

---

**Briefing Note for shareholders on HFC and its impact on HSBC valuation, capital requirements and image**

**New York, 29<sup>th</sup> February 2008**

---

On Monday, HSBC is expected to announce excellent results for its core activities in Hong Kong and the emerging markets (in line with Standard Chartered) and will no doubt also announce that it is continuing with its efforts to contain losses at its HSBC Finance Corporation (“HFC”) subsidiary in the United States. The fact that HSBC has the world’s most profitable emerging markets franchise is, of course, not a surprise, and its good results in these markets should not distract investors’ attention from the fact that, were it not for the acquisition of HFC, HSBC’s share price would most likely be £2.00 to £ 3.00 per share higher than where it stands today. The true value of HSBC is not reflected in its share price largely because of investors’ concerns about the risk of sub-prime contagion. Knight Vinke has been calling for HSBC to dispose of this business, or at the very least to “ring-fence” it, since May 2007, and this note summarises some of the options which Knight Vinke has proposed to the Board and management over the past few months.

HSBC acquired Household International (now HFC) in 2003 for approximately \$ 15 billion. Unlike a bank, HFC has no access to consumer deposits and therefore finances its lending activities almost exclusively in the wholesale debt markets. As of 30<sup>th</sup> September 2007, HFC had approximately \$ 165 billion in tangible assets (i.e., loans) which were financed with approximately \$ 150 billion in debt (of which \$ 15 billion from HSBC), tangible shareholders’ equity of approximately \$ 10 billion and other liabilities of \$ 5 billion. HFC has booked over \$ 10 billion in loan impairment charges over the past four quarters and will certainly announce more when its Q4 results are published on Monday. The trend has been deteriorating steadily throughout 2007, in line with delinquency rates, as the US housing market has collapsed and Goldman Sachs (HSBC’s house broker) estimates that HSBC will have to write off at least \$ 10 billion of goodwill associated with the HFC acquisition and expects a further \$ 10 to 15 billion in loan impairment charges before the current downturn comes to an end.

HSBC’s decision to enter the sub-prime business in the United States was a catastrophic strategic error. This was a reflection of the Group’s obsession with the pursuit of geographic diversification instead of comparative advantage. The strategic pursuit of geographic diversification has only come to an end in the past few months (see strategy presentation made in October 2007). While it would certainly have made a great deal of sense for HSBC to acquire a major wealth management business in the United States, what it has today amounts to a business which lends to those least able to repay the loans made to them and one that is probably in terminal decline. In due course, the U.S. property market will come out of its current downturn, but we are of the view that lenders have now learned their lesson and that the sub-prime business which survives (if at all) will be a fraction of the industry which was spawned by the excesses of the past three years. This is clearly not a business which HSBC should own in the future, regardless of what management says, and the financial costs of downsizing it appear not yet to have been properly taken into account by the market. It also represents a huge distraction for management and may prevent HSBC from being able to acquire the sort of business which would really make a difference, strategically, during this time of opportunity.

What are HSBC’s options?

The most radical would be for HSBC to simply walk away from HFC and put the business into administration or receivership. This would result in HSBC losing its equity in HFC (and possibly its \$ 15 billion loan to HFC as well), but its shareholders would enjoy a huge value uplift from the removal of \$ 150 billion in HFC debt from the HSBC consolidated balance sheet (out of \$ 230 billion currently outstanding). HFC’s debt is not guaranteed by HSBC so any cash injection by HSBC to support HFC effectively amounts to the HSBC shareholders subsidising the HFC creditors (and the cash flow from highly rated Hong Kong being used to fund a worthless U.S. business). In practice, this would oblige HFC’s creditors to restructure their loans, cutting interest and converting part of their investment into equity (i.e., a “work-out” situation).

A second solution would be for HSBC itself to enter into negotiations with HFC's creditors to restructure this debt, much as it is doing with its Structured Investment Vehicles ("SIVs"). If successful, this would allow HFC to carry on as an HSBC subsidiary, but on a stand-alone basis with no further support from HSBC.

Thirdly, HSBC could recapitalise HFC by injecting \$ 10 to 15 billion in cash, say, or writing off its existing inter-company loan, and then selling the business to a third party (and we have reason to believe that there would be buyers at a price).

Finally, we have also suggested that HSBC could recapitalise HFC before listing it and spinning it off to its own shareholders. HSBC's shareholders would then benefit from the optionality which goes with being able to choose to retain their exposure to HFC (if this is what they want to do) or to sell their HFC shares, while retaining their shares in a sub-prime free (and much stronger) HSBC.

Each of these solutions would effectively build a firewall around HSBC's "toxic" sub-prime business and would result in greater focus and less distraction for HSBC's management. Most important, however, we believe that this would result in a massive re-rating of HSBC's shares due to the much greater weight of its emerging markets businesses within the overall portfolio.

Another, less obvious, consequence of walking away from HFC (or selling or spinning it off) would be that HSBC would see its Tier 1 capital ratio rise to over 10% at a time when most of its competitors are seeing erosion in their own ratios. In effect, if one excludes UBS (whose Tier 1 ratio is distorted by an unusual balance sheet structure), this would make HSBC the strongest of its peers in terms of capitalisation.

One issue which needs to be considered is the reaction of the regulators. Clearly, if HSBC were to allow HFC to default on its debts, this might compromise its ability to build a business in the United States in the near future and this needs to be taken into account (although we have every reason to believe that the US regulators are very market driven and regulators in other countries would be relieved at the strengthening of HSBC's balance sheet and the lower risk of contagion). This is why some of the other options may be preferable to walking away from HFC. Ultimately, however, HSBC is unlikely to be able to extricate itself from the decision to acquire Household without some pain.

The current crisis will result in many of the world's largest banks changing their business models and there will undoubtedly be winners and losers. HSBC was the first to identify the problems associated with sub-prime exposure. Its Board and management need to realise that the winners will be those banks that are ready to "grasp the nettle" and take remedial action when this is still possible, not those that were first to sound the alarm.

Knight Vinke Asset Management