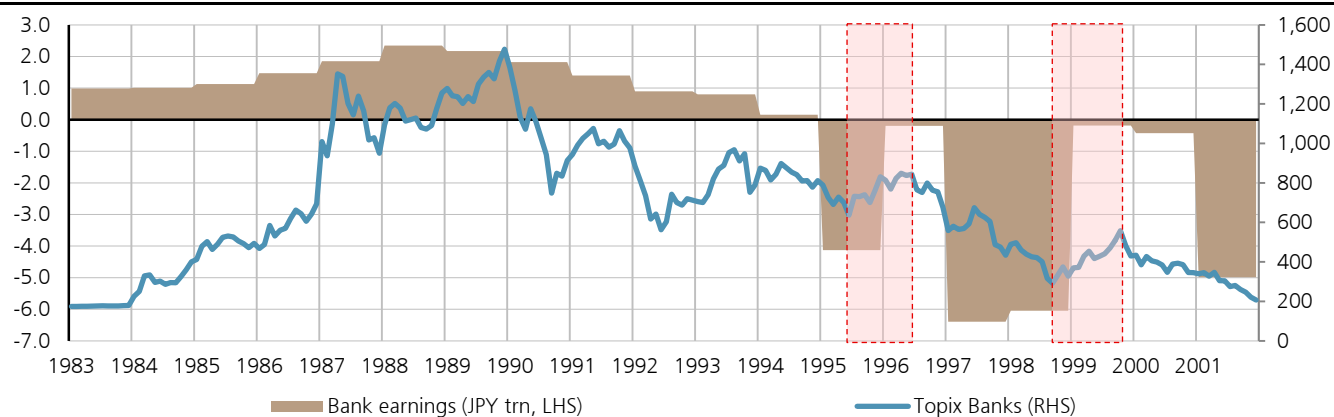
- The GDP growth quickly turned negative in 1998, as the Japanese government implemented tightening measures in 1997 to alleviate increased budget burdens from the stimulus packages. The key measures included: 1) a consumption tax hike (3% to 5%); and 2) an increase in the co-payment ratio for national health insurance from 10% to 20%. These measures had a significant impact on private consumption, a primary constituent of Japan's GDP.

Figure 76: Topix banks vs. stimulus packages



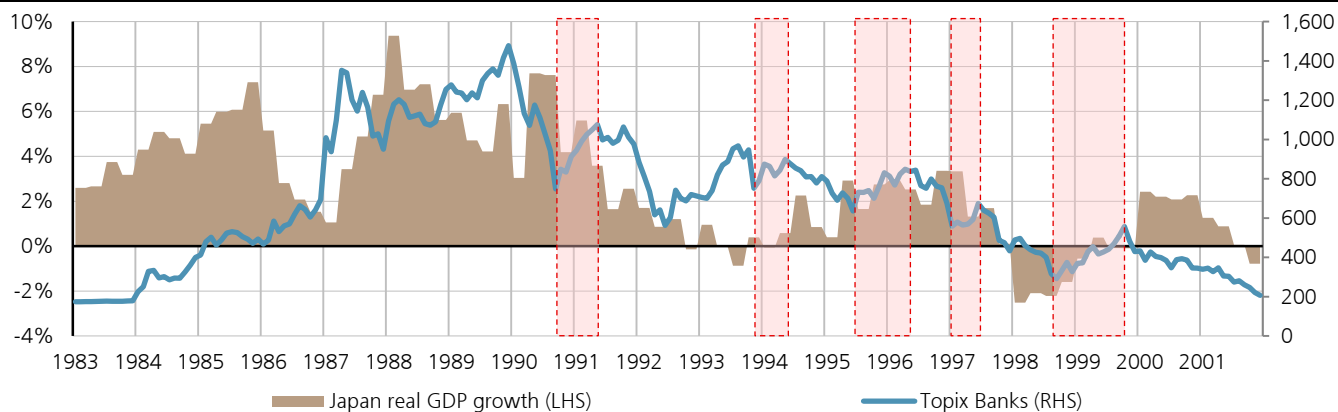
Source: Bloomberg, UBS

Figure 77: Topix banks vs. bank sector earnings



Source: Bank of Japan, Bloomberg, UBS

Figure 78: Topix banks vs. Japan real GDP growth



Source: CEIC, Bloomberg, UBS

In the case of Korea, we believe the primary determinant of the rebound was an improvement in external economies combined with low valuations, reflecting Korea's export-led economic structure. During global recoveries, Korea banks tend to outperform the KOSPI and global banks. However, we note that the outperformances were less significant during recent recoveries (2010-11 and 2012-14), which we attribute to structurally weaker banking and economic fundamentals. At the stock level, high-beta (Woori) and small-cap (DGB and BS) banks have outperformed larger peers (Shinhan and KB) during the historical recovery cycles; but we note that during recent recoveries, the tendency is fading with dividend stocks (Shinhan and IBK) outperforming peers, again reflecting structural changes.

During global recoveries, Korea banks tend to outperform the KOSPI and global banks

Figure 79: Bank sector performance during global recoveries

Start	End	Months	KRX Banks	KOSPI Index	MSCI World Banks	MSCI EU Banks	DJ US Banks	MSCI EM Banks
Oct-01	May-02	8	81%	48%	17%	12%	22%	32%
Jan-03	May-07	53	193%	187%	111%	105%	57%	280%
Feb-09	Sep-09	8	121%	57%	105%	113%	103%	117%
Jun-10	Feb-11	9	9%	14%	25%	12%	17%	19%
May-12	Aug-14	28	23%	12%	56%	69%	67%	22%
Average		21	85%	64%	63%	62%	53%	94%

Source: Bloomberg, UBS

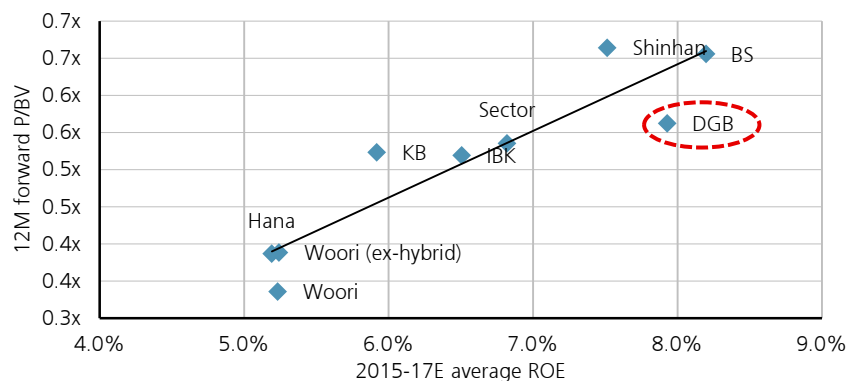
Figure 80: Stock performance during global recoveries

Start	End	Months	KRX Banks	DGB	Woori	BS	IBK	Shinhan	KB	Hana
Oct-01	May-02	8	81%	206%	N/A	92%	80%	63%	97%	N/A
Jan-03	May-07	53	193%	263%	375%	241%	261%	337%	110%	N/A
Feb-09	Sep-09	8	121%	189%	154%	153%	143%	102%	110%	119%
Jun-10	Feb-11	9	9%	9%	-7%	22%	17%	3%	16%	37%
May-12	Aug-14	28	23%	21%	23%	45%	47%	38%	13%	14%
Average		21	85%	138%	136%	111%	109%	109%	69%	57%

Source: Bloomberg, UBS

Among the stocks under coverage, we have upgraded DGB to Buy as we believe recent weakness presents an attractive buying opportunity. After DGB unexpectedly announced a dilutive capital raising in November 2014 to support growth of existing and new businesses (life insurance), the stock corrected by 23%, underperforming the sector by 9%. As a result, DGB is the most inexpensively valued bank relative to ROE.

Figure 81: DGB is the most inexpensive bank in Korea relative to ROE



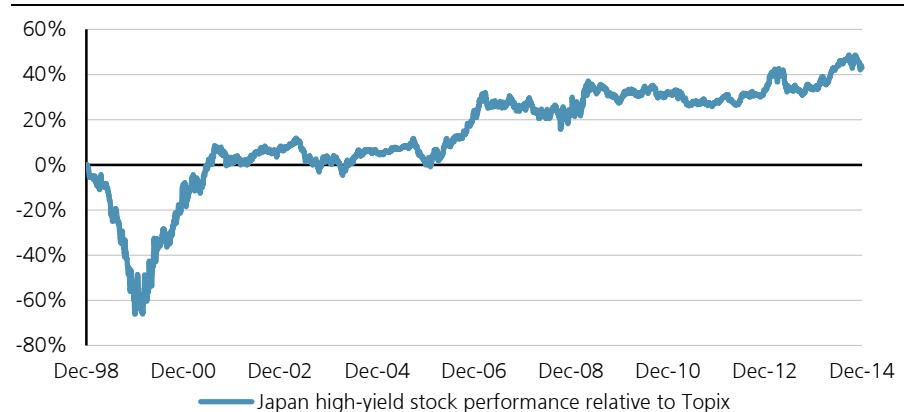
Source: UBS estimates

While question marks remain about management transparency which has weighed on valuation, we believe the share price correction was excessive even after factoring in the dilution and our cautious outlook for the sector (our earnings estimates for DGB are 1%/9%/8% lower than consensus in 2015/2016/2017).

Dividends

Due to their relative attractiveness in a low rate environment, high-yield stocks have been outperformers in Japan, as noted by UBS Japan Strategist Tomohiro Okawa and Korea Strategist Young Chang (for more detail, please see Young Chang's 16 January 2015 report, *Korea Strategy: Korea's competitiveness is fading—what to do?*).

Figure 82: Japan high-yield stock performance relative to Topix



Source: Bloomberg, UBS

For banks we continue to believe that better shareholder returns would become a key differentiating factor among stocks, as highlighted in our 16 June 2014 report, *Korea Banks—Finding Value in Yield*. Among the stocks under coverage, we believe KB and Shinhan qualify as yield stocks. Our view is premised on two factors:

1) Sufficient capital. Based on our capital ratio estimate that reflects recent capital events (the Woori Bank-Woori FG merger), DGB's capital raising and BS's acquisition of Kyeongnam Bank), KB and Shinhan's capital ratios (in particular, common equity Tier 1) are stronger than peers. The gap widens further if we consider the Basel III full phase-in up to 2019: taking out the hybrid capital (currently partly qualified as additional Tier-1 capital) and subordinate bonds (currently partly qualified as Tier-2 capital), KB and Shinhan's total BIS ratio would stay at 14% and 12%, respectively, while other banks may be more affected due to their high reliance on these instruments to maintain capital levels. We believe weak capitalised banks would have limited room to increase dividends to avoid choosing expensive funding options (Basel III-compliant contingent capital, etc).

Better shareholder returns should become a key differentiating factor among stocks

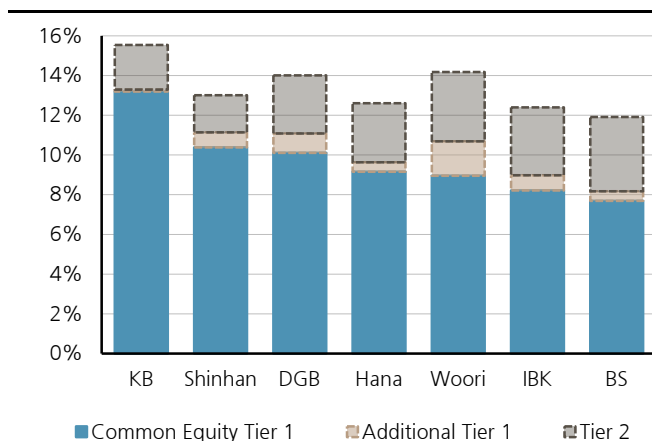
Figure 83: Estimate of Basel III full phase-in BIS capital ratios, excluding "disqualified" hybrid capital and subordinate bonds

		Common Equity Tier 1			Tier 1			Total BIS Ratio		
		Basel III full			Basel III full			Basel III full		
		Current	phase-in	Change	Current	phase-in	Change	Current	phase-in	Change
KB	Group	13.19%	13.19%	0.00%	13.29%	13.29%	0.00%	15.54%	13.94%	-1.60%
	Kookmin Bank	13.36%	13.36%	0.00%	13.36%	13.36%	0.00%	15.95%	13.97%	-1.99%
Shinhan	Group	10.38%	10.38%	0.00%	11.13%	10.58%	-0.55%	13.01%	11.49%	-1.52%
	Shinhan Bank	12.54%	12.54%	0.00%	13.35%	12.54%	-0.81%	15.45%	13.23%	-2.23%
Hana	Group	9.15%	9.15%	0.00%	9.63%	9.54%	-0.10%	12.61%	10.77%	-1.84%
	Hana Bank	11.21%	11.21%	0.00%	11.12%	11.37%	0.25%	14.46%	12.30%	-2.16%
	KEB	11.44%	11.44%	0.00%	11.72%	11.46%	-0.26%	14.40%	12.79%	-1.61%
Woori	Bank	8.95%	8.95%	0.00%	10.69%	9.40%	-1.28%	14.18%	10.45%	-3.73%
IBK	Bank	8.21%	8.55%	0.34%	8.98%	8.55%	-0.42%	12.40%	9.84%	-2.56%
DGB	Group	10.11%	10.11%	0.00%	11.08%	10.11%	-0.97%	14.01%	11.09%	-2.91%
	Daegu Bank	9.47%	9.47%	0.00%	10.50%	9.47%	-1.03%	13.57%	10.55%	-3.02%
BS	Group	7.69%	7.69%	0.00%	8.17%	7.69%	-0.48%	11.91%	9.20%	-2.71%
	Busan Bank	9.38%	9.38%	0.00%	9.68%	9.37%	-0.30%	13.30%	10.80%	-2.50%
	Kyeongnam Bank	7.65%	7.65%	0.00%	8.59%	7.65%	-0.94%	12.74%	8.78%	-3.96%

Note: 1) All figures based on Q414 data; 2) disqualified capital based on Q314 data; 3) assuming Won490bn pref shares (disqualified post Basel III full phase in) to be converted into common equity for IBK; 4) DGB reflecting Won315bn/Won100bn capital raising for Group/Bank entities in Q115.

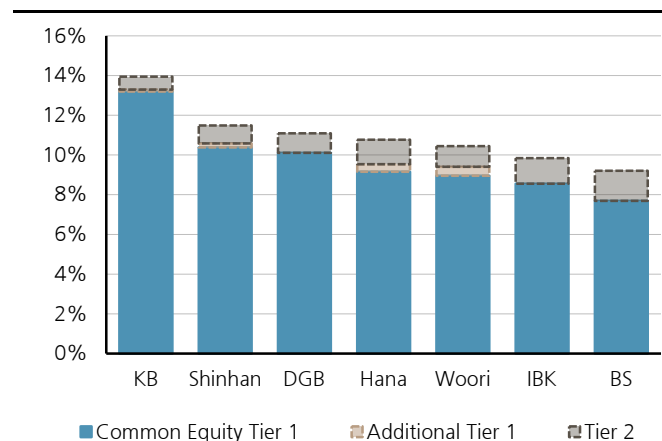
Source: Korea Federation of Banks, FISIS, UBS estimates

Figure 84: Capital ratio structure: current



Source: UBS estimates

Figure 85: Capital ratio structure excluding disqualifying hybrid/subordinate bonds

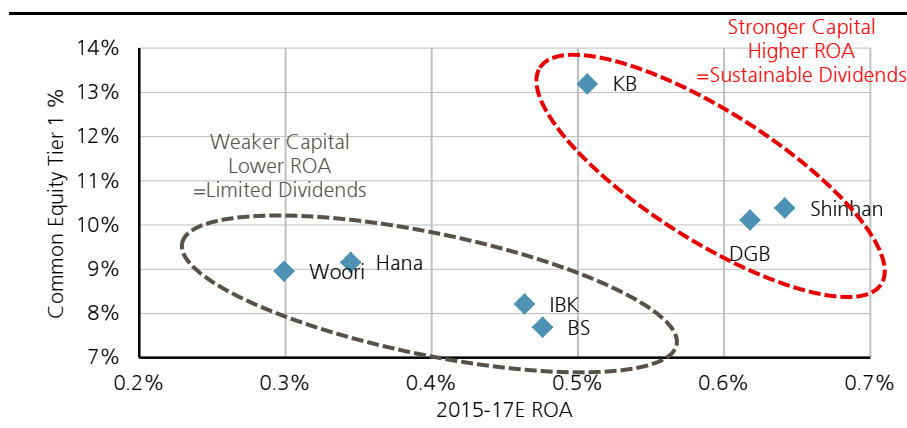


Source: UBS estimates

2) Profitability is another factor that determines dividend payout capabilities. On average, Korea banks generate 6% ROE, which is just enough to cover a 5% loan (= RWA) growth while maintaining the capital ratio. This implies that it is impossible to expect a sustainable payout ratio of above 20% unless banks decide to shrink their capital base (which is unlikely). We believe KB and Shinhan are different:

- Although KB's headline ROE is low at 6.0%, this is largely due to its lowest leverage. ie, excess capital among the sector. ROE could rise by utilising capital via acquisitions or dividends; we are also positive on the longer-term dividend potential as KB's ROA is relatively high in the sector.
- Shinhan has the highest ROE (7.5% in 2015-17E) among major banks while maintaining one of the most sufficient capital buffers. This is driven by a relatively higher ROA from its profit-driven strategies and a better business model (higher portion of credit cards). As a result, Shinhan is well-positioned to maintain a higher payout versus peers, in our view.

Figure 86: ROA vs. CET1 ratio

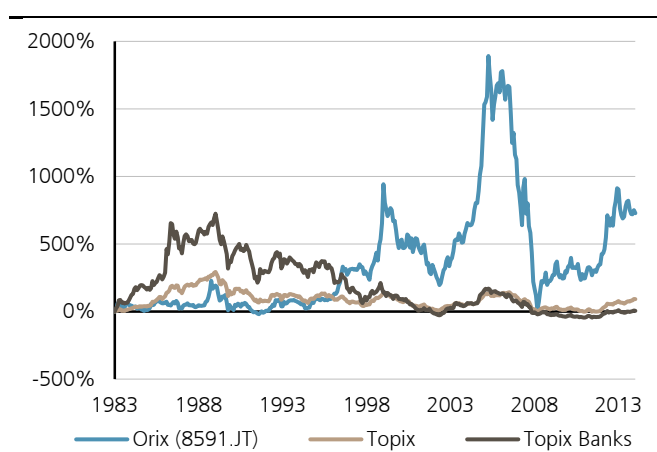


Source: UBS estimates

Who were the outliers? Orix and Suruga Bank

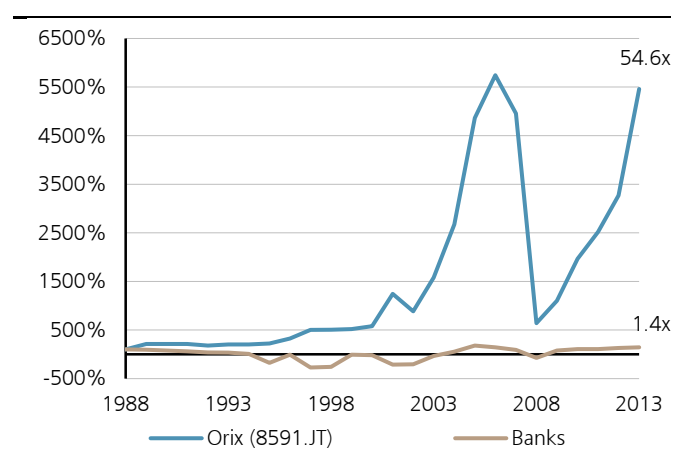
UBS Japan bank analyst, Shinichi Ina, notes that the most successful financial stock in Japan since 1990s was Orix (8591.J), a non-bank financial services firm that was established as a small leasing business and rapidly grew through a flexible business model while avoiding regulatory pressure by remaining as a non-bank. Over the past 30 years (1983-2014), Orix's share prices appreciated 728% versus 92% for the Topix and 5% for Topix Banks. Its earnings base also grew 55x since 1988, while banks' earnings rose only 1.4x after suffering from a long period of negative earnings in the late 1990s and early 2000s.

Figure 87: Orix vs. Topix price trends (Dec 1983 = 0)



Source: Bloomberg, UBS

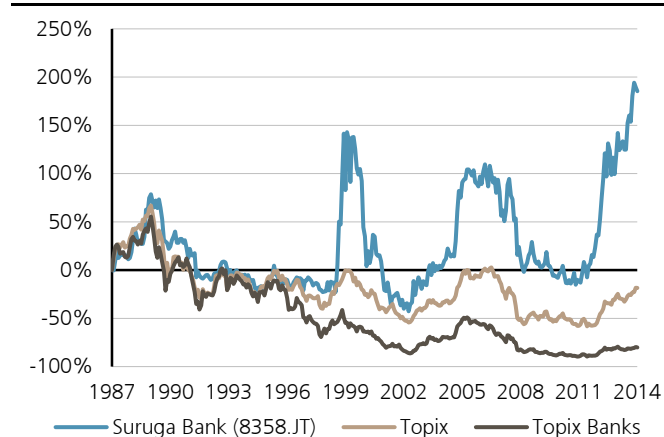
Figure 88: Orix vs. banks profit trends (1988 = 100%)



Source: Bloomberg, UBS

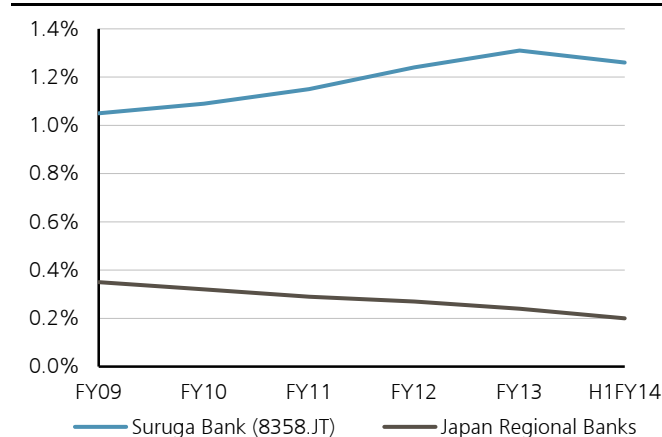
Among the pure banks, Suruga Bank (8358.J), a regional bank based in Shizuoka, has been an outlier through its unique positioning as a higher risk and higher return personal loan lender since 1987. Suruga Bank's ratio of personal loans increased from 13.4% in 1985 to 86.3% at 2014; and as a result, it maintained a better NIM structure that resulted in better share price performance compared to peers.

Figure 89: Suruga vs. Topix price trends (Dec 1987 = 0)



Source: Bloomberg, UBS

Figure 90: Suruga vs. regional bank NIM trends



Source: Company data, UBS

We think profitability-driven, niche and (preferably) non-bank models could be successful in Korea as well, as these models could avoid: 1) pricing pressure; and 2) the obligation to save zombie companies; which we believe have been key causes of Korea banks' eroding profitability.

A strong inflow of Asia region-based companies penetrating the Korean financial sector could be evidence of opportunities in Korea if backed by competitive strategies. The trend has been particularly evident for Japanese companies (J-Trust, APRO Service Group and Sanwa Money) that are now dominant in the low-tier consumer financing segment (Won10trn market size) and who have expanded their businesses by acquiring savings banks (Won37trn market size) and companies with abundant capital, accumulated experience and funding cost advantages. According to the FSS, Japanese companies' market share in consumer financing and savings bank segments reached 55.1% in Q213 and 14.4% in Q413, respectively.

In addition to the Japanese, China and Taiwan-based companies have increased participation in the Korean M&A market recently, eg, Yuanta FH's (Taiwan) acquisition of Tongyang Securities (the 16th-largest brokerage in Korea) in June 2014 and Anbang Insurance's (China) acquisition of Tongyang Life in February 2015. Fosun Group (China) has participated in multiple M&As including Hyundai Securities (the seventh-largest brokerage in Korea), KDB Life (12th largest life insurer) and LIG Insurance (four-largest non-life insurer).

Figure 91: Penetration of regional companies into Korea

Company	Country	Operations in Korea	Industry	Total Assets (Won bn)	Status	Note
Currently operating / acquired						
J-Trust	Japan	Chinae Savings Bank	Savings Bank	930	Under Operation	Jun-14
J-Trust	Japan	Neoline Credit	Consumer Financing	28	Under Operation	Sep-14
J-Trust	Japan	KJI Credit	Consumer Financing	256	Under Operation	Nov-13
J-Trust	Japan	Hi Capital	Consumer Financing	159	Under Operation	Dec-13
J-Trust	Japan	Standard Chartered Savings Bank	Savings Bank	358	Under Operation	Jun-14
APRO Service Group	Japan	Rush & Cash	Consumer Financing			
APRO Service Group	Japan	Miz Sarang	Consumer Financing	2,207	Under Operation	Sep-13
APRO Service Group	Japan	APRO Capital	Capital			
APRO Service Group	Japan	OK Savings Bank	Savings Bank	486	Under Operation	Jun-14
SBI Group	Japan	SBI Savings Bank	Savings Bank	3,839	Under Operation	Jun-14, Previously Hyundai-Swiss SB
Sanwa Money	Japan	Sanwa Money	Consumer Financing	1,208	Under Operation	Dec-13
Orix Group	Japan	OSB Savings Bank	Savings Bank	866	Under Operation	Jun-14, Pureun2 SB + Smile SB
Orix Group	Japan	Orix Capital Korea	Capital	1,009	Under Operation	Sep-14
Yuanta FH	Taiwan	Yuanta Securities	Brokerage	6,793	Under Operation	Sep-14, Previously Tongyang Sec.
Currently in process						
J-Trust	Japan	Standard Chartered Capital	Capital	1,165	Awaiting regulatory approval	Jun-14
Orix Group	Japan	Hyundai Securities	Brokerage	20,008	Selected as preferred bidder	Sep-14
Anbang Insurance	China	Tongyang Life	Life Insurance	20,374	Selected as preferred bidder	Dec-14
Previous attempts						
J-Trust	Japan	Aju Capital	Capital	6,429	Negotiation failed w/ seller	Sep-14
J-Trust	Japan	Aju Savings Bank	Savings Bank	701	Negotiation failed w/ seller	Jun-14
Fosun Group	China	KDB Life	Life Insurance	13,269	Abandoned bid	Sep-14
Fosun Group	China	LIG Insurance	Non-Life Insurance	23,281	Dropped off	Sep-14
Fosun Group	China	Hyundai Securities	Brokerage	20,008	Dropped off	Sep-14
Orix Group	Japan	KT Rental	Auto Rental	2,622	Dropped off	Sep-14
Anbang Insurance	China	Woori Bank	Bank	253,774	Abandoned bid	Sep-14

Source: DART, FISIS, Kookmin Ilbo, Seoul Economy, Donga Ilbo, Chosun Biz, NICE Investors Service, UBS

Company pages

KB Financial Group

Positive catalysts to bear fruit after a turbulent 2014

Operating momentum could materialise in 2015E

We expect KB Financial Group (KB) to have the best operating momentum in the sector in 2015, following an exceptionally difficult 2014 when several incidents (for example, credit card data leakage and the loan frauds at KT ENS and Moneual) and a management dispute weighed on investor sentiment and fundamentals (weaker credit card revenue, weaker low-cost deposit growth, and higher provisioning). We believe the issues have been largely resolved since the appointment of a new well-respected chairman in November 2014.

2015E catalysts

1) Acceleration of KB Card's volume growth from a low base in 2014 (due to market share loss after the credit card data leakage incident), which could partly offset the impact from lower interest rates. 2) An improvement in KB's cost-to-income, the result of baby-boomer attrition. 3) We estimate the potential acquisition of a 19.8% stake in LIG Insurance could initially add Won40-50bn equity-method income to KB annually from 2015; the acquisition of an additional stake at market price should be value-accretive, given LIG Insurance's above 10% ROE. 4) A potentially strong Q115 due to a Won466bn tax refund of which Won199bn would be reflected in the P&L.

Our study of Japan's Lost Decade suggests KB maybe positioned in Korea

As was the case in Japan after the 1990s, we believe stocks with sustainable dividends are likely to outperform in Korea. We believe Korea banks, on average, have difficulty in paying high dividends, given limited capital and low profitability; however, KB is an exception, considering its 13% common equity tier 1 capital against a 9% peer average.

Valuation: most preferred Buy, maintain price target

KB is trading at 0.5x 2015E P/BV and 8.7x 2015E PE. To reflect: 1) better sustainable NIM; and 2) SG&A improvement offset by 3) our moderately higher credit cost assumptions, we adjust 2015E/2016E/2017E EPS 2%/-4%/-1%. We base our price target on a 2015E target P/BV of 0.6x, which implies a 2015E target PE of 9.9x.

Equities

Korea
Banks, Ex-S&L

12-month rating **Buy**

12m price target **Won43,000**

Price **Won37,600**

RIC: 105560.KS **BBG:** 105560 KS

Trading data and key metrics

52-wk range	Won43,000-34,200
Market cap.	Won14,527bn/US\$13.4bn
Shares o/s	386m (ORD)
Free float	91%
Avg. daily volume ('000)	794
Avg. daily value (m)	Won29,702.0
Common s/h equity (12/15E)	Won27,558bn
P/BV (12/15E)	0.5x
Tier 1 ratio	13%

EPS (UBS, diluted) (Won)

	From	To	% ch	Cons.
12/15E	4,171	4,255	2.00	4,273
12/16E	4,377	4,220	-3.59	4,525
12/17E	4,563	4,525	-0.83	4,518

Junho Lee

Analyst

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Highlights (Wonbn)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Revenues	7,754	7,242	7,139	7,667	7,821	8,120	8,448	8,792
Profit before tax	2,356	1,815	1,901	2,190	2,173	2,328	2,506	2,729
Net earnings (local GAAP)	1,775	1,261	1,401	1,843	1,631	1,748	1,883	2,052
Net earnings (UBS)	1,775	1,261	1,401	1,644	1,631	1,748	1,883	2,052
Tier 1 ratio %	10.9	12.6	13.4	13.1	13.1	13.2	13.2	13.3
EPS (UBS, diluted) (Won)	4,592	3,262	3,625	4,255	4,220	4,525	4,874	5,311
Profitability/valuation	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
ROE (UBS) %	7.7	5.1	5.4	6.1	5.8	5.9	6.1	6.3
P/POP (diluted)	3.9	4.5	4.7	4.1	4.0	3.7	3.5	3.3
P/BV x	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.4
P/BV (UBS) x	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.4
P/E (UBS, diluted)	8.4	11.5	10.5	8.8	8.9	8.3	7.7	7.1
Net dividend yield %	1.6	1.3	2.0	2.3	2.2	2.4	2.6	2.8

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied. Valuations: based on an average share price that year, (E): based on a share price of Won37,600 on 02 Mar 2015 22:40 HKT

Investment Thesis

KB Financial Group

Investment case

We base our Buy rating for KB Financial Group (KB) on our expectations of better-than-peers operating momentum, an improvement in corporate governance with new well-respected senior management, and a low base in 2014 (the negative impact of the KT ENS, Moneual and management incidents). For 2015, we expect the company to: 1) regain credit card market share lost in 2014; 2) improve cost-to-income, the result of baby-boomer attrition; and 3) use excess capital for the potential acquisition of a stake in LIG Insurance—a top 5 non-life insurer in Korea. We believe KB will outperform its peers in the long term due to its sector-strongest CET1 ratio of 13% (vs. the 9% peer average) which allows for a sustainable dividend. As in the case of Japan since the 1990s, we believe sustainable dividends will also result in a valuation premium in Korea.

Upside scenario

Our base-case estimates for KB are premised on: 1) NIM being affected by a 25bp Bank of Korea (BOK) rate cut in 2015E, and 2) provisioning bottoming out, from 54bp in 2014 to 56-59bp in 2015-16E, and resulting in a 5.9% sustainable ROE assumption and a 0.59x target P/BV. In our upside scenario, we assume: 1) no BOK rate cut; 2) provisioning falls 5% in 2015-16E; and 3) loan growth increases 2% resulting in a 6.8% sustainable ROE assumption, a 0.77x 2015E target P/BV, and a Won55,000/share valuation.

Downside scenario

In our downside scenario, we assume Korea banks face a sharp increase in credit costs (instead of the moderate rise in our base case). We assume KB's provisioning yield reaches 20% in 2015-16E. This results in a sustainable ROE of 5.2% leading to a 0.44x 2015E target P/BV and a Won31,000/share downside scenario valuation.

Upcoming catalysts

Utilisation of KB's excess capital for dividends or for value-accretive M&A should be key catalysts, in our view. An improvement in KB's cost-to-income, the result of baby-boomer attrition, should be a positive catalyst. In the near term, the completion of the LIG Insurance acquisition should be positive.

12-month rating

Buy

12m price target

Won43,000

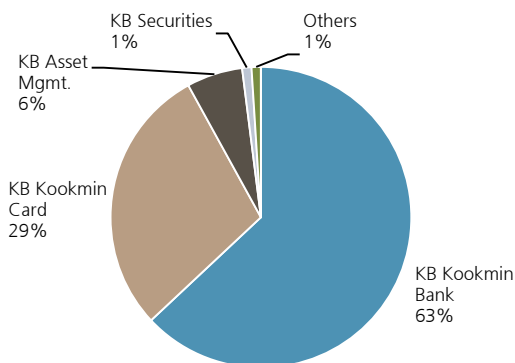
Business description

KB Financial Group is one of the largest financial groups in Korea with total assets of Won286trn as of 2013. Its key subsidiaries include KB Kookmin Bank (one of the largest retail banks with focus on household loans), KB Kookmin Card (credit card), KB Investment & Securities, KB Life Insurance, and KB Asset Management. As of 2013, National Pension Services was the largest shareholder with a 9.96% stake.

Industry outlook

We believe the macro conditions for Korean banks should improve moderately in the near term but are unlikely to be sustainable. Near-term improvements could be the result of a pick-up in corporate loans, driven by the unleashing of pent-up capex demand. However, increasing overseas production and foreign labour participation could weaken the correlation between the corporate and household sectors. This, in turn, could hamper the virtuous cycle of improving corporate activity that leads to higher employment, income, and consumption to drive the next corporate growth stage.

Earnings by subsidiary (2013)



Source: Company data

KB Financial Group (105560.KS)

	12/12	12/13	12/14	12/15E	% ch	12/16E	% ch	12/17E	12/18E	12/19E
Profit & Loss (Wonbn)										
Net income interest	8,543	7,929	7,825	8,201	4.8	8,413	2.6	8,802	9,226	9,672
Total non interest income	(789)	(687)	(685)	(534)	22.1	(592)	-10.9	(682)	(778)	(880)
Total income	7,754	7,242	7,139	7,667	7.4	7,821	2.0	8,120	8,448	8,792
Total cash expenses	(3,885)	(3,984)	(4,010)	(4,127)	-2.9	(4,151)	-0.6	(4,184)	(4,253)	(4,380)
Pre-depreciation operating profit	3,869	3,259	3,129	3,540	13.1	3,670	3.7	3,936	4,196	4,412
Depreciation & amort (excl. goodwill)	0	0	0	0	-	0	-	0	0	0
Operating profit pre provisions	3,869	3,259	3,129	3,540	13.1	3,670	3.7	3,936	4,196	4,412
Total provisions	(1,513)	(1,444)	(1,228)	(1,350)	-9.9	(1,497)	-11.0	(1,608)	(1,690)	(1,683)
Operating profit post provisions	2,356	1,815	1,901	2,190	15.2	2,173	-0.8	2,328	2,506	2,729
Income from associates & JVs (pre-tax)	0	0	0	0	-	0	-	0	0	0
Other pre-tax items	0	0	0	0	-	0	-	0	0	0
Profit before tax (UBS)	2,356	1,815	1,901	2,190	15.2	2,173	-0.8	2,328	2,506	2,729
Exceptionals (incl goodwill)	0	0	0	0	-	0	-	0	0	0
Profit before tax	2,356	1,815	1,901	2,190	15.2	2,173	-0.8	2,328	2,506	2,729
Tax	(572)	(552)	(486)	(530)	-9.0	(526)	0.8	(563)	(606)	(660)
Profit after tax	1,784	1,264	1,415	1,660	17.3	1,647	-0.8	1,765	1,899	2,068
Other post-tax items	0	0	0	199	-	0	-	0	0	0
Preference dividends	0	0	0	0	-	0	-	0	0	0
Minorities	(9)	(3)	(14)	(16)	-12.4	(16)	0.0	(16)	(16)	(16)
Net earnings (local GAAP)	1,775	1,261	1,401	1,843	31.6	1,631	-11.5	1,748	1,883	2,052
Net earnings (before pref divs)	1,775	1,261	1,401	1,843	31.6	1,631	-11.5	1,748	1,883	2,052
Net earnings (UBS)	1,775	1,261	1,401	1,644	17.4	1,631	-0.8	1,748	1,883	2,052
Per share (Won)										
EPS (local GAAP, basic)	4,592	3,262	3,625	4,770	31.6	4,220	-11.5	4,525	4,874	5,311
EPS (UBS, diluted)	4,592	3,262	3,625	4,255	17.4	4,220	-0.8	4,525	4,874	5,311
PPOP (diluted)	10,013	8,433	8,098	9,161	13.1	9,498	3.7	10,185	10,858	11,417
Net DPS	600	500	780	851	9.1	844	-0.8	905	975	1,062
BVPS	62,071	64,845	69,147	71,329	3.2	74,698	4.7	78,380	82,350	86,686
BVPS (UBS)	60,777	63,698	67,882	70,002	3.1	73,311	4.7	76,928	80,830	85,096
Balance sheet (Wonbn)										
Banking assets (year end)	282,101	291,838	308,356	323,196	4.8	338,101	4.6	353,751	370,185	387,451
Banking assets (average)	279,851	286,969	300,097	315,776	5.2	330,648	4.7	345,926	361,968	378,818
Total assets (year end)	282,101	291,838	308,356	323,196	4.8	338,101	4.6	353,751	370,185	387,451
Risk weighted assets (RWA) (year end)	148,596	146,743	146,829	153,895	4.8	160,992	4.6	168,444	176,270	184,491
Risk weighted assets (RWA) (average)	146,890	147,669	146,786	150,362	2.4	157,444	4.7	164,718	172,357	180,380
Customer loans	215,994	221,872	233,902	245,818	5.1	258,357	5.1	271,552	285,439	300,056
Customer loans (average)	215,782	218,933	227,887	239,860	5.3	252,088	5.1	264,955	278,496	292,748
Interest earning assets (average)	269,096	276,196	288,656	302,809	4.9	317,354	4.8	332,630	348,674	365,528
Customer deposits	194,403	200,882	211,549	221,888	4.9	232,732	4.9	244,105	256,035	268,548
Common s/h equity (year end)	23,981	25,053	26,715	27,558	3.2	28,860	4.7	30,282	31,816	33,491
Common s/h equity (average)	23,150	24,517	25,884	27,137	4.8	28,209	4.0	29,571	31,049	32,654
Total SHF (equity, pref & MI) (year end)	24,176	25,053	26,913	27,772	3.2	29,090	4.7	30,528	32,078	33,770
Total SHF (equity, pref & MI) (average)	23,338	24,614	25,983	27,342	5.2	28,431	4.0	29,809	31,303	32,924
Net tangible assets	23,676	24,610	26,424	27,259	3.2	28,554	4.7	29,967	31,491	33,156
Balance sheet structure (%)										
Loans / banking assets (year end)	76.6	76.0	75.9	76.1	0.3	76.4	0.5	76.8	77.1	77.4
Deposits / banking assets (year end)	68.9	68.8	68.6	68.7	0.1	68.8	0.3	69.0	69.2	69.3
Loans / deposits	111.1	110.4	110.6	110.8	0.2	111.0	0.2	111.2	111.5	111.7
Total SHF / banking assets (year end)	8.6	8.6	8.7	8.6	-1.5	8.6	0.1	8.6	8.7	8.7

Source: Company accounts, UBS estimates. (UBS) metrics use reported figures which have been adjusted by UBS analysts.

KB Financial Group (105560.KS)

Capital adequacy (Wonbn)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Tier 1 capital	16,184	18,502	19,621	20,227	21,162	22,183	23,285	24,489
Total capital	21,426	22,624	23,422	24,145	25,261	26,481	27,796	29,233
Risk weighted assets (RWA) (year end)	148,596	146,743	146,829	153,895	160,992	168,444	176,270	184,491
Core tier 1 ratio %	10.8	12.6	13.4	13.1	13.1	13.2	13.2	13.3
Tier 1 ratio %	10.9	12.6	13.4	13.1	13.1	13.2	13.2	13.3
Total capital ratio %	14.4	15.4	16.0	15.7	15.7	15.7	15.8	15.8
Tangible equity	23,481	24,610	26,226	27,046	28,324	29,721	31,229	32,877
Equity / assets %	8.5	8.6	8.7	8.5	8.5	8.6	8.6	8.6
Tangible equity to tangible assets %	8.3	8.4	8.5	8.4	8.4	8.4	8.4	8.5
Asset quality (Wonbn)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Non performing assets	3,456	3,338	2,875	3,155	3,501	3,759	3,951	3,935
Total risk reserves	3,184	2,871	2,452	2,520	2,594	2,675	2,759	2,843
NPLs / loans %	1.6	1.5	1.2	1.3	1.3	1.4	1.4	1.3
NPL coverage %	92.1	86.0	85.3	79.9	74.1	71.2	69.8	72.3
Provision charge / average loans %	0.7	0.7	0.5	0.6	0.6	0.6	0.6	0.6
Net NPAs / shareholders funds %	1.1	1.9	1.6	2.3	3.1	3.6	3.7	3.2
Profitability (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Net interest margin (avg assets)	3.05	2.76	2.61	2.60	2.54	2.54	2.55	2.55
Provisions / operating profit	39.1	44.3	39.2	38.1	40.8	40.8	40.3	38.1
ROE (UBS earnings)	7.7	5.1	5.4	6.1	5.8	5.9	6.1	6.3
RoAdjE (UBS earnings & equity)	7.8	5.2	5.5	6.2	5.9	6.0	6.2	6.4
RoRWA (UBS)	1.21	0.86	0.96	1.10	1.05	1.07	1.10	1.15
RoA (UBS earnings)	0.64	0.44	0.47	0.53	0.50	0.51	0.52	0.55
Productivity (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Cost income ratio	50.1	55.0	56.2	53.8	53.1	51.5	50.3	49.8
Cost / average assets	1.39	1.39	1.34	1.31	1.26	1.21	1.17	1.16
Compensation expense ratio	32.0	43.7	45.3	41.2	40.4	38.9	37.8	37.3
Growth (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Revenue	-10.9	-6.6	-1.4	7.4	2.0	3.8	4.0	4.1
Operating profit pre provisions	-19.0	-15.8	-4.0	13.1	3.7	7.2	6.6	5.1
Net earnings (UBS)	-25.2	-29.0	11.1	17.4	-0.8	7.2	7.7	9.0
Net DPS	-16.7	-16.7	56.0	9.1	-0.8	7.2	7.7	9.0
Total assets (year end)	1.6	3.5	5.7	4.8	4.6	4.6	4.6	4.7
Customer loans	0.2	2.7	5.4	5.1	5.1	5.1	5.1	5.1
Customer deposits	2.1	3.3	5.3	4.9	4.9	4.9	4.9	4.9
Value (x)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Market cap/revenues	1.9	2.0	2.1	1.9	1.9	1.8	1.7	1.7
Market cap/deposits	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
P/PPOP (diluted)	3.9	4.5	4.7	4.1	4.0	3.7	3.5	3.3
P/E (local GAAP, basic)	8.4	11.5	10.5	7.9	8.9	8.3	7.7	7.1
P/E (UBS, diluted)	8.4	11.5	10.5	8.8	8.9	8.3	7.7	7.1
Net dividend yield %	1.6	1.3	2.0	2.3	2.2	2.4	2.6	2.8
P/BV x	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.4
P/BV (UBS) x	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.4

Source: Company accounts, UBS estimates. (UBS) metrics use reported figures which have been adjusted by UBS analysts.

Shinhan Financial Group

Valuation premium to be sustained with capital, stability, and governance

Our study of Japan's 'Lost Decade' suggests Shinhan is well positioned in Korea

As was the case in Japan after the 1990s, we believe stocks with sustainable dividends are likely to outperform in the long term in Korea. While the 2014 payout of 22% did not meet market expectations, we think Shinhan Financial Group's (Shinhan) relatively strong CET1 of 10.4% and ROE of 7-8% (5-6% for other major banks) should enable it to become one of a few banks in Korea that could accumulate distributable earnings on a sustained basis.

Earnings stability should justify a premium

1) Limited downside from credit cards: Shinhan Card's ROA has continued to fall over the past several years due to diminishing NPL recoveries (from legacy NPLs acquired with LG Card in 2004); gains from NPL recoveries fell from Won458bn in 2007 to Won220bn in 2014. However, further decrease is unlikely as legacy NPL contribution was almost zero by end-2014. Shinhan Card's 2014 provisioning yield of 205bp was in line with that of competitors such as Samsung Card—evidence that contribution from legacy NPL recoveries is minimal. 2) As a result of the large early-retirement programme (ERP) in 2014 that was about twice the size of the one in 2013, we expect 2015E SG&A growth to be contained at 2%. 3) It still has around Won400bn in valuation gains in VISA and MasterCard stakes, which it could use to offset potential one-off losses.

Shareholder-friendly governance structure differentiates Shinhan from peers

Transparent and solid governance is a key consideration in our positive view and valuation of Shinhan. It remains the only bank with shareholders on its board; we believe this is an important factor in its valuation premium in the Korea banking sector, as it can effectively balance shareholder interest with regulatory and political influence. This should prevent undesirable outcomes such as margin destruction (IBK in 2012-13), lack of leadership (KB until late 2014), excessive risk-taking to play a policy bank role (Woori), and pursuit of growth strategies at the expense of shareholder value (DGB).

Valuation: maintain Buy with 4% lower price target

Shinhan is trading at 0.67x 2015E P/BV and 9.0x 2015E PE. To reflect: 1) lower loan growth (from 6% to 5%); 2) a potential rate cut in 2015, and 3) a gradual rise in credit costs, we lower our 2015-17E EPS estimates 6% on average and our price target to Won52,000 on a 2015E target P/BV of 0.83x, implying a 2015E target PE of 11x.

Equities

Korea
Banks, Ex-S&L

12-month rating

Buy

12m price target

Won52,000
Prior: Won54,000

Price

Won42,200
RIC: 055550.KS **BBG:** 055550 KS

Trading data and key metrics

52-wk range Won53,400-41,250

Market cap. Won20,011bn/US\$18.2bn

Shares o/s 474m (ORD)

Free float 95%

Avg. daily volume ('000) 820

Avg. daily value (m) Won36,829.2

Common s/h equity (12/15E) Won29,842bn

P/BV (12/15E) 0.7x

Tier 1 ratio 11%

EPS (UBS, diluted) (Won)

	From	To	% ch	Cons.
12/15E	4,685	4,680	-0.11	4,632
12/16E	5,238	4,763	-9.06	5,044
12/17E	5,772	5,189	-10.11	5,007

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Highlights (Wonbn)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Revenues	8,708	8,225	8,505	8,951	9,219	9,699	10,223	10,774
Profit before tax	3,231	2,682	2,868	3,154	3,206	3,473	3,798	4,109
Net earnings (local GAAP)	2,243	1,841	2,019	2,219	2,259	2,460	2,707	2,943
Net earnings (UBS)	2,243	1,841	2,019	2,219	2,259	2,460	2,707	2,943
Tier 1 ratio %	9.5	11.3	11.1	11.3	11.5	11.7	12.0	12.2
EPS (UBS, diluted) (Won)	4,730	3,882	4,258	4,680	4,763	5,189	5,708	6,206
Profitability/valuation	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
ROE (UBS) %	9.3	7.1	7.4	7.7	7.3	7.5	7.8	7.9
P/POP (diluted)	4.0	4.9	5.5	4.5	4.4	4.0	3.7	3.5
P/BV x	0.7	0.7	0.8	0.7	0.6	0.6	0.6	0.5
P/BV (UBS) x	0.9	0.9	0.9	0.8	0.7	0.7	0.6	0.6
P/E (UBS, diluted)	8.3	10.7	11.1	9.0	8.9	8.1	7.4	6.8
Net dividend yield %	1.8	1.6	2.0	2.2	2.3	2.5	2.7	2.9

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied. Valuations: based on an average share price that year, (E): based on a share price of Won42,200 on 02 Mar 2015 22:40 HKT

Investment Thesis

Shinhan Financial Group

Investment case

In the context of the Korea banking industry, where regulation and political influence are often discount factors, we believe having shareholder representatives on the board is an important premium valuation factor, as it should effectively balance shareholder interest with that of management and government. Of Shinhan's 12-member board, five directors are directly appointed by shareholders. We are positive on Shinhan's earnings stability too, as we expect: 1) limited downside from diminishing legacy NPL recoveries which currently are minimal; 2) 2015E SG&A growth to be contained at 2%, given the large early-retirement programme (ERP) in 2014; and 3) valuation gains of around Won400bn in VISA and MasterCard stakes, which could be used to offset potential one-off losses.

Upside scenario

Our base-case estimates for Shinhan are premised on: 1) NIM being affected by a 25bp Bank of Korea (BOK) rate cut in 2015E, and 2) provisioning gradually rising from 54bp in 2014E to 59bp in 2017E, resulting in a 7.2% sustainable ROE assumption and a 0.83x 2015E target P/BV. In our upside scenario, we assume: 1) no BOK rate cut; 2) provisioning yield falls 5% in 2015-16E; and 3) loan growth increases 2% resulting in an 8.3% sustainable ROE assumption, leading to a 1.04x 2015E target P/BV, and a Won66,000/share valuation.

Downside scenario

In our downside scenario, we assume Korea banks' credit costs rise sharply (instead of the moderate rise in our base case). We assume Shinhan's provisioning yield rises 20% in 2015-16E, resulting in a sustainable ROE assumption of 6.6% leading to 0.63x 2015E target P/BV and a Won45,000/share downside scenario valuation.

Upcoming catalysts

We believe indications of higher dividends from management or key shareholders such as National Pension Services will be supportive. A value-accretive M&A opportunity could be a key catalyst over the long term.

12-month rating

Buy

12m price target

Won52,000

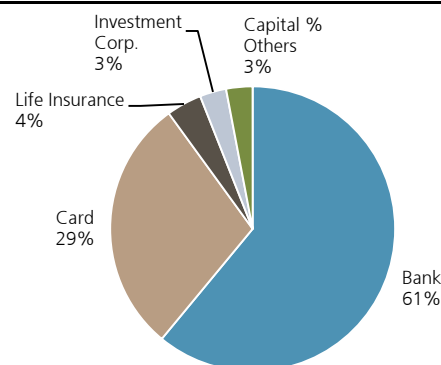
Business description

Shinhan Financial Group (SFG) is one of the largest financial groups in Korea, with total assets of Won311trn as of 2013. SFG is a major company in the areas of retail banking (Shinhan Bank), credit cards (Shinhan Card), life insurance (Shinhan Life), brokerage (Shinhan Investment), and asset management (Shinhan-BNP Paribas Asset Management). National Pension Services (with an 8.8% stake) and BNP Paribas (5.35%) are the largest shareholders.

Industry outlook

We believe the operating environment will remain challenging for the Korea banking industry. For the near term, we expect limited operating momentum, due to: 1) growth in rolled-over loans; 2) NIM further affected by rate cuts, 3) provisioning bottoming out after a seven-year low in 2014; partly offset by 4) improving SG&A. Considering similar macro conditions and the lack of competitiveness, we believe the Korea banks sector faces the risk of prolonged stagnation over the long term, as has been the case in Japan since the 1990s.

Earnings by segment (2013)



Source: Company data

Shinhan Financial Group (055550.KS)

	12/12	12/13	12/14	12/15E	% ch	12/16E	% ch	12/17E	12/18E	12/19E
Profit & Loss (Wonbn)										
Net income interest	9,145	8,849	9,090	9,520	4.7	9,746	2.4	10,168	10,627	11,107
Total non interest income	(437)	(625)	(585)	(569)	2.8	(528)	7.2	(469)	(404)	(333)
Total income	8,708	8,225	8,505	8,951	5.2	9,219	3.0	9,699	10,223	10,774
Total cash expenses	(4,062)	(4,203)	(4,463)	(4,546)	-1.9	(4,637)	-2.0	(4,737)	(4,847)	(4,992)
Pre-depreciation operating profit	4,647	4,022	4,042	4,405	9.0	4,581	4.0	4,962	5,376	5,782
Depreciation & amort (excl. goodwill)	0	0	0	0	-	0	-	0	0	0
Operating profit pre provisions	4,647	4,022	4,042	4,405	9.0	4,581	4.0	4,962	5,376	5,782
Total provisions	(1,416)	(1,340)	(1,174)	(1,251)	-6.5	(1,375)	-9.9	(1,489)	(1,579)	(1,673)
Operating profit post provisions	3,231	2,682	2,868	3,154	10.0	3,206	1.7	3,473	3,798	4,109
Income from associates & JVs (pre-tax)	0	0	0	0	-	0	-	0	0	0
Other pre-tax items	0	0	0	0	-	0	-	0	0	0
Profit before tax (UBS)	3,231	2,682	2,868	3,154	10.0	3,206	1.7	3,473	3,798	4,109
Exceptionals (incl goodwill)	0	0	0	0	-	0	-	0	0	0
Profit before tax	3,231	2,682	2,868	3,154	10.0	3,206	1.7	3,473	3,798	4,109
Tax	(739)	(623)	(668)	(763)	-14.3	(776)	-1.7	(840)	(919)	(994)
Profit after tax	2,492	2,060	2,200	2,391	8.7	2,431	1.7	2,632	2,879	3,115
Other post-tax items	0	0	0	0	-	0	-	0	0	0
Preference dividends	(79)	(62)	(62)	(62)	0.0	(62)	0.0	(62)	(62)	(62)
Minorities	(170)	(157)	(119)	(110)	7.3	(110)	0.0	(110)	(110)	(110)
Net earnings (local GAAP)	2,243	1,841	2,019	2,219	9.9	2,259	1.8	2,460	2,707	2,943
Net earnings (before pref divs)	2,322	1,903	2,081	2,281	9.6	2,321	1.7	2,522	2,769	3,005
Net earnings (UBS)	2,243	1,841	2,019	2,219	9.9	2,259	1.8	2,460	2,707	2,943
Per share (Won)										
EPS (local GAAP, basic)	4,730	3,882	4,258	4,680	9.9	4,763	1.8	5,189	5,708	6,206
EPS (UBS, diluted)	4,730	3,882	4,258	4,680	9.9	4,763	1.8	5,189	5,708	6,206
PPOP (diluted)	9,799	8,482	8,524	9,289	9.0	9,661	4.0	10,464	11,338	12,192
Net DPS	700	650	950	936	-1.5	953	1.8	1,038	1,142	1,241
BVPS	53,143	55,741	59,202	62,932	6.3	66,759	6.1	70,995	75,665	80,729
BVPS (UBS)	44,305	46,828	50,444	53,784	6.6	57,234	6.4	61,074	65,329	69,958
Balance sheet (Wonbn)										
Banking assets (year end)	300,848	311,297	338,022	353,067	4.5	367,633	4.1	382,914	398,939	415,740
Banking assets (average)	294,483	306,073	324,659	345,544	6.4	360,350	4.3	375,274	390,926	407,339
Total assets (year end)	300,848	311,297	338,022	353,067	4.5	367,633	4.1	382,914	398,939	415,740
Risk weighted assets (RWA) (year end)	201,184	190,717	199,161	208,026	4.5	216,608	4.1	225,611	235,053	244,952
Risk weighted assets (RWA) (average)	198,382	195,951	194,939	203,593	4.4	212,317	4.3	221,109	230,332	240,003
Customer loans	202,334	208,080	223,989	235,865	5.3	247,392	4.9	259,482	272,164	285,464
Customer loans (average)	198,677	205,207	216,034	229,927	6.4	241,629	5.1	253,437	265,823	278,814
Interest earning assets (average)	275,187	285,764	303,858	324,541	6.8	339,761	4.7	355,077	371,100	387,862
Customer deposits	170,096	178,810	193,710	203,981	5.3	213,950	4.9	224,405	235,372	246,875
Common s/h equity (year end)	25,200	26,432	28,074	29,842	6.3	31,657	6.1	33,666	35,880	38,282
Common s/h equity (average)	24,243	25,816	27,253	28,958	6.3	30,750	6.2	32,661	34,773	37,081
Total SHF (equity, pref & MI) (year end)	28,780	29,860	30,515	32,367	6.1	34,268	5.9	36,372	38,692	41,207
Total SHF (equity, pref & MI) (average)	27,819	29,320	30,187	31,441	4.2	33,318	6.0	35,320	37,532	39,949
Net tangible assets	24,589	25,633	26,362	28,030	6.3	29,752	6.1	31,668	33,790	36,099
Balance sheet structure (%)										
Loans / banking assets (year end)	67.3	66.8	66.3	66.8	0.8	67.3	0.7	67.8	68.2	68.7
Deposits / banking assets (year end)	56.5	57.4	57.3	57.8	0.8	58.2	0.7	58.6	59.0	59.4
Loans / deposits	119.0	116.4	115.6	115.6	0.0	115.6	0.0	115.6	115.6	115.6
Total SHF / banking assets (year end)	9.6	9.6	9.0	9.2	1.6	9.3	1.7	9.5	9.7	9.9

Source: Company accounts, UBS estimates. (UBS) metrics use reported figures which have been adjusted by UBS analysts.

Shinhan Financial Group (055550.KS)

Capital adequacy (Wonbn)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Tier 1 capital	19,125	21,538	22,176	23,519	24,898	26,425	28,108	29,932
Total capital	25,076	25,606	25,901	27,471	29,082	30,864	32,830	34,961
Risk weighted assets (RWA) (year end)	201,184	190,717	199,161	208,026	216,608	225,611	235,053	244,952
Core tier 1 ratio %	8.1	10.0	10.4	10.6	10.8	11.0	11.3	11.6
Tier 1 ratio %	9.5	11.3	11.1	11.3	11.5	11.7	12.0	12.2
Total capital ratio %	12.5	13.4	13.0	13.2	13.4	13.7	14.0	14.3
Tangible equity	21,009	22,206	23,921	25,504	27,140	28,961	30,979	33,174
Equity / assets %	8.4	8.5	8.3	8.5	8.6	8.8	9.0	9.2
Tangible equity to tangible assets %	7.1	7.2	7.2	7.3	7.5	7.7	7.9	8.1
Asset quality (Wonbn)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Non performing assets	2,655	2,558	2,524	2,524	2,524	2,524	2,524	2,524
Total risk reserves	2,678	2,357	2,371	2,496	2,634	2,782	2,940	3,108
NPLs / loans %	1.3	1.2	1.1	1.1	1.0	1.0	0.9	0.9
NPL coverage %	100.9	92.1	93.9	98.9	104.3	110.2	116.5	123.1
Provision charge / average loans %	0.7	0.7	0.5	0.5	0.6	0.6	0.6	0.6
Net NPAs / shareholders funds %	(0.1)	0.7	0.5	0.1	(0.3)	(0.7)	(1.1)	(1.4)
Profitability (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Net interest margin (avg assets)	3.11	2.89	2.80	2.76	2.70	2.71	2.72	2.73
Provisions / operating profit	30.5	33.3	29.1	28.4	30.0	30.0	29.4	28.9
ROE (UBS earnings)	9.3	7.1	7.4	7.7	7.3	7.5	7.8	7.9
RoAdjE (UBS earnings & equity)	11.2	8.5	8.8	9.0	8.6	8.8	9.0	9.2
RoRWA (UBS)	1.22	1.02	1.10	1.14	1.12	1.16	1.22	1.27
RoA (UBS earnings)	0.85	0.67	0.68	0.69	0.67	0.70	0.74	0.76
Productivity (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Cost income ratio	46.6	51.1	52.5	50.8	50.3	48.8	47.4	46.3
Cost / average assets	1.38	1.37	1.37	1.32	1.29	1.26	1.24	1.23
Compensation expense ratio	34.4	38.3	40.4	37.9	37.4	36.1	34.7	33.8
Growth (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Revenue	-6.7	-5.6	3.4	5.2	3.0	5.2	5.4	5.4
Operating profit pre provisions	-10.7	-13.4	0.5	9.0	4.0	8.3	8.4	7.5
Net earnings (UBS)	-21.7	-17.9	9.7	9.9	1.8	8.9	10.0	8.7
Net DPS	-6.7	-7.1	46.2	-1.5	1.8	8.9	10.0	8.7
Total assets (year end)	4.4	3.5	8.6	4.5	4.1	4.2	4.2	4.2
Customer loans	3.8	2.8	7.6	5.3	4.9	4.9	4.9	4.9
Customer deposits	4.3	5.1	8.3	5.3	4.9	4.9	4.9	4.9
Value (x)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Market cap/revenues	2.1	2.4	2.6	2.2	2.2	2.1	2.0	1.9
Market cap/deposits	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
P/PPOP (diluted)	4.0	4.9	5.5	4.5	4.4	4.0	3.7	3.5
P/E (local GAAP, basic)	8.3	10.7	11.1	9.0	8.9	8.1	7.4	6.8
P/E (UBS, diluted)	8.3	10.7	11.1	9.0	8.9	8.1	7.4	6.8
Net dividend yield %	1.8	1.6	2.0	2.2	2.3	2.5	2.7	2.9
P/BV x	0.7	0.7	0.8	0.7	0.6	0.6	0.6	0.5
P/BV (UBS) x	0.9	0.9	0.9	0.8	0.7	0.7	0.6	0.6

Source: Company accounts, UBS estimates. (UBS) metrics use reported figures which have been adjusted by UBS analysts.

DGB Financial Group

Upgrade to Buy due to excessive discount

Valuation factors in the worst and more

After the weakest performance in the sector in 2014 (-32%) and the 3% rebound YTD, we believe there is still upside potential for DGB Financial Group (DGB), as we believe the current valuation implies an unjustifiable discount to the sector average, considering DGB's higher ROE (7.5% vs the 6.4% peer average in 2015-17E). Although the weak share price performance since November 2014 has in part been due to the dilution from the recent share offering, we believe the absolute and relative valuations imply limited downside, and provide an attractive buying opportunity even after YTD rebound.

Long-term upside depends on regaining confidence in a difficult environment

Our Buy rating is based on valuation rather than fundamental improvement. We believe DGB will face several challenges in the coming few years, including: 1) unfavourable regional economic conditions; 2) concerns about a potential housing market slowdown in Daegu after being the best-performing market in Korea since 2010; 3) a turnaround of newly acquired DGB Life (previously Woori-Aviva Life), which has weak capital and existing policies that have negative value; and 4) further cross-sector and cross-regional diversification, which may be challenged by shareholders.

Our 2015 estimates are conservative and below company guidance

Our 2015 earnings estimate of Won268bn, 8% below company guidance of Won290bn. 1) We lower our long-term loan growth assumptions from 8.5% to 7.0%, also below company guidance of 8.0%. Under our assumptions of 8% ROE and a 12% dividend payout, we think DGB will increase assets at a slower-than-guided pace to maintain capital levels. 2) We expect DGB's NIM to fall 12bp in 2015 versus 8bp company guidance, as we factor in an additional 25bp policy rate cut. Due to the high proportion of low-cost deposits, DGB's NIM is more sensitive to yield movements than that of peers. 3) We assume a gradual rise in credit costs for the sector including DGB.

Valuation: upgrade from Neutral to Buy; lower PT to Won14,000

We lower our EPS estimates for 2015/2016/2017 by 11%/19%/21% and our price target 13%, from Won16,000 to Won14,000 based on a target 2015E P/BV of 0.68x, and implying a target PE of 8.8x.

Equities

Korea
Banks, Ex-S&L

12-month rating	Buy
	<i>Prior: Neutral</i>
12m price target	Won14,000
	<i>Prior: Won16,000</i>
Price	Won11,650
RIC: 139130.KS BBG: 139130 KS	

Trading data and key metrics

52-wk range	Won18,100-10,600
Market cap.	Won1,543bn/US\$1.40bn
Shares o/s	132m (ORD)
Free float	90%
Avg. daily volume ('000)	480
Avg. daily value (m)	Won5,441.1
Common s/h equity (12/15E)	Won3,463bn
P/BV (12/15E)	0.6x
Tier 1 ratio	9%

EPS (UBS, diluted) (Won)

	From	To	% ch	Cons.
12/15E	1,785	1,587	-11.09	1,770
12/16E	2,004	1,622	-19.07	1,906
12/17E	2,237	1,775	-20.64	1,973

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Highlights (Wonbn)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Revenues	1,020	992	1,065	1,113	1,157	1,230	1,311	1,397
Profit before tax	362	329	317	371	379	413	462	488
Net earnings (local GAAP)	273	238	230	268	274	300	337	357
Net earnings (UBS)	273	238	230	268	274	300	337	357
Tier 1 ratio %	10.9	11.6	10.1	9.4	10.3	9.9	9.5	9.0
EPS (UBS, diluted) (Won)	2,039	1,777	1,714	1,587	1,622	1,775	1,994	2,112
Profitability/valuation	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
ROE (UBS) %	11.3	9.1	8.2	8.4	7.7	7.8	8.2	8.1
P/POP (diluted)	3.6	4.5	4.0	3.5	3.3	3.0	2.7	2.5
P/BV x	0.7	0.8	0.7	0.6	0.5	0.5	0.5	0.4
P/BV (UBS) x	0.8	0.8	0.7	0.6	0.5	0.5	0.5	0.4
P/E (UBS, diluted)	6.9	9.1	9.0	7.3	7.2	6.6	5.8	5.5
Net dividend yield %	2.3	1.7	2.1	1.6	1.7	1.8	2.1	2.2

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied. Valuations: based on an average share price that year, (E): based on a share price of Won11,650 on 02 Mar 2015 22:40 HKT

Investment Thesis

DGB Financial Group

Investment case

We believe DGB's steep valuation discount to peers provides an attractive buying opportunity. Following the unexpected dilutive capital-raising in November 2014, the stock has underperformed its peers. Even after accounting for the dilution, we believe the current valuation implies an unjustifiable discount to the sector average, given its higher ROE (7.9% vs. the 6.1% peer average). However, we believe there are some uncertainties in DGB's fundamentals.

Upside scenario

Our base-case estimates for DGB are premised on: 1) NIM being affected by a 25bp Bank of Korea (BOK) rate cut in 2015E, and 2) provisioning gradually rising from 58bp in 2015E to 64bp in 2017E, resulting in an 8.4% sustainable ROE assumption and a 0.63x 2015E target P/BV. In our upside scenario, we assume: 1) no BOK rate cut; 2) provisioning falls 5% in 2015-16E; and 3) loans rise 2% resulting in an 8.9% sustainable ROE assumption, leading to a 0.81x 2015E target P/BV, and a Won17,000/share valuation.

Downside scenario

In our downside scenario, we assume a significant increase in credit costs (instead of the moderate rise in our base case) for Korea banks. We assume DGB's provisioning yield rises 20% in 2015-16E, resulting in sustainable ROE assumption of 6.9% leading to a 0.54x 2015E target P/BV and a Won11,000/share downside scenario valuation.

Upcoming catalysts

1) Signs of improvement in the regional economy; 2) a faster-than-expected turnaround of DGB Life; and 3) improving investor sentiment due to management reliability (via transparent and realistic growth strategies) should be positive for the stock.

12-month rating

Buy

12m price target

Won14,000

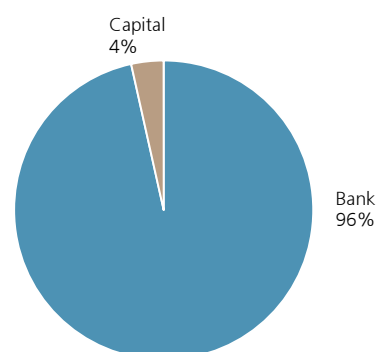
Business description

DGB Financial Group is a regional financial group based in Daegu, Korea's third-largest city. Its key subsidiary Daegu Bank serves over 70% of the region's population, mainly focusing on SME loans. It was listed on the Korea Stock Exchange in 1972. As of 2013, the Saudi Arabian Monetary Agency (with a 7.7% stake), Samsung Life (7.3%), National Pension Services (5.6%), and Aberdeen Global (5.1%) are the largest shareholders.

Industry outlook

We believe the operating environment will remain challenging for the Korea banking industry. For the near term, we expect limited operating momentum, due to: 1) growth in rolled-over loans; 2) NIM further affected by rate cuts, 3) provisioning bottoming out after a seven-year low in 2014; partly offset by 4) improving SG&A. Considering similar macro conditions and the lack of competitiveness, we believe the Korea banks sector faces the risk of prolonged stagnation over the longer term, as has been the case in Japan since the 1990s.

Earnings by segment (2013)



Source: Company data

DGB Financial Group (139130.KS)

	12/12	12/13	12/14	12/15E	% ch	12/16E	% ch	12/17E	12/18E	12/19E
Profit & Loss (Wonbn)										
Net income interest	924	942	1,022	1,057	3.4	1,098	3.9	1,167	1,244	1,326
Total non interest income	95	50	44	56	28.4	59	6.1	63	67	71
Total income	1,020	992	1,065	1,113	4.4	1,157	4.0	1,230	1,311	1,397
Total cash expenses	(494)	(508)	(544)	(552)	-1.6	(563)	-1.9	(575)	(590)	(608)
Pre-depreciation operating profit	526	484	521	560	7.4	594	6.1	655	721	789
Depreciation & amort (excl. goodwill)	0	0	0	0	-	0	-	0	0	0
Operating profit pre provisions	526	484	521	560	7.4	594	6.1	655	721	789
Total provisions	(164)	(155)	(204)	(189)	7.5	(215)	-13.9	(242)	(259)	(301)
Operating profit post provisions	362	329	317	371	17.0	379	2.1	413	462	488
Income from associates & JVs (pre-tax)	0	0	0	0	-	0	-	0	0	0
Other pre-tax items	0	0	0	0	-	0	-	0	0	0
Profit before tax (UBS)	362	329	317	371	17.0	379	2.1	413	462	488
Exceptionals (incl goodwill)	0	0	0	0	-	0	-	0	0	0
Profit before tax	362	329	317	371	17.0	379	2.1	413	462	488
Tax	(89)	(85)	(73)	(90)	-22.3	(92)	-2.1	(100)	(112)	(118)
Profit after tax	273	245	244	281	15.4	287	2.1	313	350	370
Other post-tax items	0	0	0	0	-	0	-	0	0	0
Preference dividends	0	0	0	0	-	0	-	0	0	0
Minorities	0	(6)	(14)	(13)	6.6	(13)	0.0	(13)	(13)	(13)
Net earnings (local GAAP)	273	238	230	268	16.8	274	2.2	300	337	357
Net earnings (before pref divs)	273	238	230	268	16.8	274	2.2	300	337	357
Net earnings (UBS)	273	238	230	268	16.8	274	2.2	300	337	357
Per share (Won)										
EPS (local GAAP, basic)	2,039	1,777	1,714	1,587	-7.4	1,622	2.2	1,775	1,994	2,112
EPS (UBS, diluted)	2,039	1,777	1,714	1,587	-7.4	1,622	2.2	1,775	1,994	2,112
PPOP (diluted)	3,924	3,611	3,889	3,313	-14.8	3,515	6.1	3,875	4,264	4,668
Net DPS	330	280	320	190	-40.5	195	2.2	213	239	253
BVPS	19,116	20,457	22,066	20,483	-7.2	21,915	7.0	23,495	25,276	27,148
BVPS (UBS)	18,559	19,767	21,381	19,907	-6.9	21,301	7.0	22,841	24,579	26,406
Balance sheet (Wonbn)										
Banking assets (year end)	34,463	37,578	41,010	44,025	7.4	46,909	6.6	49,985	53,267	56,767
Banking assets (average)	32,878	36,020	39,294	42,517	8.2	45,467	6.9	48,447	51,626	55,017
Total assets (year end)	34,463	37,578	41,010	44,025	7.4	46,909	6.6	49,985	53,267	56,767
Risk weighted assets (RWA) (year end)	23,940	25,977	28,195	30,268	7.4	32,251	6.6	34,366	36,622	39,029
Risk weighted assets (RWA) (average)	23,075	24,958	27,086	29,232	7.9	31,259	6.9	33,308	35,494	37,825
Customer loans	26,239	28,497	31,718	33,930	7.0	36,297	7.0	38,829	41,537	44,435
Customer loans (average)	24,954	27,368	30,107	32,824	9.0	35,114	7.0	37,563	40,183	42,986
Interest earning assets (average)	32,719	35,845	39,130	42,362	8.3	45,308	7.0	48,284	51,459	54,847
Customer deposits	24,763	26,784	30,747	32,892	7.0	35,186	7.0	37,640	40,266	43,075
Common s/h equity (year end)	2,531	2,709	2,922	3,463	18.5	3,705	7.0	3,972	4,273	4,590
Common s/h equity (average)	2,411	2,620	2,815	3,192	13.4	3,584	12.3	3,838	4,122	4,431
Total SHF (equity, pref & MI) (year end)	2,531	2,709	2,922	3,463	18.5	3,705	7.0	3,972	4,273	4,590
Total SHF (equity, pref & MI) (average)	2,411	2,620	2,815	3,192	13.4	3,584	12.3	3,838	4,122	4,431
Net tangible assets	2,458	2,618	2,831	3,365	18.9	3,601	7.0	3,861	4,155	4,464
Balance sheet structure (%)										
Loans / banking assets (year end)	76.1	75.8	77.3	77.1	-0.4	77.4	0.4	77.7	78.0	78.3
Deposits / banking assets (year end)	71.9	71.3	75.0	74.7	-0.4	75.0	0.4	75.3	75.6	75.9
Loans / deposits	106.0	106.4	103.2	103.2	0.0	103.2	0.0	103.2	103.2	103.2
Total SHF / banking assets (year end)	7.3	7.2	7.1	7.9	10.4	7.9	0.4	7.9	8.0	8.1

Source: Company accounts, UBS estimates. (UBS) metrics use reported figures which have been adjusted by UBS analysts.

DGB Financial Group (139130.KS)

Capital adequacy (Wonbn)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Tier 1 capital	2,607	3,018	2,860	2,860	3,330	3,402	3,468	3,519
Total capital	3,500	3,952	3,725	3,725	4,195	4,268	4,333	4,385
Risk weighted assets (RWA) (year end)	23,940	25,977	28,195	30,268	32,251	34,366	36,622	39,029
Core tier 1 ratio %	9.2	9.2	9.1	8.5	9.4	9.1	8.7	8.3
Tier 1 ratio %	10.9	11.6	10.1	9.4	10.3	9.9	9.5	9.0
Total capital ratio %	14.6	15.2	13.2	12.3	13.0	12.4	11.8	11.2
Tangible equity	2,458	2,618	2,831	3,365	3,601	3,861	4,155	4,464
Equity / assets %	7.3	7.2	7.1	7.9	7.9	7.9	8.0	8.1
Tangible equity to tangible assets %	7.1	7.0	6.9	7.7	7.7	7.7	7.8	7.9
Asset quality (Wonbn)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Non performing assets	248	272	326	326	326	326	326	326
Total risk reserves	352	363	414	414	414	414	414	414
NPLs / loans %	0.9	0.9	1.0	0.9	0.9	0.8	0.8	0.7
NPL coverage %	141.6	133.5	126.9	126.9	126.9	126.9	126.9	126.9
Provision charge / average loans %	0.7	0.6	0.7	0.6	0.6	0.6	0.6	0.7
Net NPAs / shareholders funds %	(4.1)	(3.4)	(3.0)	(2.5)	(2.4)	(2.2)	(2.1)	(1.9)
Profitability (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Net interest margin (avg assets)	2.81	2.61	2.60	2.49	2.41	2.41	2.41	2.41
Provisions / operating profit	31.2	32.0	39.2	33.7	36.2	36.9	35.9	38.1
ROE (UBS earnings)	11.3	9.1	8.2	8.4	7.7	7.8	8.2	8.1
RoAdjE (UBS earnings & equity)	11.7	9.4	8.4	8.7	7.9	8.0	8.4	8.3
RoRWA (UBS)	1.18	0.98	0.90	0.96	0.92	0.94	0.99	0.98
RoA (UBS earnings)	0.83	0.68	0.62	0.66	0.63	0.65	0.68	0.67
Productivity (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Cost income ratio	48.4	51.2	51.1	49.7	48.6	46.8	45.0	43.5
Cost / average assets	1.50	1.41	1.38	1.30	1.24	1.19	1.14	1.11
Compensation expense ratio	31.7	37.0	37.4	33.3	32.5	30.7	29.3	28.1
Growth (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Revenue	-0.1	-2.7	7.4	4.4	4.0	6.3	6.6	6.6
Operating profit pre provisions	-5.4	-8.0	7.7	7.4	6.1	10.2	10.0	9.5
Net earnings (UBS)	-10.6	-12.8	-3.6	16.8	2.2	9.4	12.3	5.9
Net DPS	-5.7	-15.2	14.3	-40.5	2.2	9.4	12.3	5.9
Total assets (year end)	10.1	9.0	9.1	7.4	6.6	6.6	6.6	6.6
Customer loans	10.9	8.6	11.3	7.0	7.0	7.0	7.0	7.0
Customer deposits	12.8	8.2	14.8	7.0	7.0	7.0	7.0	7.0
Value (x)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Market cap/revenues	1.8	2.1	1.9	1.4	1.3	1.3	1.2	1.1
Market cap/deposits	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
P/PPOP (diluted)	3.6	4.5	4.0	3.5	3.3	3.0	2.7	2.5
P/E (local GAAP, basic)	6.9	9.1	9.0	7.3	7.2	6.6	5.8	5.5
P/E (UBS, diluted)	6.9	9.1	9.0	7.3	7.2	6.6	5.8	5.5
Net dividend yield %	2.3	1.7	2.1	1.6	1.7	1.8	2.1	2.2
P/BV x	0.7	0.8	0.7	0.6	0.5	0.5	0.5	0.4
P/BV (UBS) x	0.8	0.8	0.7	0.6	0.5	0.5	0.5	0.4

Source: Company accounts, UBS estimates. (UBS) metrics use reported figures which have been adjusted by UBS analysts.

Industrial Bank of Korea

Need to manage dividend expectations from 2015E; maintain Neutral

The best performing stock in 2014

Industrial Bank of Korea (IBK) was up 16% in 2014 and was the only stock with a positive return in a sector, which corrected 17% over the year. We believe the primary driver of the outperformance was a solid dividend yield, supported by the government's need to make up the ongoing tax deficit.

Competitive advantages haven't changed...

Operating fundamentals were robust, as NIM remained solid (up 2bp in 2014 despite two rate cuts), due to: 1) the normalisation of lending rates to the average industry level; and 2) refinancing of SMIF (Small and Medium Industry Finance) bonds at lower funding costs. Having the lowest cost-to-income ratio (44% in 2014) in the sector was a positive too. We believe IBK will maintain these advantages in 2015E.

...but would need to manage dividend expectations if sector ROE falls lower

IBK operates with tight capital of 8.2% CET1 and 12.4% total BIS, implying that distributable earnings for dividends might be generated solely from earnings rather than excess capital (unlike KB Financial which has excess capital); if sector profitability worsens due to further rate cuts, etc, IBK may rapidly lose the ability to generate excess capital to pay dividends. We previously assumed that if IBK's RWA grew 4% (vs 6.7% in 2012-14) with 8% ROE, a 25% payout would be sustainable while allowing IBK to build up CET1 to 9% by 2019E; however, we now assume: 1) IBK will need to maintain RWA growth at 5% (to support SMEs: a policy bank role); and 2) 6.6% ROE instead of 8% to factor in rate cuts. Hence, we conclude that with a 25% payout IBK's CET1 will remain largely flat until 2019E (8.3%). Consensus payout of 27-28% seems overly optimistic, in our view; we expect 22% payout from 2015.

Valuation: maintain Neutral rating; lower price target 19%

IBK is trading at 0.5x 2015E P/BV and 7.8x PE. To reflect our cautious sector view, we: 1) lower our 2015-17E NIM assumptions 4bp to account for a rate cut; and 2) raise our provisioning yield assumption 4bp; partly offset by 3) a 5% lower SG&A assumption. As a result we reduce our 2015-17E EPS by 6-18% and price target by 19% from Won18,000 to Won14,500 based on a 2015E target P/BV of 0.6x, and implying a target PE of 8.7x.

Equities

Korea
Banks, Ex-S&L

12-month rating **Neutral**

12m price target **Won14,500**
Prior: Won18,000

Price **Won13,150**

RIC: 024110.KS **BBG:** 024110 KS

Trading data and key metrics

52-wk range	Won18,150-12,350
Market cap.	Won8,554bn/US\$7.77bn
Shares o/s	650m (ORD)
Free float	31%
Avg. daily volume ('000)	1,502
Avg. daily value (m)	Won20,652.9
Common s/h equity (12/15E)	Won16,360bn
P/BV (12/15E)	0.5x
Tier 1 ratio	9%

EPS (UBS, diluted) (Won)

	From	To	% ch	Cons.
12/15E	1,778	1,682	-5.40	1,812
12/16E	1,944	1,645	-15.38	1,950
12/17E	2,122	1,765	-16.84	2,092

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Highlights (Wonbn)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Revenues	4,603	4,401	4,558	4,801	4,967	5,246	5,550	5,871
Profit before tax	1,550	1,135	1,343	1,448	1,417	1,520	1,681	1,722
Net earnings (local GAAP)	1,180	848	1,027	1,095	1,071	1,149	1,272	1,302
Net earnings (UBS)	1,180	848	1,027	1,095	1,071	1,149	1,272	1,302
Tier 1 ratio %	8.9	9.0	9.0	9.0	9.1	9.1	9.2	9.3
EPS (UBS, diluted) (Won)	1,833	1,309	1,578	1,682	1,645	1,765	1,953	2,000
Profitability/valuation	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
ROE (UBS) %	8.7	6.0	6.9	6.9	6.4	6.5	6.8	6.6
P/POP (diluted)	2.9	3.3	3.6	3.1	3.0	2.8	2.5	2.4
P/BV x	0.6	0.5	0.6	0.5	0.5	0.5	0.4	0.4
P/BV (UBS) x	0.6	0.5	0.6	0.5	0.5	0.5	0.5	0.4
P/E (UBS, diluted)	6.8	9.2	9.1	7.8	8.0	7.5	6.7	6.6
Net dividend yield %	3.2	2.8	3.1	2.7	2.7	3.0	3.0	3.0

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied. Valuations: based on an average share price that year, (E): based on a share price of Won13,150 on 02 Mar 2015 22:40 HKT

Investment Thesis

Industrial Bank of Korea

Investment case

We believe IBK remains fundamentally well positioned in the sector as: 1) the government will likely ask IBK for a high dividend payout due to ongoing tax deficits; 2) the NIM trend will likely remain better than that of peers due to normalisation of lending rates to the average industry level and refinancing of SMIF (Small and Medium Industry Finance) bonds at lower funding costs; and 3) the lowest cost-to-income (44% in 2014) in the sector. However, IBK operates with tight capital of 8.2% CET1 and 12.4% total BIS, implying the distributable capital buffer for dividends could rapidly disappear if industry profitability deteriorates further. After its strong outperformance to peers and KOSPI, we believe IBK's valuation is now at a fair level and share price upside will be limited.

Upside scenario

Our base-case estimates for IBK are premised on: 1) NIM being affected by a 25bp Bank of Korea (BOK) rate cut in 2015E, and 2) provisioning bottoming out, from 74bp in 2014E to 76-81bp in 2015-16E, resulting in a 6.3% sustainable ROE assumption and a 0.58x 2015E target P/BV. In our upside scenario, we assume: 1) no BOK rate cut; 2) provisioning decreases 5% in 2015-16E; 3) loans increase 2% resulting in a 7.5% sustainable ROE assumption, leading to a 0.79x 2015E target P/BV, and a Won20,000/share valuation.

Downside scenario

In our downside scenario, we assume a sharp rise in credit costs for Korea banks (instead of the moderate rise in our base case). We assume IBK's provisioning yield rises 20% in 2015-16E, resulting in a sustainable ROE assumption to 5.6% leading to a 0.36x 2015E target P/BV and a Won9,000/share downside scenario valuation.

Upcoming catalysts

We believe further newsflow on the tax deficit and higher SOE dividends are positive catalysts. On the other hand, any signs of shareholder value erosion to meet the government's social obligations would be major risk of investing in IBK.

12-month rating

Neutral

12m price target

Won14,500

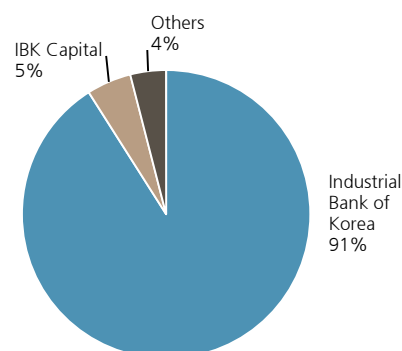
Business description

Industrial Bank of Korea (IBK) was established in 1961 as a government-controlled bank to promote growth among Korea's small and medium-sized enterprises (SMEs). IBK has around a 20% share of the SME lending market and is also involved in retail banking, brokerage, credit cards, and venture capital, with around Won213trn in assets as of 2013. IBK was listed on the KOSDAQ in 1994 and transferred to the Korea Exchange in 2003. The government has a 60% direct ownership stake in IBK.

Industry outlook

We believe the operating environment will remain challenging for the Korea banking industry. For the near term, we expect limited operating momentum, due to: 1) growth in rolled-over loans; 2) NIM further affected by rate cuts, 3) provisioning bottoming out after a seven-year low in 2014; partly offset by 4) improving SG&A. Considering similar macro conditions and the lack of competitiveness, we believe the Korea banks sector faces the risk of prolonged stagnation over the longer term, as has been the case in Japan since the 1990s.

Earnings by segment (2013)



Source: Company data

Industrial Bank of Korea (024110.KS)

	12/12	12/13	12/14	12/15E	% ch	12/16E	% ch	12/17E	12/18E	12/19E
Profit & Loss (Wonbn)										
Net income interest	4,468	4,256	4,511	4,672	3.6	4,779	2.3	4,995	5,231	5,477
Total non interest income	134	144	47	129	176.2	188	45.2	251	319	394
Total income	4,603	4,401	4,558	4,801	5.3	4,967	3.5	5,246	5,550	5,871
Total cash expenses	(1,859)	(2,012)	(2,005)	(2,042)	-1.8	(2,083)	-2.0	(2,139)	(2,189)	(2,255)
Pre-depreciation operating profit	2,743	2,389	2,552	2,759	8.1	2,884	4.5	3,108	3,361	3,616
Depreciation & amort (excl. goodwill)	0	0	0	0	-	0	-	0	0	0
Operating profit pre provisions	2,743	2,389	2,552	2,759	8.1	2,884	4.5	3,108	3,361	3,616
Total provisions	(1,194)	(1,254)	(1,209)	(1,311)	-8.4	(1,467)	-11.9	(1,588)	(1,680)	(1,894)
Operating profit post provisions	1,550	1,135	1,343	1,448	7.8	1,417	-2.2	1,520	1,681	1,722
Income from associates & JVs (pre-tax)	0	0	0	0	-	0	-	0	0	0
Other pre-tax items	0	0	0	0	-	0	-	0	0	0
Profit before tax (UBS)	1,550	1,135	1,343	1,448	7.8	1,417	-2.2	1,520	1,681	1,722
Exceptionals (incl goodwill)	0	0	0	0	-	0	-	0	0	0
Profit before tax	1,550	1,135	1,343	1,448	7.8	1,417	-2.2	1,520	1,681	1,722
Tax	(368)	(280)	(311)	(350)	-12.6	(343)	2.2	(368)	(407)	(417)
Profit after tax	1,181	854	1,032	1,098	6.4	1,074	-2.2	1,152	1,274	1,305
Other post-tax items	0	0	0	0	-	0	-	0	0	0
Preference dividends	0	0	0	0	-	0	-	0	0	0
Minorities	(1)	(6)	(5)	(3)	52.4	(3)	0.0	(3)	(3)	(3)
Net earnings (local GAAP)	1,180	848	1,027	1,095	6.7	1,071	-2.2	1,149	1,272	1,302
Net earnings (before pref divs)	1,180	848	1,027	1,095	6.7	1,071	-2.2	1,149	1,272	1,302
Net earnings (UBS)	1,180	848	1,027	1,095	6.7	1,071	-2.2	1,149	1,272	1,302
Per share (Won)										
EPS (local GAAP, basic)	1,833	1,309	1,578	1,682	6.6	1,645	-2.2	1,765	1,953	2,000
EPS (UBS, diluted)	1,833	1,309	1,578	1,682	6.6	1,645	-2.2	1,765	1,953	2,000
PPOP (diluted)	4,260	3,685	3,924	4,237	8.0	4,429	4.5	4,773	5,161	5,553
Net DPS	400	330	450	350	-22.2	350	0.0	400	400	400
BVPS	21,542	22,283	23,924	25,124	5.0	26,412	5.1	27,820	29,364	30,955
BVPS (UBS)	21,308	22,003	23,637	24,824	5.0	26,099	5.1	27,492	29,021	30,596
Balance sheet (Wonbn)										
Banking assets (year end)	198,270	212,583	219,761	229,931	4.6	240,586	4.6	251,750	263,448	275,704
Banking assets (average)	192,123	205,427	216,172	224,846	4.0	235,259	4.6	246,168	257,599	269,576
Total assets (year end)	198,270	212,583	219,761	229,931	4.6	240,586	4.6	251,750	263,448	275,704
Risk weighted assets (RWA) (year end)	125,799	135,559	143,647	150,295	4.6	157,260	4.6	164,557	172,203	180,214
Risk weighted assets (RWA) (average)	122,007	130,679	139,603	146,971	5.3	153,777	4.6	160,908	168,380	176,209
Customer loans	149,958	156,954	169,045	177,481	5.0	186,339	5.0	195,639	205,403	215,654
Customer loans (average)	147,460	153,456	162,999	173,263	6.3	181,910	5.0	190,989	200,521	210,528
Interest earning assets (average)	187,615	199,966	211,147	220,648	4.5	231,028	4.7	241,906	253,304	265,248
Customer deposits	76,325	80,846	85,429	89,693	5.0	94,169	5.0	98,869	103,803	108,984
Common s/h equity (year end)	13,872	14,350	15,562	16,360	5.1	17,199	5.1	18,116	19,121	20,158
Common s/h equity (average)	13,497	14,111	14,956	15,961	6.7	16,780	5.1	17,658	18,619	19,640
Total SHF (equity, pref & MI) (year end)	14,546	15,229	16,446	17,249	4.9	18,092	4.9	19,014	20,025	21,067
Total SHF (equity, pref & MI) (average)	14,171	14,888	15,838	16,847	6.4	17,670	4.9	18,553	19,519	20,546
Net tangible assets	14,396	15,049	16,260	17,054	4.9	17,888	4.9	18,800	19,801	20,833
Balance sheet structure (%)										
Loans / banking assets (year end)	75.6	73.8	76.9	77.2	0.3	77.5	0.3	77.7	78.0	78.2
Deposits / banking assets (year end)	38.5	38.0	38.9	39.0	0.3	39.1	0.3	39.3	39.4	39.5
Loans / deposits	196.5	194.1	197.9	197.9	0.0	197.9	0.0	197.9	197.9	197.9
Total SHF / banking assets (year end)	7.3	7.2	7.5	7.5	0.2	7.5	0.2	7.6	7.6	7.6

Source: Company accounts, UBS estimates. (UBS) metrics use reported figures which have been adjusted by UBS analysts.

Industrial Bank of Korea (024110.KS)

Capital adequacy (Wonbn)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Tier 1 capital	11,242	12,245	12,895	13,556	14,252	15,011	15,844	16,703
Total capital	15,563	16,680	17,806	18,695	19,628	20,637	21,731	22,864
Risk weighted assets (RWA) (year end)	125,799	135,559	143,647	150,295	157,260	164,557	172,203	180,214
Core tier 1 ratio %	8.2	8.1	8.2	8.3	8.4	8.5	8.6	8.7
Tier 1 ratio %	8.9	9.0	9.0	9.0	9.1	9.1	9.2	9.3
Total capital ratio %	12.4	12.3	12.4	12.4	12.5	12.5	12.6	12.7
Tangible equity	13,722	14,170	15,376	16,165	16,995	17,902	18,898	19,924
Equity / assets %	7.0	6.8	7.1	7.1	7.1	7.2	7.3	7.3
Tangible equity to tangible assets %	6.9	6.7	7.0	7.0	7.1	7.1	7.2	7.2
Asset quality (Wonbn)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Non performing assets	2,037	2,127	2,312	2,312	2,312	2,312	2,312	2,312
Total risk reserves	2,214	2,266	2,363	2,363	2,363	2,363	2,363	2,363
NPLs / loans %	1.3	1.3	1.3	1.3	1.2	1.2	1.1	1.1
NPL coverage %	108.7	106.5	102.2	102.2	102.2	102.2	102.2	102.2
Provision charge / average loans %	0.8	0.8	0.7	0.8	0.8	0.8	0.8	0.9
Net NPAs / shareholders funds %	(1.2)	(0.9)	(0.3)	(0.3)	(0.3)	(0.3)	(0.3)	(0.2)
Profitability (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Net interest margin (avg assets)	2.33	2.07	2.09	2.08	2.03	2.03	2.03	2.03
Provisions / operating profit	43.5	52.5	47.4	47.5	50.9	51.1	50.0	52.4
ROE (UBS earnings)	8.7	6.0	6.9	6.9	6.4	6.5	6.8	6.6
RoAdjE (UBS earnings & equity)	8.8	6.1	6.9	6.9	6.5	6.6	6.9	6.7
RoRWA (UBS)	0.97	0.65	0.74	0.75	0.70	0.72	0.76	0.74
RoA (UBS earnings)	0.61	0.42	0.48	0.49	0.46	0.47	0.49	0.48
Productivity (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Cost income ratio	40.4	45.7	44.0	42.5	41.9	40.8	39.4	38.4
Cost / average assets	0.97	0.98	0.93	0.91	0.89	0.87	0.85	0.84
Compensation expense ratio	21.5	25.6	25.0	23.1	22.7	21.9	20.9	20.2
Growth (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Revenue	-8.1	-4.4	3.6	5.3	3.5	5.6	5.8	5.8
Operating profit pre provisions	-17.8	-12.9	6.9	8.1	4.5	7.7	8.1	7.6
Net earnings (UBS)	-18.6	-28.1	21.0	6.7	-2.2	7.3	10.6	2.4
Net DPS	-31.0	-17.5	36.4	-22.2	0.0	14.3	0.0	0.0
Total assets (year end)	6.6	7.2	3.4	4.6	4.6	4.6	4.6	4.7
Customer loans	3.4	4.7	7.7	5.0	5.0	5.0	5.0	5.0
Customer deposits	14.1	5.9	5.7	5.0	5.0	5.0	5.0	5.0
Value (x)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Market cap/revenues	1.7	1.8	2.0	1.8	1.7	1.6	1.5	1.5
Market cap/deposits	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
P/PPOP (diluted)	2.9	3.3	3.6	3.1	3.0	2.8	2.5	2.4
P/E (local GAAP, basic)	6.8	9.2	9.1	7.8	8.0	7.5	6.7	6.6
P/E (UBS, diluted)	6.8	9.2	9.1	7.8	8.0	7.5	6.7	6.6
Net dividend yield %	3.2	2.8	3.1	2.7	2.7	3.0	3.0	3.0
P/BV x	0.6	0.5	0.6	0.5	0.5	0.5	0.4	0.4
P/BV (UBS) x	0.6	0.5	0.6	0.5	0.5	0.5	0.5	0.4

Source: Company accounts, UBS estimates. (UBS) metrics use reported figures which have been adjusted by UBS analysts.

BS Financial Group

A year of integration

A relatively better performer; maintain Neutral on valuation

BS Financial Group (BS) was the third-best performing bank stock in our coverage (-9% vs. the sector average of -17%) in 2014 after IBK and Shinhan, and we attribute this to solid earnings. We maintain our Neutral rating as we think BS's valuation to peers has reached a historical peak after the better performance in 2014 and 2015 YTD.

KNB's earnings contribution could be a key swing factor in 2015E

We expect material changes for BS in 2015, as it starts consolidating Kyoungnam Bank's (KNB) Won33trn assets in addition to BS's Won52trn. KNB's ROE deteriorated sharply in 2013-14, to below 5% from 11% in 2010-11 and 16% in 2007-09. We attribute this to: 1) increased SG&A spending prior to its privatisation (cost-income rose from 43% to 58% in 2011-14); and 2) higher provisioning. However, as these could be partly viewed as kitchen-sinking before the acquisition, we believe there is potential for KNB to turnaround in 2015.

Longer-term upside depends on integration

The history of bank M&A in Korea indicates shareholder value accretion (through higher EPS/ROE) when there has been effective post-merger integration and reduction in cost overlap. We think BS's acquisition of KNB will be successful unlike the Hana-KEB merger, given BS's: 1) better relationship with its labour union; 2) limited branch overlap; and 3) KNB employees' c10% lower wages. However, as BS has assured independent operations for KNB and no restructuring for five years, flexibility in integration could be at risk, particularly when the sector's operating environment becomes more challenging.

Valuation: maintain Neutral rating; lower price target 9%

Based on our cautious sector view, we: 1) lower BS's long-term loan growth from 8.2% to 7.0%, 2) lower 2015E/2016E NIM 4bp/11bp to reflect rate cuts; partly offset by 3) 4bp lower provisioning in 2015E (assuming a credit cost stabilisation for KNB); and 4) 3% lower SG&A in 2015-17E. As a result, we lower our 2015-16E EPS 9% on average and our price target from Won17,000 to Won15,500. We would revisit our estimates if KNB turns around and integration synergies materialise in quarterly earnings.

Equities

Korea
Banks, Ex-S&L

12-month rating **Neutral**

12m price target **Won15,500**
Prior: Won17,000

Price **Won14,600**

RIC: 138930.KS **BBG:** 138930 KS

Trading data and key metrics

52-wk range	Won17,750-13,500
Market cap.	Won2,823bn/US\$2.56bn
Shares o/s	193m (ORD)
Free float	85%
Avg. daily volume ('000)	570
Avg. daily value (m)	Won8,249.0
Common s/h equity (12/15E)	Won5,160bn
P/BV (12/15E)	0.7x
Tier 1 ratio	8%

EPS (UBS, diluted) (Won)

	From	To	% ch	Cons.
12/15E	1,938	1,871	-3.45	1,996
12/16E	2,134	1,823	-14.58	2,161
12/17E	2,348	1,934	-17.60	2,147

Junho Lee

Analyst

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Highlights (Wonbn)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Revenues	1,254	1,209	1,491	2,058	2,119	2,238	2,380	2,530
Profit before tax	479	403	472	650	633	672	735	816
Net earnings (local GAAP)	361	305	363	439	427	453	496	551
Net earnings (UBS)	361	305	363	439	427	453	496	551
Tier 1 ratio %	10.5	10.8	8.2	8.2	8.2	8.2	8.2	8.2
EPS (UBS, diluted) (Won)	1,868	1,575	1,877	1,871	1,823	1,934	2,118	2,350
Profitability/valuation	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
ROE (UBS) %	11.6	9.0	8.8	8.8	8.0	7.9	8.1	8.4
P/POP (diluted)	3.5	4.6	4.2	3.3	3.2	3.0	2.7	2.5
P/BV x	0.7	0.8	0.6	0.7	0.6	0.6	0.5	0.5
P/BV (UBS) x	0.8	0.9	0.7	0.7	0.7	0.6	0.6	0.5
P/E (UBS, diluted)	6.6	9.7	8.5	7.8	8.0	7.5	6.9	6.2
Net dividend yield %	2.7	1.8	1.3	2.1	2.1	2.2	2.4	2.4

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied. Valuations: based on an average share price that year, (E): based on a share price of Won14,600 on 02 Mar 2015 22:40 HKT

Investment Thesis

BS Financial Group

Investment case

We maintain our Neutral rating on BS Financial (BS) mainly for its relatively high valuation to peers. We believe KNB's (acquired in Q414) operating performance will be a key swing factor in 2015E. KNB's profitability has deteriorated sharply in recent years, due mainly to the rise in cost-income (from 43% in 2011 to 58% in 2014); and 2) higher provisioning. However, as these could be viewed partly as kitchen-sinking before the acquisition, we think there is potential for KNB to turnaround in 2015; a turnaround would result in a revisit to our estimates.

Upside scenario

Our base-case estimates for BS are premised on: 1) NIM being affected by a 25bp Bank of Korea (BOK) rate cut in 2015E; and 2) provisioning gradually rising, from 54bp in 2015E to 59bp in 2017E, and resulting in an 8.1% sustainable ROE, leading to a 0.70x 2015E target P/BV. In our upside scenario, we assume: 1) no BOK rate cut; 2) provisioning decreases 5% in 2015-16E; 3) loans increase 2% resulting in 9.4% sustainable ROE assumption, a 0.9x 2015E target P/BV, and a Won20,000/share valuation.

Downside scenario

In our downside scenario, we assume a sharp increase in credit costs for Korea banks (instead of the moderate rise in our base case). We assume BS's provisioning yield rises 20% in 2015-16E. As a result, sustainable ROE would be 7.1% leading to a 0.55x 2015E target P/BV and Won12,000/share downside scenario valuation.

Upcoming catalysts

We believe signs of Kyoungnam Bank's turnaround (in terms of an NIM recovery, lower SG&A, and lower provisioning) will be key factors that investors will focus on at the Q115 results release in late April-early May 2015.

12-month rating

Neutral

12m price target

Won15,500

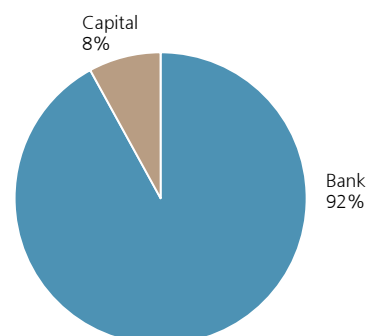
Business description

BS Financial Group (BS) is a regional financial group based in Busan (Korea's second-largest city) with total assets of Won47trn in 2013. Its subsidiaries include Busan Bank, BS Securities, BS Capital, and BS Savings Bank. As a regional operator, Busan Bank focuses on SME loans (62% of total loans).

Industry outlook

We believe the operating environment will remain challenging for the Korea banking industry. For the near term, we expect limited operating momentum, due to: 1) growth in rolled-over loans; 2) NIM further affected by rate cuts, 3) provisioning bottoming out after a seven-year low in 2014; partly offset by 4) improving SG&A. Considering similar macro conditions and the lack of competitiveness, we believe the Korea banks sector faces the risk of prolonged stagnation over the longer term, as has been the case in Japan since the 1990s.

Earnings by segment (2013)



Source: Company data

BS Financial Group (138930.KS)

Profit & Loss (Wonbn)	12/12	12/13	12/14	12/15E	% ch	12/16E	% ch	12/17E	12/18E	12/19E
Net income interest	1,140	1,154	1,427	1,994	39.7	2,058	3.2	2,181	2,325	2,480
Total non interest income	114	54	64	64	0.2	61	-4.2	58	54	50
Total income	1,254	1,209	1,491	2,058	38.0	2,119	3.0	2,238	2,380	2,530
Total cash expenses	(574)	(574)	(752)	(1,034)	-37.6	(1,063)	-2.8	(1,094)	(1,128)	(1,162)
Pre-depreciation operating profit	679	635	739	1,023	38.4	1,056	3.2	1,144	1,252	1,368
Depreciation & amort (excl. goodwill)	0	0	0	0	-	0	-	0	0	0
Operating profit pre provisions	679	635	739	1,023	38.4	1,056	3.2	1,144	1,252	1,368
Total provisions	(201)	(232)	(267)	(374)	-39.9	(423)	-13.2	(472)	(516)	(552)
Operating profit post provisions	479	403	472	650	37.6	633	-2.6	672	735	816
Income from associates & JVs (pre-tax)	0	0	0	0	-	0	-	0	0	0
Other pre-tax items	0	0	0	0	-	0	-	0	0	0
Profit before tax (UBS)	479	403	472	650	37.6	633	-2.6	672	735	816
Exceptionals (incl goodwill)	0	0	0	0	-	0	-	0	0	0
Profit before tax	479	403	472	650	37.6	633	-2.6	672	735	816
Tax	(118)	(97)	(99)	(157)	-58.2	(153)	2.6	(163)	(178)	(197)
Profit after tax	361	306	373	493	32.1	480	-2.6	509	557	618
Other post-tax items	0	0	0	0	-	0	-	0	0	0
Preference dividends	0	0	0	0	-	0	-	0	0	0
Minorities	0	(1)	(10)	(54)	NM	(53)	2.6	(56)	(61)	(68)
Net earnings (local GAAP)	361	305	363	439	20.8	427	-2.6	453	496	551
Net earnings (before pref divs)	361	305	363	439	20.8	427	-2.6	453	496	551
Net earnings (UBS)	361	305	363	439	20.8	427	-2.6	453	496	551
Per share (Won)	12/12	12/13	12/14	12/15E	% ch	12/16E	% ch	12/17E	12/18E	12/19E
EPS (local GAAP, basic)	1,868	1,575	1,877	1,871	-0.3	1,823	-2.6	1,934	2,118	2,350
EPS (UBS, diluted)	1,868	1,575	1,877	1,871	-0.3	1,823	-2.6	1,934	2,118	2,350
PPOP (diluted)	3,514	3,285	3,824	4,367	14.2	4,506	3.2	4,882	5,340	5,838
Net DPS	330	280	200	300	50.0	300	0.0	325	350	350
BVPS	16,833	18,104	24,644	22,017	-10.7	23,541	6.9	25,175	26,968	28,967
BVPS (UBS)	16,202	17,407	22,512	20,144	-10.5	21,545	7.0	23,048	24,701	26,552
Balance sheet (Wonbn)	12/12	12/13	12/14	12/15E	% ch	12/16E	% ch	12/17E	12/18E	12/19E
Banking assets (year end)	42,891	46,917	84,050	89,538	6.5	95,395	6.5	101,644	108,314	115,433
Banking assets (average)	41,125	44,904	65,483	86,794	32.5	92,466	6.5	98,519	104,979	111,874
Total assets (year end)	42,891	46,917	84,050	89,538	6.5	95,395	6.5	101,644	108,314	115,433
Risk weighted assets (RWA) (year end)	28,518	30,493	61,614	65,637	6.5	69,930	6.5	74,512	79,401	84,620
Risk weighted assets (RWA) (average)	27,400	29,505	46,053	63,626	38.2	67,784	6.5	72,221	76,957	82,011
Customer loans	32,503	36,555	67,162	71,846	7.0	76,858	7.0	82,219	87,954	94,089
Customer loans (average)	30,775	34,529	51,858	69,504	34.0	74,352	7.0	79,539	85,087	91,022
Interest earning assets (average)	40,689	44,323	64,422	85,331	32.5	90,989	6.6	97,028	103,474	110,354
Customer deposits	28,346	31,059	59,906	64,085	7.0	68,555	7.0	73,337	78,453	83,925
Common s/h equity (year end)	3,255	3,501	4,766	5,160	8.3	5,517	6.9	5,901	6,321	6,789
Common s/h equity (average)	3,105	3,378	4,133	4,963	20.1	5,339	7.6	5,709	6,111	6,555
Total SHF (equity, pref & MI) (year end)	3,255	3,501	4,766	5,160	8.3	5,517	6.9	5,901	6,321	6,789
Total SHF (equity, pref & MI) (average)	3,105	3,378	4,133	4,963	20.1	5,339	7.6	5,709	6,111	6,555
Net tangible assets	3,133	3,366	4,353	4,721	8.4	5,050	7.0	5,402	5,789	6,223
Balance sheet structure (%)	12/12	12/13	12/14	12/15E	% ch	12/16E	% ch	12/17E	12/18E	12/19E
Loans / banking assets (year end)	75.8	77.9	79.9	80.2	0.4	80.6	0.4	80.9	81.2	81.5
Deposits / banking assets (year end)	66.1	66.2	71.3	71.6	0.4	71.9	0.4	72.2	72.4	72.7
Loans / deposits	114.7	117.7	112.1	112.1	0.0	112.1	0.0	112.1	112.1	112.1
Total SHF / banking assets (year end)	7.6	7.5	5.7	5.8	1.6	5.8	0.4	5.8	5.8	5.9

Source: Company accounts, UBS estimates. (UBS) metrics use reported figures which have been adjusted by UBS analysts.

BS Financial Group (138930.KS)

Capital adequacy (Wonbn)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Tier 1 capital	2,993	3,281	5,033	5,412	5,740	6,093	6,480	6,912
Total capital	4,238	4,456	7,338	7,866	8,356	8,880	9,450	10,077
Risk weighted assets (RWA) (year end)	28,518	30,493	61,614	65,637	69,930	74,512	79,401	84,620
Core tier 1 ratio %	9.7	10.0	7.8	7.9	7.9	7.9	7.9	7.9
Tier 1 ratio %	10.5	10.8	8.2	8.2	8.2	8.2	8.2	8.2
Total capital ratio %	14.9	14.6	11.9	12.0	11.9	11.9	11.9	11.9
Tangible equity	3,133	3,366	4,353	4,721	5,050	5,402	5,789	6,223
Equity / assets %	7.6	7.5	5.7	5.8	5.8	5.8	5.8	5.9
Tangible equity to tangible assets %	7.3	7.2	5.2	5.3	5.3	5.3	5.4	5.4
Asset quality (Wonbn)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Non performing assets	369	448	474	474	474	474	474	474
Total risk reserves	323	355	608	608	608	608	608	608
NPLs / loans %	1.1	1.2	0.7	0.7	0.6	0.6	0.5	0.5
NPL coverage %	87.6	79.3	128.2	128.2	128.2	128.2	128.2	128.2
Provision charge / average loans %	0.7	0.7	0.5	0.5	0.6	0.6	0.6	0.6
Net NPAs / shareholders funds %	1.4	2.6	(2.8)	(2.6)	(2.4)	(2.3)	(2.1)	(2.0)
Profitability (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Net interest margin (avg assets)	2.77	2.57	2.18	2.30	2.23	2.21	2.22	2.22
Provisions / operating profit	29.5	36.6	36.1	36.5	40.1	41.3	41.3	40.4
ROE (UBS earnings)	11.6	9.0	8.8	8.8	8.0	7.9	8.1	8.4
RoAdjE (UBS earnings & equity)	11.9	9.4	9.4	9.7	8.7	8.7	8.9	9.2
RoRWA (UBS)	1.32	1.04	0.81	0.77	0.71	0.71	0.72	0.75
RoA (UBS earnings)	0.88	0.68	0.57	0.57	0.52	0.52	0.53	0.55
Productivity (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Cost income ratio	45.8	47.5	50.4	50.3	50.2	48.9	47.4	45.9
Cost / average assets	1.40	1.28	1.15	1.19	1.15	1.11	1.07	1.04
Compensation expense ratio	17.2	20.7	18.6	22.2	21.7	20.4	19.4	18.7
Growth (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Revenue	8.5	-3.6	23.3	38.0	3.0	5.6	6.3	6.3
Operating profit pre provisions	1.8	-6.5	16.4	38.4	3.2	8.3	9.4	9.3
Net earnings (UBS)	-9.8	-15.7	19.2	20.8	-2.6	6.1	9.5	11.0
Net DPS	-5.7	-15.2	-28.6	50.0	0.0	8.3	7.7	0.0
Total assets (year end)	9.0	9.4	79.1	6.5	6.5	6.6	6.6	6.6
Customer loans	11.9	12.5	83.7	7.0	7.0	7.0	7.0	7.0
Customer deposits	13.4	9.6	92.9	7.0	7.0	7.0	7.0	7.0
Value (x)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Market cap/revenues	1.9	2.4	2.1	1.4	1.3	1.3	1.2	1.1
Market cap/deposits	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
P/PPOP (diluted)	3.5	4.6	4.2	3.3	3.2	3.0	2.7	2.5
P/E (local GAAP, basic)	6.6	9.7	8.5	7.8	8.0	7.5	6.9	6.2
P/E (UBS, diluted)	6.6	9.7	8.5	7.8	8.0	7.5	6.9	6.2
Net dividend yield %	2.7	1.8	1.3	2.1	2.1	2.2	2.4	2.4
P/BV x	0.7	0.8	0.6	0.7	0.6	0.6	0.5	0.5
P/BV (UBS) x	0.8	0.9	0.7	0.7	0.7	0.6	0.6	0.5

Source: Company accounts, UBS estimates. (UBS) metrics use reported figures which have been adjusted by UBS analysts.

Hana Financial Group

Maintain Neutral despite inexpensive valuation; we expect upside from delivery, not anticipation

Rated Neutral due to protracted realisation of synergies

We base our Neutral rating on Hana Financial Group (Hana) on our concerns about the lack of post-merger integration with Korea Exchange Bank (KEB), which Hana acquired in Q112. We believe Hana's agreement with the KEB labour union to operate two banks separately until early 2017 was correlated to Hana's cost-to-income ratio rising from 47% in 2006-11 to 57% in 2012-14. We believe investor disappointment is reflected in the share price, the weakest performer in the sector since 2012 (-18%).

Hana's steps towards earlier integration a positive

We believe management is also concerned about the situation. It has been emphasising the necessity of early integration of the two banks and taking constructive steps towards resolving the issues since July 2014. These initiatives include board resolutions on the merger of overseas subsidiaries and credit card operations and requesting regulatory approval.

However, re-rating likely only after earnings delivery

Despite management's moves in the right direction, we believe investors are unlikely to assign value to any potential synergies, and will wait until these materialise in earnings. The recent court order to temporarily halt the merger process will likely delay earnings contribution. Hana has missed consensus estimates in nine of 12 quarterly results since acquiring KEB in Q112 and this has also contributed to the loss in investor confidence.

Valuation: maintain Neutral rating, lower price target 20%

Reflecting our cautious sector view, we lower 2015E/2016E/2017E EPS 7%/17%/15%. We also lower our price target from Won40,000 to Won32,000 based on an ROE-g/COE-g implied 2015E target P/BV of 0.42x.

Equities

Korea
Banks, Ex-S&L

12-month rating **Neutral**

12m price target **Won32,000**
Prior: Won40,000

Price **Won29,400**

RIC: 086790.KS **BBG:** 086790 KS

Trading data and key metrics

52-wk range Won43,550-28,700

Market cap. Won8,523bn/US\$7.74bn

Shares o/s 290m (ORD)

Free float 89%

Avg. daily volume ('000) 927

Avg. daily value (m) Won28,971.8

Common s/h equity (12/15E) Won21,876bn

P/BV (12/15E) 0.4x

Tier 1 ratio 10%

EPS (UBS, diluted) (Won)

	From	To	% ch	Cons.
12/15E	4,301	4,007	-6.84	3,948
12/16E	4,589	3,822	-16.70	4,405
12/17E	4,937	4,178	-15.38	4,235

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Highlights (Wonbn)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Revenues	7,668	6,388	6,633	6,782	6,999	7,372	7,697	8,040
Profit before tax	2,193	1,270	1,253	1,563	1,493	1,631	1,845	1,979
Net earnings (local GAAP)	1,684	934	938	1,162	1,108	1,211	1,372	1,473
Net earnings (UBS)	1,684	934	938	1,162	1,108	1,211	1,372	1,473
Tier 1 ratio %	8.1	9.2	9.6	9.7	9.7	9.7	9.7	9.8
EPS (UBS, diluted) (Won)	6,987	3,221	3,235	4,007	3,822	4,178	4,733	5,080
Profitability/valuation	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
ROE (UBS) %	11.5	5.3	4.6	5.4	5.0	5.2	5.6	5.7
P/POP (diluted)	2.4	4.3	4.1	3.1	2.9	2.7	2.5	2.3
P/BV x	0.6	0.6	0.5	0.4	0.4	0.4	0.3	0.3
P/BV (UBS) x	0.6	0.6	0.6	0.4	0.4	0.4	0.4	0.3
P/E (UBS, diluted)	5.3	11.7	11.8	7.3	7.7	7.0	6.2	5.8
Net dividend yield %	1.2	1.1	1.0	1.6	1.6	1.7	1.9	2.1

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied. Valuations: based on an average share price that year, (E): based on a share price of Won29,400 on 02 Mar 2015 22:40 HKT

Investment Thesis

Hana Financial Group

Investment case

We maintain our Neutral rating on Hana based on protracted synergy creation with KEB (acquired in 2012). We believe Hana's agreement with the KEB labour union to operate two banks separately until early 2017 contributed to the rising cost-to-income ratio (47% in 2006-11 to 57% in 2012-14). We are positive on management's emphasis on the need for early integration between the two banks and its subsequent actions. We believe investors are unlikely to assign value to any potential synergies, and will wait until these materialise in earnings. Since the acquisition of KEB, Hana has missed consensus estimates in nine of 12 quarterly results, which has also resulted in a loss of investor confidence.

Upside scenario

Our base-case estimates for Hana are premised on: 1) NIM being affected by a 25bp Bank of Korea (BOK) rate cut in 2015E, 2) provisioning gradually increasing, from 55bp in 2015E to 64bp in 2017E, and resulting in a 5.4% sustainable ROE assumption and a 0.42x 2015E target P/BV. In our upside scenario, we assume 1) no BOK rate cut; 2) provisioning falling 5% in 2015-16E; 3) loans increasing 2% and resulting in 6.4% sustainable ROE, and leading to a 0.6x 2015E target P/BV, and a Won45,000/share valuation.

Downside scenario

In our downside scenario, we assume a sharp increase in credit costs for Korea banks (instead of the moderate rise in our base case). We assume Hana's provisioning yield rises 20% in 2015-16E. As a result sustainable ROE falls to 4.5% leading to a 0.26x 2015E target P/BV and a Won20,000/share downside scenario valuation.

Upcoming catalysts

Accelerated post-merger integration with aggressive cost-cutting measures should be a positive catalyst for Hana.

12-month rating

Neutral

12m price target

Won32,000

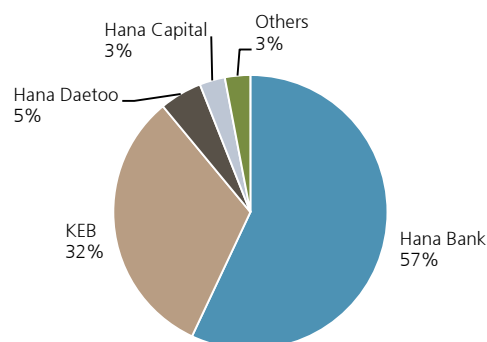
Business description

Hana Financial Group (Hana) is one of the largest financial groups in Korea, with total assets of Won295trn in 2013. Its key subsidiaries include Hana Bank, Korea Exchange Bank (acquired from Lone Star in 2012), Hana Daetoo Securities, Hana-SK Card, Hana Capital, and Hana Life Insurance. As of 2013, National Pension Services was the largest shareholder with a 9.95% stake.

Industry outlook

We believe the operating environment will remain challenging for the Korea banking industry. For the near term, we expect limited operating momentum, due to: 1) growth in rolled-over loans; 2) NIM further affected by rate cuts, 3) provisioning bottoming out after a seven-year low in 2014; partly offset by 4) improving SG&A. Considering similar macro conditions and the lack of competitiveness, we believe the Korea banks sector faces the risk of prolonged stagnation over the longer term, as has been the case in Japan since the 1990s.

Earnings by segment (2013)



Source: Company data

Hana Financial Group (086790.KS)

	12/12	12/13	12/14	12/15E	% ch	12/16E	% ch	12/17E	12/18E	12/19E
Profit & Loss (Wonbn)										
Net income interest	6,057	5,842	6,092	6,152	1.0	6,235	1.4	6,513	6,820	7,141
Total non interest income	1,611	546	541	630	16.5	763	21.1	860	877	899
Total income	7,668	6,388	6,633	6,782	2.2	6,999	3.2	7,372	7,697	8,040
Total cash expenses	(3,945)	(3,846)	(3,936)	(4,006)	-1.8	(4,085)	-2.0	(4,171)	(4,267)	(4,395)
Pre-depreciation operating profit	3,723	2,542	2,697	2,776	2.9	2,914	5.0	3,201	3,430	3,645
Depreciation & amort (excl. goodwill)	0	0	0	0	-	0	-	0	0	0
Operating profit pre provisions	3,723	2,542	2,697	2,776	2.9	2,914	5.0	3,201	3,430	3,645
Total provisions	(1,530)	(1,272)	(1,444)	(1,213)	16.0	(1,421)	-17.1	(1,570)	(1,586)	(1,666)
Operating profit post provisions	2,193	1,270	1,253	1,563	24.8	1,493	-4.4	1,631	1,845	1,979
Income from associates & JVs (pre-tax)	0	0	0	0	-	0	-	0	0	0
Other pre-tax items	0	0	0	0	-	0	-	0	0	0
Profit before tax (UBS)	2,193	1,270	1,253	1,563	24.8	1,493	-4.4	1,631	1,845	1,979
Exceptionals (incl goodwill)	0	0	0	0	-	0	-	0	0	0
Profit before tax	2,193	1,270	1,253	1,563	24.8	1,493	-4.4	1,631	1,845	1,979
Tax	(332)	(277)	(273)	(378)	-38.7	(361)	4.4	(395)	(446)	(479)
Profit after tax	1,860	993	980	1,185	20.9	1,132	-4.4	1,236	1,398	1,500
Other post-tax items	0	0	0	0	-	0	-	0	0	0
Preference dividends	0	0	0	0	-	0	-	0	0	0
Minorities	(176)	(59)	(42)	(23)	45.5	(24)	-4.4	(25)	(26)	(27)
Net earnings (local GAAP)	1,684	934	938	1,162	23.9	1,108	-4.6	1,211	1,372	1,473
Net earnings (before pref divs)	1,684	934	938	1,162	23.9	1,108	-4.6	1,211	1,372	1,473
Net earnings (UBS)	1,684	934	938	1,162	23.9	1,108	-4.6	1,211	1,372	1,473
Per share (Won)										
EPS (local GAAP, basic)	6,987	3,221	3,235	4,007	23.9	3,822	-4.6	4,178	4,733	5,080
EPS (UBS, diluted)	6,987	3,221	3,235	4,007	23.9	3,822	-4.6	4,178	4,733	5,080
PPOP (diluted)	15,445	8,768	9,302	9,575	2.9	10,052	5.0	11,041	11,832	12,574
Net DPS	450	400	388	481	23.9	459	-4.6	501	568	610
BVPS	64,419	67,722	71,846	75,464	5.0	78,805	4.4	82,524	86,756	91,267
BVPS (UBS)	57,593	62,696	67,258	70,674	5.1	73,804	4.4	77,302	81,301	85,570
Balance sheet (Wonbn)										
Banking assets (year end)	283,796	295,189	315,548	329,448	4.4	343,998	4.4	359,237	375,211	391,952
Banking assets (average)	231,016	289,492	305,368	322,498	5.6	336,723	4.4	351,617	367,224	383,582
Total assets (year end)	283,796	295,189	315,548	329,448	4.4	343,998	4.4	359,237	375,211	391,952
Risk weighted assets (RWA) (year end)	205,723	184,686	188,113	196,399	4.4	205,073	4.4	214,158	223,681	233,661
Risk weighted assets (RWA) (average)	168,500	195,204	186,399	192,256	3.1	200,736	4.4	209,615	218,919	228,671
Customer loans	198,786	205,773	216,086	227,095	5.1	238,664	5.1	250,823	263,601	277,031
Customer loans (average)	164,624	202,280	210,930	221,590	5.1	232,879	5.1	244,744	257,212	270,316
Interest earning assets (average)	217,386	269,839	285,714	302,996	6.0	317,244	4.7	332,178	347,833	364,243
Customer deposits	177,099	187,226	201,897	212,183	5.1	222,992	5.1	234,353	246,292	258,839
Common s/h equity (year end)	15,527	19,632	20,827	21,876	5.0	22,845	4.4	23,923	25,150	26,458
Common s/h equity (average)	14,657	17,579	20,230	21,352	5.5	22,361	4.7	23,384	24,537	25,804
Total SHF (equity, pref & MI) (year end)	20,460	20,890	21,894	22,966	4.9	23,958	4.3	25,061	26,314	27,649
Total SHF (equity, pref & MI) (average)	17,643	20,675	21,392	22,430	4.9	23,462	4.6	24,510	25,688	26,982
Net tangible assets	18,814	19,432	20,564	21,577	4.9	22,509	4.3	23,548	24,733	25,998
Balance sheet structure (%)										
Loans / banking assets (year end)	70.0	69.7	68.5	68.9	0.7	69.4	0.6	69.8	70.3	70.7
Deposits / banking assets (year end)	62.4	63.4	64.0	64.4	0.7	64.8	0.6	65.2	65.6	66.0
Loans / deposits	112.2	109.9	107.0	107.0	0.0	107.0	0.0	107.0	107.0	107.0
Total SHF / banking assets (year end)	7.2	7.1	6.9	7.0	0.5	7.0	-0.1	7.0	7.0	7.1

Source: Company accounts, UBS estimates. (UBS) metrics use reported figures which have been adjusted by UBS analysts.

Hana Financial Group (086790.KS)

Capital adequacy (Wonbn)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Tier 1 capital	16,760	17,069	18,122	19,009	19,831	20,744	21,781	22,886
Total capital	24,072	22,674	23,717	24,878	25,954	27,149	28,506	29,952
Risk weighted assets (RWA) (year end)	205,723	184,686	188,113	196,399	205,073	214,158	223,681	233,661
Core tier 1 ratio %	6.1	8.6	9.2	9.2	9.2	9.3	9.3	9.4
Tier 1 ratio %	8.1	9.2	9.6	9.7	9.7	9.7	9.7	9.8
Total capital ratio %	11.7	12.3	12.6	12.7	12.7	12.7	12.7	12.8
Tangible equity	13,882	18,175	19,497	20,488	21,395	22,409	23,569	24,806
Equity / assets %	5.5	6.7	6.6	6.6	6.6	6.7	6.7	6.8
Tangible equity to tangible assets %	4.9	6.2	6.2	6.2	6.2	6.3	6.3	6.4
Asset quality (Wonbn)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Non performing assets	2,866	3,291	3,119	3,136	3,155	3,175	3,194	3,214
Total risk reserves	2,389	2,176	2,123	2,244	2,386	2,543	2,702	2,869
NPLs / loans %	1.4	1.6	1.4	1.4	1.3	1.3	1.2	1.1
NPL coverage %	83.4	66.1	68.1	71.6	75.6	80.1	84.6	89.3
Provision charge / average loans %	0.9	0.6	0.7	0.5	0.6	0.6	0.6	0.6
Net NPAs / shareholders funds %	2.3	5.3	4.5	3.9	3.2	2.5	1.9	1.2
Profitability (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Net interest margin (avg assets)	2.62	2.02	1.99	1.91	1.85	1.85	1.86	1.86
Provisions / operating profit	41.1	50.0	53.5	43.7	48.8	49.1	46.2	45.7
ROE (UBS earnings)	11.5	5.3	4.6	5.4	5.0	5.2	5.6	5.7
RoAdjE (UBS earnings & equity)	12.3	5.8	5.0	5.8	5.3	5.5	6.0	6.1
RoRWA (UBS)	1.10	0.51	0.53	0.62	0.56	0.59	0.64	0.66
RoA (UBS earnings)	0.81	0.34	0.32	0.37	0.34	0.35	0.38	0.39
Productivity (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Cost income ratio	51.5	60.2	59.3	59.1	58.4	56.6	55.4	54.7
Cost / average assets	1.71	1.33	1.29	1.24	1.21	1.19	1.16	1.15
Compensation expense ratio	29.7	37.4	40.1	38.4	38.2	36.3	35.3	34.6
Growth (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Revenue	71.4	-16.7	3.8	2.2	3.2	5.3	4.4	4.5
Operating profit pre provisions	57.3	-31.7	6.1	2.9	5.0	9.8	7.2	6.3
Net earnings (UBS)	37.8	-44.5	0.4	23.9	-4.6	9.3	13.3	7.3
Net DPS	-25.0	-11.1	-3.0	23.9	-4.6	9.3	13.3	7.3
Total assets (year end)	59.2	4.0	6.9	4.4	4.4	4.4	4.4	4.5
Customer loans	52.4	3.5	5.0	5.1	5.1	5.1	5.1	5.1
Customer deposits	69.4	5.7	7.8	5.1	5.1	5.1	5.1	5.1
Value (x)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Market cap/revenues	1.2	1.6	1.7	1.3	1.2	1.2	1.1	1.1
Market cap/deposits	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0
P/PPOP (diluted)	2.4	4.3	4.1	3.1	2.9	2.7	2.5	2.3
P/E (local GAAP, basic)	5.3	11.7	11.8	7.3	7.7	7.0	6.2	5.8
P/E (UBS, diluted)	5.3	11.7	11.8	7.3	7.7	7.0	6.2	5.8
Net dividend yield %	1.2	1.1	1.0	1.6	1.6	1.7	1.9	2.1
P/BV x	0.6	0.6	0.5	0.4	0.4	0.4	0.3	0.3
P/BV (UBS) x	0.6	0.6	0.6	0.4	0.4	0.4	0.4	0.3

Source: Company accounts, UBS estimates. (UBS) metrics use reported figures which have been adjusted by UBS analysts.

Woori Bank

Upgrade to Neutral on valuation

Upgrade to Neutral after the steep correction

We upgrade Woori to Neutral as we believe its valuation has fallen sufficiently to reflect the unsuccessful privatisation attempt, which suggested that most investors are reluctant to pay a premium to the current share price. In December 2014, the government succeeded in selling 5.94% of its 56.97% stake in Woori Bank at a price of Won11,280/share, but the only acquirers were Woori's employees and corporate clients.

Changes required for upside potential

Under Korea Deposit Insurance Company's (KDIC) control, we think Woori has effectively played a policy bank role similar to that of state-owned Korea Development Bank by providing credit support to troubled large corporates—to save jobs and prevent bankruptcies. As a result, Woori's large corporate NPL ratio of 5% is double the industry average. While there could be cyclical improvements in Woori's NPL cycle (which has been a key reason when Woori outperformed peers), we believe the policy bank nature will limit room for a valuation premium. We believe separation of the policy bank role and "bad bank" exposure is a viable option to enhance the valuation and successfully privatise Woori.

Valuation inexpensive, but not inexpensive enough

With the merger of the holding company and bank in Q414, Won148bn annual interest expense for Won2.5trn hybrid capital (average 5.8% funding cost) will not be shown in Woori's P&L, although it does incur cash outflow (previously the majority was deducted as minority interest). Considering Woori's reliance on hybrid capital to supplement weak capital, we believe earnings and book value should be adjusted to determine the amount that is actually attributable to common equity shareholders. Based on our 2015E estimates Woori's current share price implies 0.34x P/BV and 6.5x PE on a reported basis, but 0.39x P/BV and 7.7x PE adjusting for hybrid capital.

Valuation: upgrade to Neutral, lower PT from Won12,000 to Won10,000

Reflecting our cautious sector view of 8bp lower NIM reflecting a 25bp policy rate cut in 2015E and 2) 5bp higher provisioning assumptions as well as adjustments on hybrid capital (-15% on EPS), we lower our 2015-17 EPS estimates 18% on average and our price target 17% based on 0.4x ex-hybrid 2015E P/BV.

Equities

Korea
Banks, Ex-S&L

12-month rating	Neutral
	<i>Prior: Sell</i>
12m price target	Won10,000
	<i>Prior: Won12,000</i>
Price	Won9,300
RIC: 000030.KS	BBG: 000030 KS

Trading data and key metrics

52-wk range	Won14,550-8,780
Market cap.	Won6,289bn/US\$5.85bn
Shares o/s	676m (ORD)
Free float	39%
Avg. daily volume ('000)	2,160
Avg. daily value (m)	Won21,050.0
Common s/h equity (12/15E)	Won18,621bn
P/BV (12/15E)	0.3x
Tier 1 ratio	11%

EPS (UBS, diluted) (Won)

	From	To	% ch	Cons.
12/15E	1,395	1,212	-13.12	1,513
12/16E	1,571	1,236	-21.30	1,700
12/17E	1,744	1,385	-20.61	1,752

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Highlights (Wonbn)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Revenues	8,367	7,486	4,890	5,583	5,701	5,984	6,293	6,616
Profit before tax	2,357	743	834	1,277	1,298	1,431	1,577	1,924
Net earnings (local GAAP)	1,634	(538)	1,214	968	984	1,085	1,195	1,458
Net earnings (UBS)	1,634	476	435	820	836	936	1,047	1,310
Tier 1 ratio %	9.1	10.1	10.7	10.6	10.5	10.5	10.6	10.7
EPS (UBS, diluted) (Won)	2,027	590	644	1,212	1,236	1,385	1,548	1,937
Profitability/valuation	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
ROE (UBS) %	9.2	2.7	2.6	4.5	4.4	4.7	5.1	6.1
P/POP (diluted)	2.1	2.8	4.3	2.3	2.2	2.0	1.9	1.8
P/BV x	0.5	0.6	0.5	0.3	0.3	0.3	0.3	0.3
P/BV (UBS) x	0.5	0.6	0.5	0.3	0.3	0.3	0.3	0.3
P/E (UBS, diluted)	5.7	20.6	19.3	7.7	7.5	6.7	6.0	4.8
Net dividend yield %	2.2	0.0	6.0	2.2	2.2	2.7	2.7	2.7

Source: Company accounts, Thomson Reuters, UBS estimates. Metrics marked as (UBS) have had analyst adjustments applied. Valuations: based on an average share price that year, (E): based on a share price of Won9,300 on 02 Mar 2015 22:40 HKT

Investment Thesis

Woori Bank

Investment case

We have a Neutral rating on Woori Bank as we believe its valuation has corrected sufficiently to reflect the failed privatisation attempt, which suggested that most investors are reluctant to pay a premium on the current share price. While there could be cyclical improvements in Woori's NPL cycle (which has been a key reason for Woori outperforming peers historically), we believe the policy bank nature will limit room a valuation premium. We believe separation of the policy bank role and "bad bank" exposure is a viable option to enhance valuation and successfully privatise Woori.

Upside scenario

Our base-case estimates for Woori are premised on: 1) NIM being affected by a 25bp Bank of Korea (BOK) rate cut in 2015E; and 2) provisioning bottoming out from 50bp in 2014E to an average 64bp in 2015-17E, and resulting in a 5.4% sustainable ROE assumption and a 0.42x 2015E target P/BV. In our upside scenario, we assume 1) no BOK rate cuts; 2) provisioning falls 10% in 2015-16E; 3) loan growth increases 2%; resulting in a 7.3% sustainable ROE, a 0.75x 2015E target P/BV, and a Won18,000/share valuation.

Downside scenario

In our downside scenario, we assume a sharp increase in credit costs for Korea banks (instead of the moderate rise in our base case). We assume Woori's provisioning yield rises 10% in 2015-16E. As a result, sustainable ROE falls to 4.7% leading to a 0.30x 2015E target P/BV and a Won7,000/share downside scenario valuation.

Upcoming catalysts

Lower credit costs, driven by improvements in troubled large corporate loans, could result in earnings upside for Woori. The annual large corporate restructuring may impact Woori's credit costs in the near term.

12-month rating

Neutral

12m price target

Won10,000

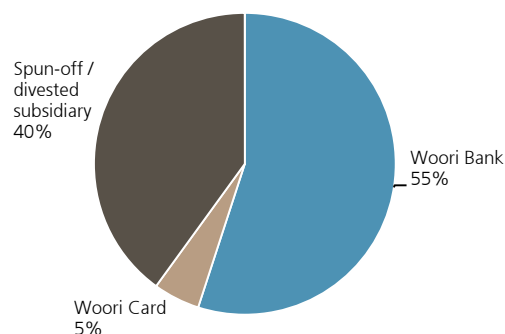
Business description

Woori Bank is one of the four largest financial companies in Korea, with around Won254trn in assets in Q314. Korea Deposit Insurance Corporation (KDIC, a government entity) is the largest shareholder with a 57% stake. Under KDIC's privatisation plans, Woori has divested most of its subsidiaries in 2014, notably Kwangju Bank, Kyoungnam Bank, Woori Financial, Woori Asset Management, Woori F&I, and Woori Investment & Securities. The remaining subsidiaries include Woori Bank, Woori Card, and a few minor entities.

Industry outlook

We believe the operating environment will remain challenging for the Korea banking industry. For the near term, we expect limited operating momentum, due to: 1) growth in rolled-over loans; 2) NIM further affected by rate cuts, 3) provisioning bottoming out after a seven-year low in 2014; partly offset by 4) improving SG&A. Considering similar macro conditions and the lack of competitiveness, we believe the Korea banks sector faces the risk of prolonged stagnation over the longer term, as has been the case in Japan since the 1990s.

Revenue by segment (2013)



Source: Company data

Woori Bank (000030.KS)

	12/12	12/13	12/14	12/15E	% ch	12/16E	% ch	12/17E	12/18E	12/19E
Profit & Loss (Wonbn)										
Net income interest	7,290	6,894	5,239	5,441	3.8	5,499	1.1	5,721	5,967	6,224
Total non interest income	1,076	592	(349)	142	-	202	42.5	264	327	392
Total income	8,367	7,486	4,890	5,583	14.2	5,701	2.1	5,984	6,293	6,616
Total cash expenses	(3,888)	(4,037)	(2,959)	(2,840)	4.0	(2,869)	-1.0	(2,903)	(2,943)	(3,032)
Pre-depreciation operating profit	4,479	3,449	1,931	2,743	42.0	2,833	3.3	3,081	3,350	3,584
Depreciation & amort (excl. goodwill)	0	0	0	0	-	0	-	0	0	0
Operating profit pre provisions	4,479	3,449	1,931	2,743	42.0	2,833	3.3	3,081	3,350	3,584
Total provisions	(2,122)	(2,706)	(1,097)	(1,466)	-33.6	(1,534)	-4.7	(1,650)	(1,773)	(1,660)
Operating profit post provisions	2,357	743	834	1,277	53.0	1,298	1.7	1,431	1,577	1,924
Income from associates & JVs (pre-tax)	0	0	0	0	-	0	-	0	0	0
Other pre-tax items	0	0	0	0	-	0	-	0	0	0
Profit before tax (UBS)	2,357	743	834	1,277	53.0	1,298	1.7	1,431	1,577	1,924
Exceptionals (incl goodwill)	0	0	0	0	-	0	-	0	0	0
Profit before tax	2,357	743	834	1,277	53.0	1,298	1.7	1,431	1,577	1,924
Tax	(509)	(35)	(288)	(309)	-7.2	(314)	-1.7	(346)	(382)	(466)
Profit after tax	1,849	708	546	968	77.2	984	1.7	1,085	1,195	1,458
Other post-tax items	0	(1,013)	779	148	-81.0	148	0.0	148	148	148
Preference dividends	0	0	0	0	-	0	-	0	0	0
Minorities	(215)	(232)	(111)	(148)	-33.7	(148)	0.0	(148)	(148)	(148)
Net earnings (local GAAP)	1,634	(538)	1,214	968	-20.3	984	1.7	1,085	1,195	1,458
Net earnings (before pref divs)	1,634	(538)	1,214	968	-20.3	984	1.7	1,085	1,195	1,458
Net earnings (UBS)	1,634	476	435	820	88.3	836	2.0	936	1,047	1,310
Per share (Won)										
EPS (local GAAP, basic)	2,027	(667)	1,796	1,431	-20.3	1,455	1.7	1,604	1,767	2,156
EPS (UBS, diluted)	2,027	590	644	1,212	88.3	1,236	2.0	1,385	1,548	1,937
PPOP (diluted)	5,557	4,280	2,856	4,056	42.0	4,189	3.3	4,556	4,954	5,300
Net DPS	250	0	750	200	-73.3	200	0.0	250	250	250
BVPS	22,958	21,925	26,592	27,535	3.5	28,602	3.9	29,816	31,149	32,867
BVPS (UBS)	22,411	21,381	26,155	27,077	3.5	28,125	3.9	29,319	30,630	32,326
Balance sheet (Wonbn)										
Banking assets (year end)	327,102	340,690	270,157	282,679	4.6	294,672	4.2	307,179	320,225	333,856
Banking assets (average)	319,953	333,896	305,424	276,418	-9.5	288,675	4.4	300,925	313,702	327,041
Total assets (year end)	327,102	340,690	270,157	282,679	4.6	294,672	4.2	307,179	320,225	333,856
Risk weighted assets (RWA) (year end)	213,228	200,978	146,501	153,291	4.6	159,795	4.2	166,577	173,652	181,044
Risk weighted assets (RWA) (average)	210,648	207,103	173,739	149,896	-13.7	156,543	4.4	163,186	170,115	177,348
Customer loans	254,094	269,085	226,362	237,424	4.9	248,045	4.5	259,140	270,732	282,842
Customer loans (average)	246,639	261,590	247,724	231,893	-6.4	242,735	4.7	253,592	264,936	276,787
Interest earning assets (average)	318,837	333,323	305,096	275,708	-9.6	288,098	4.5	300,490	313,421	326,915
Customer deposits	204,210	213,915	188,516	197,729	4.9	206,574	4.5	215,814	225,468	235,554
Common s/h equity (year end)	18,167	17,349	17,984	18,621	3.5	19,343	3.9	20,164	21,065	22,227
Common s/h equity (average)	17,701	17,758	16,581	18,302	10.4	18,982	3.7	19,753	20,615	21,646
Total SHF (equity, pref & MI) (year end)	23,003	22,877	18,093	18,731	3.5	19,453	3.9	20,274	21,175	22,337
Total SHF (equity, pref & MI) (average)	22,548	22,940	20,485	18,412	-10.1	19,092	3.7	19,863	20,725	21,756
Net tangible assets	22,570	22,447	17,798	18,422	3.5	19,130	3.8	19,938	20,825	21,972
Balance sheet structure (%)										
Loans / banking assets (year end)	77.7	79.0	83.8	84.0	0.2	84.2	0.2	84.4	84.5	84.7
Deposits / banking assets (year end)	62.4	62.8	69.8	69.9	0.2	70.1	0.2	70.3	70.4	70.6
Loans / deposits	124.4	125.8	120.1	120.1	0.0	120.1	0.0	120.1	120.1	120.1
Total SHF / banking assets (year end)	7.0	6.7	6.7	6.6	-1.1	6.6	-0.4	6.6	6.6	6.7

Source: Company accounts, UBS estimates. (UBS) metrics use reported figures which have been adjusted by UBS analysts.

Woori Bank (000030.KS)

Capital adequacy (Wonbn)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Tier 1 capital	19,438	20,309	15,655	16,210	16,838	17,553	18,338	19,349
Total capital	27,191	26,139	20,770	21,562	22,417	23,369	24,400	25,670
Risk weighted assets (RWA) (year end)	213,228	200,978	146,501	153,291	159,795	166,577	173,652	181,044
Core tier 1 ratio %	7.2	7.4	9.0	8.9	8.9	9.0	9.1	9.3
Tier 1 ratio %	9.1	10.1	10.7	10.6	10.5	10.5	10.6	10.7
Total capital ratio %	12.8	13.0	14.2	14.1	14.0	14.0	14.1	14.2
Tangible equity	17,734	16,919	17,688	18,312	19,020	19,828	20,715	21,862
Equity / assets %	5.6	5.1	6.7	6.6	6.6	6.6	6.6	6.7
Tangible equity to tangible assets %	5.4	5.0	6.6	6.5	6.5	6.5	6.5	6.6
Asset quality (Wonbn)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Non performing assets	3,883	6,568	4,309	4,309	4,309	4,309	4,309	4,309
Total risk reserves	3,819	4,377	2,992	3,138	3,292	3,457	3,634	3,800
NPLs / loans %	1.5	2.4	1.9	1.8	1.7	1.6	1.6	1.5
NPL coverage %	98.3	66.6	69.4	72.8	76.4	80.2	84.3	88.2
Provision charge / average loans %	0.9	1.0	0.4	0.6	0.6	0.7	0.7	0.6
Net NPAs / shareholders funds %	0.3	9.6	7.3	6.3	5.2	4.2	3.2	2.3
Profitability (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Net interest margin (avg assets)	2.28	2.06	1.72	1.97	1.90	1.90	1.90	1.90
Provisions / operating profit	47.4	78.5	56.8	53.4	54.2	53.6	52.9	46.3
ROE (UBS earnings)	9.2	2.7	2.6	4.5	4.4	4.7	5.1	6.1
RoAdjE (UBS earnings & equity)	9.5	2.7	2.5	4.6	4.5	4.8	5.2	6.2
RoRWA (UBS)	0.88	0.34	0.31	0.65	0.63	0.66	0.70	0.82
RoA (UBS earnings)	0.58	0.21	0.18	0.35	0.34	0.36	0.38	0.45
Productivity (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Cost income ratio	46.5	53.9	60.5	50.9	50.3	48.5	46.8	45.8
Cost / average assets	1.22	1.21	0.97	1.03	0.99	0.96	0.94	0.93
Compensation expense ratio	35.4	41.2	48.4	38.4	38.0	36.2	34.6	33.8
Growth (%)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Revenue	-9.3	-10.5	-34.7	14.2	2.1	5.0	5.2	5.1
Operating profit pre provisions	-17.8	-23.0	-44.0	42.0	3.3	8.8	8.7	7.0
Net earnings (UBS)	-24.2	-70.9	-8.5	88.3	2.0	12.0	11.8	25.1
Net DPS	0.0	-	-	-73.3	0.0	25.0	0.0	0.0
Total assets (year end)	4.6	4.2	-20.7	4.6	4.2	4.2	4.2	4.3
Customer loans	6.2	5.9	-15.9	4.9	4.5	4.5	4.5	4.5
Customer deposits	4.2	4.8	-11.9	4.9	4.5	4.5	4.5	4.5
Value (x)	12/12	12/13	12/14	12/15E	12/16E	12/17E	12/18E	12/19E
Market cap/revenues	1.1	1.3	1.8	1.1	1.1	1.1	1.0	1.0
Market cap/deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
P/PPOP (diluted)	2.1	2.8	4.3	2.3	2.2	2.0	1.9	1.8
P/E (local GAAP, basic)	5.7	NM	6.9	6.5	6.4	5.8	5.3	4.3
P/E (UBS, diluted)	5.7	20.6	19.3	7.7	7.5	6.7	6.0	4.8
Net dividend yield %	2.2	0.0	6.0	2.2	2.2	2.7	2.7	2.7
P/BV x	0.5	0.6	0.5	0.3	0.3	0.3	0.3	0.3
P/BV (UBS) x	0.5	0.6	0.5	0.3	0.3	0.3	0.3	0.3

Source: Company accounts, UBS estimates. (UBS) metrics use reported figures which have been adjusted by UBS analysts.

KB Financial Group Investment case

We base our Buy rating for KB Financial Group (KB) on our expectations of better-than-peers operating momentum, an improvement in corporate governance with new well-respected senior management, and a low base in 2014 (the negative impact of the KT ENS, Moneual and management incidents). For 2015, we expect the company to: 1) regain credit card market share lost in 2014; 2) improve cost-to-income, the result of baby-boomer attrition; and 3) use excess capital for the potential acquisition of a stake in LIG Insurance—a top 5 non-life insurer in Korea. We believe KB will outperform its peers in the long term due to its sector-strongest CET1 ratio of 13% (vs. the 9% peer average) which allows for a sustainable dividend. As in the case of Japan since the 1990s, we believe sustainable dividends will also result in a valuation premium in Korea.

Shinhan Financial Group Investment case

In the context of the Korea banking industry, where regulation and political influence are often discount factors, we believe having shareholder representatives on the board is an important premium valuation factor, as it should effectively balance shareholder interest with that of management and government. Of Shinhan's 12-member board, five directors are directly appointed by shareholders. We are positive on Shinhan's earnings stability too, as we expect: 1) limited downside from diminishing legacy NPL recoveries which currently are minimal; 2) 2015E SG&A growth to be contained at 2%, given the large early-retirement programme (ERP) in 2014; and 3) valuation gains of around Won400bn in VISA and MasterCard stakes, which could be used to offset potential one-off losses.

DGB Financial Group Investment case

We believe DGB's steep valuation discount to peers provides an attractive buying opportunity. Following the unexpected dilutive capital-raising in November 2014, the stock has underperformed its peers. Even after accounting for the dilution, we believe the current valuation implies an unjustifiable discount to the sector average, given its higher ROE (7.9% vs. the 6.1% peer average). However, we believe there are some uncertainties in DGB's fundamentals.

Industrial Bank of Korea Investment case

We believe IBK remains fundamentally well positioned in the sector as: 1) the government will likely ask IBK for a high dividend payout due to ongoing tax deficits; 2) the NIM trend will likely remain better than that of peers due to normalisation of lending rates to the average industry level and refinancing of SMIF (Small and Medium Industry Finance) bonds at lower funding costs; and 3) the lowest cost-to-income (44% in 2014) in the sector. However, IBK operates with tight capital of 8.2% CET1 and 12.4% total BIS, implying the distributable capital buffer for dividends could rapidly disappear if industry profitability deteriorates further. After its strong outperformance to peers and KOSPI, we believe IBK's valuation is now at a fair level and share price upside will be limited.

BS Financial Group Investment case

We maintain our Neutral rating on BS Financial (BS) mainly for its relatively high valuation to peers. We believe KNB's (acquired in Q414) operating performance will be a key swing factor in 2015E. KNB's profitability has deteriorated sharply in recent years, due mainly to the rise in cost-income (from 43% in 2011 to 58% in 2014); and 2) higher provisioning. However, as these could be viewed partly as kitchen-sinking before the acquisition, we think there is potential for KNB to turnaround in 2015; a turnaround would result in a revisit to our estimates.

Hana Financial Group Investment case

We maintain our Neutral rating on Hana based on protracted synergy creation with KEB (acquired in 2012). We believe Hana's agreement with the KEB labour union to operate two banks separately until early 2017 contributed to the rising cost-to-income ratio (47% in 2006-11 to 57% in 2012-14). We are positive on management's emphasis on the need for early integration between the two banks and its subsequent actions. We believe investors are unlikely to assign value to any potential synergies, and will wait until these materialise in earnings. Since the acquisition of KEB, Hana has missed consensus estimates in nine of 12 quarterly results, which has also resulted in a loss of investor confidence.

Woori Bank Investment case

We have a Neutral rating on Woori Bank as we believe its valuation has corrected sufficiently to reflect the failed privatisation attempt, which suggested that most investors are reluctant to pay a premium on the current share price. While there could be cyclical improvements in Woori's NPL cycle (which has been a key reason for Woori outperforming peers historically), we believe the policy bank nature will limit room a valuation premium. We believe separation of the policy bank role and "bad bank" exposure is a viable option to enhance valuation and successfully privatise Woori.

Statement of Risk

We believe the key risks for the Korean banking sector include yields, property prices and currency. 1) A further fall in yields will be negative for banks' interest margins. 2) Due to Korean households' high leverage to property, property price movements can have a significant impact on consumption and household loan asset quality. 3) Significant Won appreciation could negatively impact corporate asset quality and consumption.

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12-Month Rating	Definition	Coverage ¹	IB Services ²
Buy	FSR is > 6% above the MRA.	47%	37%
Neutral	FSR is between -6% and 6% of the MRA.	42%	32%
Sell	FSR is > 6% below the MRA.	11%	21%
Short-Term Rating	Definition	Coverage ³	IB Services ⁴
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

Source: UBS. Rating allocations are as of 31 December 2014.

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UBS Securities Pte. Ltd., Seoul Branch: Junho Lee.

Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
BS Financial Group	138930.KS	Neutral	N/A	Won14,600	02 Mar 2015
DGB Financial Group	139130.KS	Suspended	N/A	Won11,650	02 Mar 2015
Hana Financial Group	086790.KS	Suspended	N/A	Won29,400	02 Mar 2015
Industrial Bank of Korea ^{2, 4, 5}	024110.KS	Suspended	N/A	Won13,150	02 Mar 2015
KB Financial Group ¹⁶	105560.KS	Buy	N/A	Won37,600	02 Mar 2015
Shinhan Financial Group ¹⁶	055550.KS	Buy	N/A	Won42,200	02 Mar 2015
Woori Bank ^{5, 16}	000030.KS	Suspended	N/A	Won9,300	02 Mar 2015

Source: UBS. All prices as of local market close.

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