KBC Group

Rating Change **BUY**

Equity | Belgium | Banks-Retail
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Merrill Lynch

A true asset gatherer

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Undervalued growth in KBC AM

We are upgrading KBC from Neutral to Buy with a €109 Price Objective. We think that the recent correction in the shares provides a good entry opportunity for investors. We see KBC as an asset gatherer which has been very successful at growing its FUM and exporting its model. We think that the value of KBC Asset Management (KBC AM) is hidden by the divisional reporting structure. Within the 'Belgium' division of KBC is an asset manager which is growing FUM at ~20% per annum, delivering pretax profit margins which compare with best in class alternative asset managers, and opening up growth opportunities in CEE and Asia.

Acquisitions are regearing the balance sheet

Aside from the KBC AM story, we believe that KBC is well positioned to deliver strong performance through the next twelve months as recent acquisitions start to drive top line growth, the share buyback boosts EPS growth, and fears over CDO exposure are quantified and recede. In particular, we would highlight that Absolut Bank, the recent Russian acquisition, will be included with results in 3Q. We believe that the creation of a new 'Russia' division, along with increased disclosure, should help the market focus on the added momentum recent acquisitions are giving to KBC's earnings in the year ahead.

Estimates (Dec)

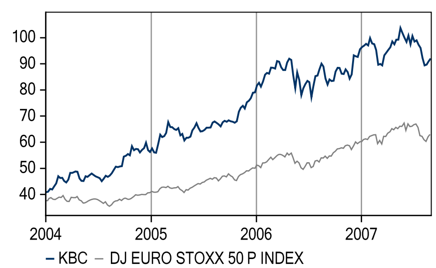
(EUR)	2005A	2006A	2007E	2008E	2009E
	IFRS	IFRS	IFRS	IFRS	IFRS
Net Profit	2,303	2,557	2,933	3,031	3,320
EPS (Adjusted)	6.40	7.22	8.51	9.05	10.18
Dividend / Share	2.51	3.31	3.57	3.80	4.27
Adjusted NAV PS	40.9	45.0	45.9	49.5	53.7

Valuation (Dec)

	2005A	2006A	2007E	2008E	2009E
Adjusted P/E	14.4	12.7	10.8	10.2	9.0
EPS Change (YoY)	42.7%	12.8%	17.9%	6.37%	12.5%
Price / BV	2.02x	1.80x	1.76x	1.64x	1.52x
Price / NAV	2.16x	1.96x	1.93x	1.79x	1.65x
Net Yield	2.84%	3.74%	4.04%	4.30%	4.83%
DPS Change (YoY)	36.4%	31.9%	7.95%	6.37%	12.5%
Price / GOP	9.26x	8.39x	7.44x	6.47x	5.70x

Stock Data

Price	EUR92.02
Price Objective	EUR109.00
Date Established	4-Sep-2007
Investment Opinion	A-2-7 to A-1-7
Volatility Risk	LOW
52-Week Range	EUR80.15-EUR106.24
Mrkt Val / Shares Out (mn)	EUR31,236 / 339.4
Average Daily Volume	1,012,056
ML Symbol / Exchange	KBCSF / ENB
Bloomberg / Reuters	KBC BB / KBKBt.BR
ROE (2007E)	17.1%
Total Dbt to Cap (Dec-2006A)	0%
Est. 5-Yr EPS / DPS Growth	12.0% / 12.0%
Free Float	49.0%



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Key Income Statement Data (Dec)	2005A	2006A	2007E	2008E	2009E
(EUR Millions)	IFRS	IFRS	IFRS	IFRS	IFRS
Net Interest Income	3,857	4,072	4,358	4,708	5,094
Net Fee Income	1,942	2,010	2,080	2,263	2,421
Securities Gains / (Losses)	1,304	1,466	1,345	1,392	1,478
Other Income	4,345	4,100	4,341	4,605	4,895
Total Non-Interest Income	7,591	7,576	7,766	8,261	8,793
Total Operating Income	11,448	11,648	12,125	12,969	13,887
Operating Expenses	(7,922)	(7,878)	(7,987)	(8,344)	(8,778)
Pre-Provision Profit	3,527	3,770	4,137	4,625	5,110
Provisions Expense	(53.3)	(173)	(205)	(386)	(467)
Operating Profit	3,473	3,597	3,932	4,239	4,642
Non-Operating Items	17.2	46.0	70.0	69.0	69.0
Pre-Tax Income	3,491	3,643	4,002	4,308	4,711
Net Income to sh/holders	2,303	2,557	2,933	3,031	3,320
Adjusted Cash Earnings	2,303	2,557	2,933	3,031	3,320
Key Balance Sheet Data					
Total Assets	325,801	325,400	372,311	398,826	426,952
Average Interest Earning Assets	289,700	307,641	330,490	366,903	393,364
Weighted Risk Assets	117,441	128,951	147,541	158,048	169,195
Total Gross Customer Loans	119,475	132,231	151,294	162,069	173,498
Total Customer Deposits	171,572	180,031	200,525	209,258	218,377
Tier 1 Capital	11,065	11,252	12,579	13,159	13,748
Tangible Equity	15,104	16,102	15,961	16,736	17,680
Common Shareholders' Equity	15,751	17,219	17,078	17,853	18,797
Key Metrics					
Net Interest Margin	1.33%	1.32%	1.32%	1.28%	1.30%
Tier 1 Ratio	9.42%	8.73%	8.53%	8.33%	8.13%
Effective Tax Rate	28.7%	25.6%	23.5%	26.4%	26.2%
Loan / Assets Ratio	36.0%	40.2%	40.0%	40.0%	40.0%
Loan / Deposit Ratio	68.4%	72.6%	74.2%	76.2%	78.2%
Oper Leverage (Inc Growth - Cost Growth)	10.5%	2.30%	2.70%	2.50%	1.88%
Gearing (Assets / Equity)	20.7x	18.9x	21.8x	22.3x	22.7x
Tangible Equity / Assets	4.64%	4.95%	4.29%	4.20%	4.14%
Tangible Equity / WRAs	12.9%	12.5%	10.8%	10.6%	10.4%
Business Performance					
Revenue Growth	-7.17%	1.74%	4.09%	6.96%	7.08%
Operating Expense Growth	-17.6%	-0.55%	1.39%	4.46%	5.20%
Provisions Expense Growth	-85.4%	225%	18.7%	87.8%	21.2%
Operating Revenue / Average Assets	1.14%	1.10%	1.13%	1.10%	1.12%
Operating Expenses / Average Assets	-2.59%	-2.42%	-2.29%	-2.16%	-2.13%
Pre-Provision ROA	1.15%	1.16%	1.19%	1.20%	1.24%
ROA	0.75%	0.79%	0.84%	0.79%	0.80%
Pre-Provision ROE	25.1%	22.9%	24.1%	26.5%	27.9%
ROE	16.4%	15.5%	17.1%	17.4%	18.1%
RoTE	17.1%	16.4%	18.3%	18.5%	19.3%
RoWRAs	2.15%	2.08%	2.12%	1.98%	2.03%
Dividend Payout Ratio	39.2%	45.9%	42.0%	42.0%	42.0%
Efficiency Ratio (Cost / Income Ratio)	69.2%	67.6%	65.9%	64.3%	63.2%
Quality of Earnings					
Total Non-Interest Inc / Operating Inc	66.3%	65.0%	64.1%	63.7%	63.3%
Market-Related Revenue / Total Revenues	23.7%	23.2%	23.5%	23.4%	22.3%
Provisioning Burden as % of PPP	1.51%	4.59%	4.96%	8.34%	9.15%
NPLs plus Foreclosed Real Estate / Loans	2.43%	1.70%	2.34%	2.34%	2.34%
Loan Loss Reserves / NPLs	72.2%	69.4%	70.0%	70.0%	70.0%
Loan Loss Reserves / Total Loans	1.75%	1.18%	1.64%	1.64%	1.64%
Provisions Expense / Average Loans	0.05%	0.14%	0.15%	0.25%	0.28%

Company Description

KBC is a Belgian bancassurer. It has a 22% share of the Belgian banking and life insurance markets, and a 9% share in non life insurance. It also operates in Central Europe, where it has leading positions in the Czech Republic and Hungary, as well as signifcant share in Poland and Slovakia. KBC was formed in 1998 following the merger of three Belgian financial institutions, and in 2005 it merged with its parent company, Almanij.

Stock Data

Price to Book Value	1.8x

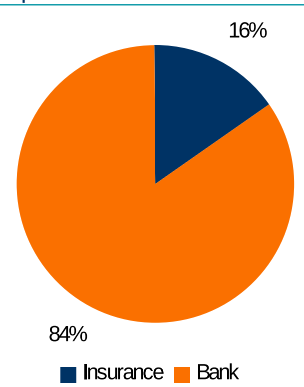
KBC: a true asset gatherer

- **We are upgrading KBC from Neutral to Buy with a €109 Price Objective. We think that the recent correction in the shares is the right entry opportunity for investors.**
- **We see KBC as an asset gatherer which has been very successful at growing its FUM and exporting its model.**
- **We think that the value of KBC Asset Management (KBC AM) is hidden by the divisional reporting structure. Within the 'Belgium' division of KBC is an asset manager which is growing FUM at ~20% per annum, delivering pretax profit margins which compare with best in class alternative asset managers, and opening up growth opportunities in CEE and Asia.**
- **Aside from the KBC AM story, we believe that KBC is well positioned to deliver strong performance through the next twelve months as recent acquisitions start to drive top line growth, the share buyback boosts EPS growth, and fears over CDO exposure are quantified and recede.**
- **In particular, we would highlight that Absolut Bank, the recent Russian acquisition, will be included with results in 3Q. We believe that the creation of a new 'Russia' division, along with increased disclosure, should help the market focus on the added momentum recent acquisitions are giving to KBC's earnings in the year ahead.**
- **The most material risk to our view comes from KBC's CDO exposure, which will suffer a mark to market impact in 3Q.**

Insurance: significant share of earnings, and market

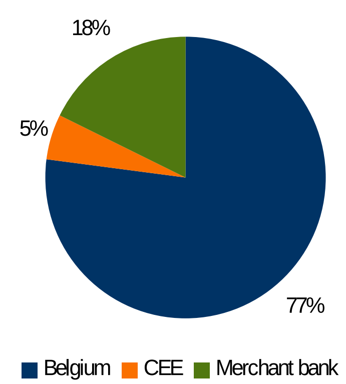
Insurance represented about 16% of KBC group profits in 2006 but in the first half of 2007 this has risen to 35%, thanks to some capital gains booked in 2Q, as well as good underlying progress in CEE in particular. Belgium is by far the largest contributor to the insurance book, but CEE is growing fast, and has moved to 9% of profits in the first half of 2007.

Chart 1: KBC split of profits 2006



Source: Company

Chart 2: Insurance net profit by division 2006



Source: Company

In 2005 (the latest data we have for the whole market) KBC was the number one life insurer in Belgium, and the number five in non-life. We think that since then Fortis has regained some market share, and taken back top slot.

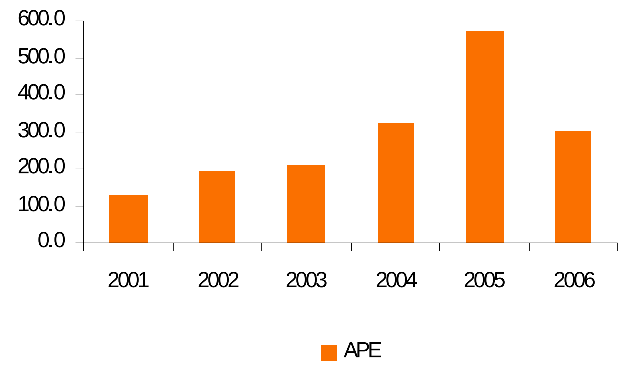
Table 1: Belgian Insurance market share

		Total	Non-life	Life
1	Fortis	19.6%	15.7%	20.9%
2	KBC	18.8%	9.0%	22.2%
3	Ethias	15.1%	13.5%	15.6%
4	AXA	12.5%	16.8%	11.0%
5	Dexia	7.3%	4.2%	8.4%

Source: Assuralia (2005 data, latest available)

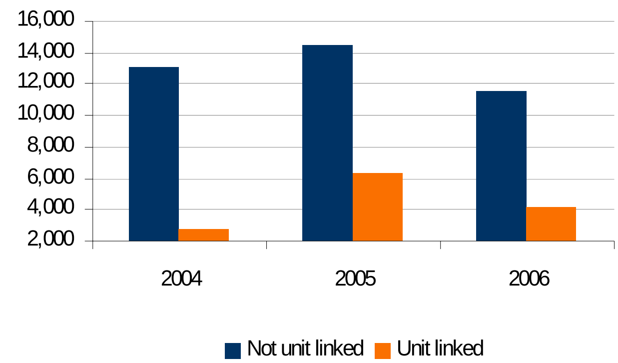
KBC's position in 05 came thanks to a surge in sales in unit linked products, which it was marketing aggressively during this period (chart, left). This pickup in unit linked sales was felt in the market as a whole as well (chart, right). It was related to tax changes in Belgium, when a 1.1% tax on buying life insurance products was introduced as of the beginning of 2006 . This sales surge has subsequently slowed down, and it led to a headwind for KBC in 2006 and 2007 in terms of year over year comparisons. The biggest surge in sales came in the unit linked products.

Chart 3: KBC APE (€m)



Source: Company

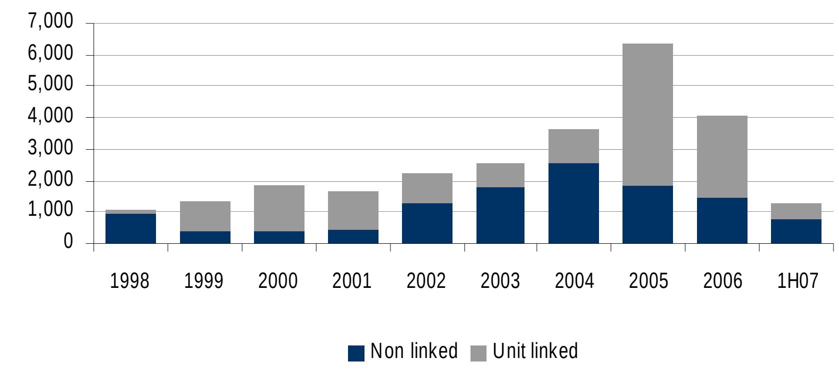
Chart 4: Market Gross Written Premiums (€m)



Source: Assuralia

So far in 2007 premiums in non-unit linked products are up 10%, but KBC commented at 2Q07 that growth in unit linked products has continued to slow. We suspect that this is in part thanks to more volatile equity markets, and in part to higher rates being offered on bank deposits. The mix has clearly shifted sharply back from unit linked to non–unit linked. So far this year, unit linked represents 41% of sales versus its peak of 75% in 2005.

Chart 5: Gross written premiums (€m)



Source: Company

KBC– the most integrated bancassurance model

In some ways, we believe **KBC has embraced the concept of bancassurance more completely than any other bank**. It continually stresses that the group is agnostic between selling life insurance products, bank deposits and mutual funds. The distribution of its unit linked products – 99% through the branch network - is probably the best example why life insurance can be considered a banking product in Belgium. As the branches shifted towards selling unit linked product, they moved away from selling non-linked products, which accounts for the decline in share evidenced in the chart below.

Table 2: KBC distribution in bank branches

Sold via bank channel	2003	2004	2005	2006
Non linked business	75.3%	81.5%	67.0%	54.0%
Unit linked business	98.1%	98.5%	99.0%	99.0%
Non life	10.2%	10.8%	11.0%	12.0%

Source: Company

About 10% of branch staff are dedicated to selling insurance products. Sales people are incentivised on increases in branch level profitability, including volumes of product sold.

KBC reporting makes business sense, but tough to use

In line with its bancassurance philosophy, **KBC now reports its divisions as integrated units** (it changed from a bank / insurance split in 2006). This means that the divisional P&L’s are each individually created as bancassurance models, with all the ‘noise’ that this entails:

- The top line is confused by gross earned premiums, which includes both non-unit linked products and non-life business;
- Gains in the insurance portfolio are reported as gains on AFS assets;
- Technical charges, which reflect the changes in liabilities and claims at the insurance business, come through the P&L as a separate line item;
- Unit linked products only get included in the commission income (no earned premium / technical charge).

All of this creates some significant divisional noise which makes it tricky to track growth at the bank or the insurance businesses at a divisional level. KBC does report the bank and the insurance companies separately in the notes to the accounts, but these conflate all the divisional items (for example the Retail bank and the Merchant bank are lumped together), so they are less helpful when thinking about underlying trends.

EV is not all – inclusive

In addition to the divisional confusions, KBC's embedded value contains some issues which need to be borne in mind:

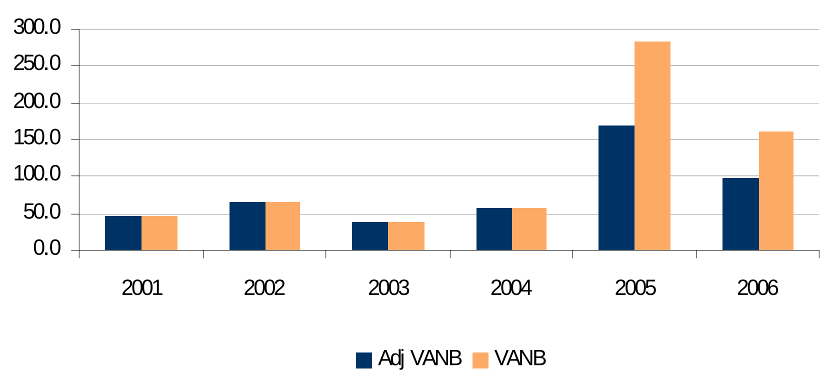
- The EV does not include the VIF of the CEE insurance business. Excluding this means that the value in force numbers cover 90% of insurance inflows and 95% of reserves. **We believe that KBC will soon include CEE in its EV, perhaps in 2008**.

- Confusingly, the EV does include the net assets of the CEE business, as well as the non-life business.

- The 'value of new business' (VANB) reported with the EV includes a share of the profit made on insurance products by the asset management company. This exacerbated the jump in VANB in 2005 caused by the strong APE sales noted above. We believe that in valuing the business it is important to strip this out because otherwise the asset manager profits are double counted. Based on company guidance, we assume that 38% of the VANB is related to the asset management portion.

- Lastly, we need to adjust the VIF for the asset management portion of profits, again to avoid double counting. The company has said that €300m of VIF is related to asset manager profits, so we strip this out.

Chart 6: Adjusting the VANB is important to avoid double counting (m)

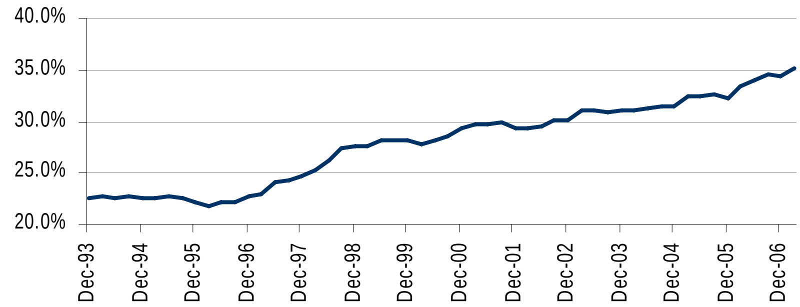


Source: ML Research, Company

Asset management – a very profitable business

We believe that KBC's asset management (KBC AM) division is highly **profitable and delivering strong growth**. Fund under management (FUM) grew by 17% in 2006, and 11% so far in 2007. It has continued to take share in the Belgian market, rising to over 35% in the first quarter of 2007.

Chart 7: KBC AM market share in Belgium



Source: BeAMA

Until 2005, KBC AM was reported as a separate unit. With a divisional reorganisation in 2006, however, it was folded into the Belgium business unit. At the same time, however, KBC AM has seen a dramatic acceleration in FUM growth and margin, which we believe the divisional reorganisation has hidden.

Structured products are the focus

KBC AM presented a detailed overview of their business at the company's investor day last year, which we use this as a basis for our work here. The main features of KBC AM's strategy are:

- **Capital guarantees**: KBC AM has grown its capital guarantee significant over the last few years as demand for these products has picked up (see chart below);

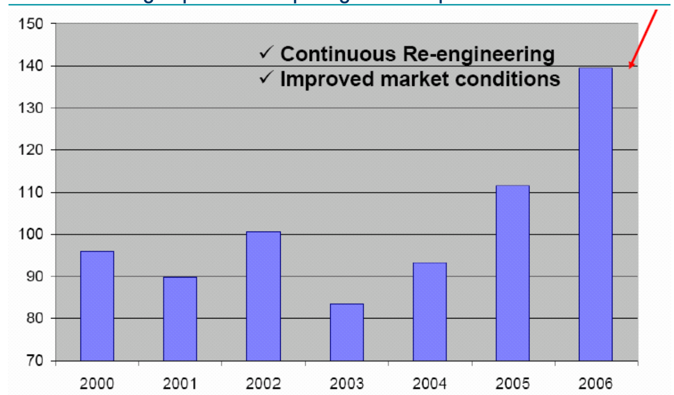
- **Simple branch sold products**: KBC AM works with the branch network to create products which respond to customer needs. These might be quite complex in design, but the end product will have a simple sales message for branch staff to deliver. There is clearly a symbiotic relationship between the branches and KBC AM – the good products have helped the branches make sales, but the distribution capabilities of KBC's branches are indispensable for KBC AM.

- **Impressive margins**: owing to the size of its funds under management, and its expertise in structuring, KBC argues that it can maintain very low costs and good revenues to deliver a margin of about 140bps on a structured product. Moreover, this has improved in recent years, thanks to higher interest rates and a bigger asset base. There was a particularly big jump in 2006.

Chart 8: Capital guarantee funds (yellow) as % of total

Source: Company

Chart 9: Average spread on capital guarantee product



Source: ML Research

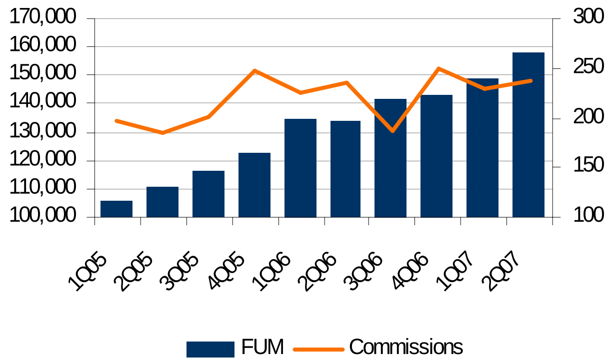
Reporting obscures the growth in KBC AM

We believe KBC's divisional reporting obscures the growth in KBC's Asset Management. This is in contrast to each of the other bancassurers, which report their asset management divisions separately, and we think it is to the detriment of KBC, because KBC AM is delivering strong growth in FUM and good margins.

The problem for KBC AM in Belgium is that their strong growth in FUM is not fully reflected in the P&L owing to the other moving parts in the Belgium division. We show below that FUM grew 18% in over the last year (2Q07 vs 2Q06), but commission growth in Belgium was only 1% in this period. We think that the slower growth in unit linked insurance products is masking high growth in KBC AM commission income (chart, left).

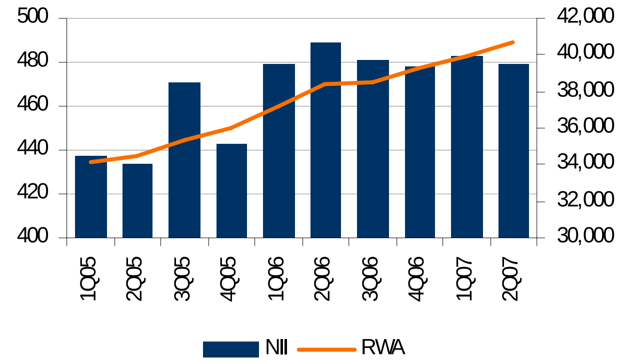
In addition, we believe that the banking business of KBC in Belgium has been holding back divisional growth. NII has been flat in Belgium over the last year, despite growth in RWAs (chart, right) as competitive pressure has impacted lending spreads; mix shift / the flat yield curve have held back deposit margins; and the upstreaming of capital to fund KBC's acquisitions and share buybacks has increased interest cost. See in this light, **the asset management's success is hidden in the Belgium division by a bank under margin pressure and a cyclically challenged insurance business**.

Chart 10: FUM growing ahead of commissions (€m)



Source: ML Research, Company

Chart 11: RWA growing ahead of NII (€m)



Source: ML Research, Company

Modelling Asset Management in Belgium

At its investor day last year, KBC gave some useful disclosure on the income generated by KBC AM. We have used this as the basis to create a separate model for the business, in order to value it separately.

KBC AM generated ~€985m of income in 2006 according to the disclosure. Of this, €286m was in the form of distribution fees (ie the product entry commission payment), which in our view should properly be assigned to the bank, not the asset manager. We focus therefore on the €645m of management income, which represents 47bps of average AUM. We grow average AUM by 12% in 07 and 08, which is very conservative, given that assets already grew 11% in 1H07. We assume that margins stay flat, which is also conservative given the comments made above regarding structured product margins.

Management also gave some cost numbers associated with KBC AM, of which the most eye catching was the very low 'management costs' line at just €46m in 2006. This includes all of the costs of creating and running the products, and the fact that it is so low is a reflection of the chart we showed above regarding low production costs. What KBC did not show in their analysis was a cost of distribution for their products. The majority are sold through the branches, and the cost is simply borne by the branch network. However, to value KBC Asset Management, we need to assume a portion of these branch costs are allocated to it. We have assumed 25% of total revenues would be the cost if distribution were done through third parties. This is in line with other asset managers (eg Invesco) which distribute through third parties.

The result implies a pre-tax profit margin of 68%, which seems high. However, when compared to other listed alternative asset managers, it seems less out of line: Man Group generates 66% operating margins and Partners Group 65%. In 2005, when Asset Management was reported as a separate unit, it reported a pre-tax profit margin that was even higher, at 85% (although this of course was excluding distribution fee estimates).

Table 3: Estimating KBC AM net profit

€m	2006	2007	2008
Av AUM	138,159	154,738	173,307
Management income	645	722	809
as % of AUM	0.47%	0.47%	0.47%
Admin fees	30	30	30
Total income	675	752	839
Management costs	(46)	(53)	(61)
Admin costs	(31)	(31)	(31)
Distribution costs (at 25%)	(161)	(181)	(202)
Pretax profit	437	488	545
Tax	(118)	(132)	(147)
Net income	319	356	398

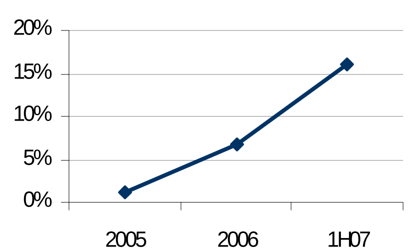
Source: ML Research

In 2005, the old Asset Management division delivered €286m of net income, so our estimate of €319m in 2006 would be 11% ahead of 05, which does not seem aggressive to us. Overall, our 2008E net income implies a CAGR of 12%, which is also relatively conservative in our view.

One last point to note is that these asset management income numbers **include income from CEE** and some other funds which KBC white labels. These latter are generally structured products which KBC AM sells to other banks around the world, notably in China. The white labelled funds have grown quickly, and we believe they are now around €4bn. So **the Belgium division includes the asset management income from the fast growing emerging market funds**, a fact which should be considered when assigning a multiple to the division.

CEE – the long term opportunity

Chart 12: Insurance as % of CEE net income



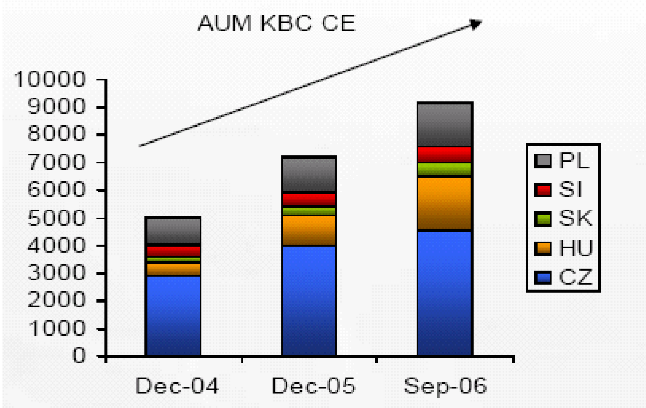
Source: Company

The insurance and asset management businesses in CEE are growing quickly. In the first half of 2007 – in spite of the impact of severe weather on the non-life business – insurance grew to over 15% of CEE profits, and assets under management in CEE were up 40% yoy. **We think CEE represents an exciting part of the future growth for KBC as an asset gatherer**.

KBC believes there are three levels of bancassurance: non-exclusive distribution; exclusive distribution; and integrated distribution. The latter involves the bank and the insurance company working together under unified governance, with integrated distribution channels, centralised IT and streamlined remuneration schemes. Clearly Belgium is already in 'level 3' and the challenge for KBC over the next several years will be to ensure that CEE delivers on the model as well. Over 50% of life insurance sales already come from the branch network, a number management intends to grow each year.

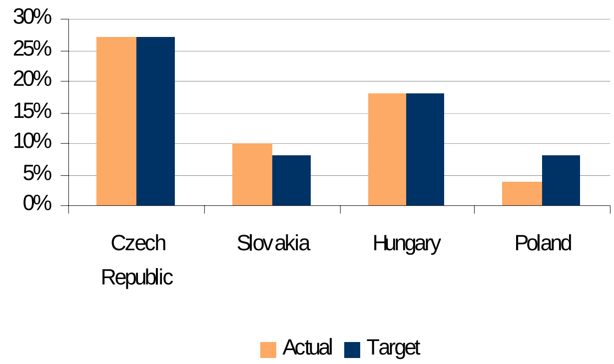
There are encouraging signs of progress already in CEE. FUM has grown dramatically over the last several years, and continued on a strong trajectory in 2007 (chart, left). KBC says that it wants its asset management division to target 150% of its bank market share, which is where the group is in Belgium. Given the bank market shares, it is clear that the group has already reached and even exceeded its targets in all of its territories except Poland. Indeed **recent data suggest that market share in the Czech Republic has improved from 27.2% at year end to 28.3% in 2Q07.**

Chart 13: FUM growth since 2004; 2Q07 was €11.1bn



Source: Company

Chart 14: Asset management – 2006 actual and target market share

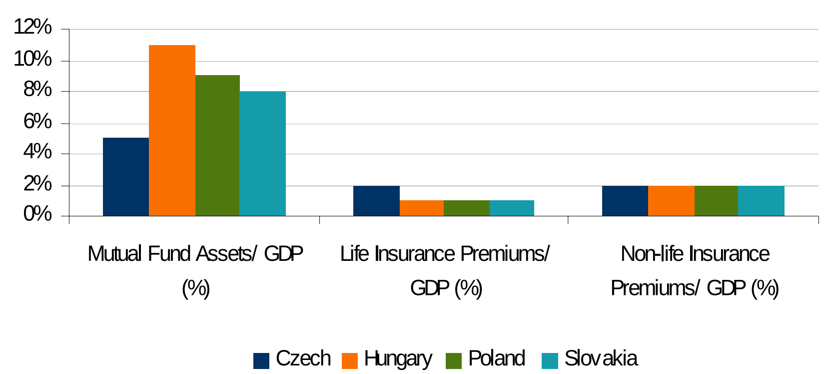


Source: Company

Of course, **these market share targets are not upper limits, and it is very possible that if it continues on its current trajectory KBC can significantly exceed them**. The expected increase in the number of CEE branches from 843 to 1,106 will also provider a kicker to growth, as it should lift banking share as well.

However, much of the growth will be delivered via the overall market growth. We show below the current penetration levels of various products in CEE, which we think will continue to rise in the years to come. As a point of reference, in the UK mutual funds are 25% of GDP and life insurance premiums 9%; Germany funds are 11% and insurance is 7%.

Chart 15: Penetration of mutual fund / insurance products



Source: Central Banks

Putting together prospective GDP growth rates, assumed increases in product penetration, potential for market share gain, and market appreciation, it is possible to build a model for FUM growth at CEE over the next few years. The result shows that **we believe an incremental €6.1bn in FUM in next 3 years is very possible for CEE, representing 30% growth per annum**.

Table 4: FUM growth should be 30% pa for the next several years in CEE

Change per annum	GDP growth	Product penetration	Market share gain	Market impact
Czech Republic	5.4%	0.5%	0%	5%
Slovakia	7.9%	1%	0%	5%
Hungary	2.7%	0%	0%	5%
Poland	6.8%	1%	1%	5%
FUM €bn	2006*	2007	2008	2009
Czech Republic	4.2	5.1	6.2	7.5
Slovakia	2.3	2.9	3.7	4.7
Hungary	0.6	0.6	0.7	0.7
Poland	1.7	3.2	3.5	4.0
Other	1.0	2.0	3.0	4.0
Total	9.8	13.8	17.1	20.9

Source: ML Research. Note: 2006 breakdown estimated

The benefit of growth in the FUM will be split between the Belgium division and CEE:

- Belgium will receive the incremental management commission on the FUM – using the run rate of 0.45%, this implies extra commission of €17m in 2009 versus 2006;

- CEE will receive the distribution fees from the sale of these products. Assuming the same ratio of distribution fees / AUM, this is an incremental €36m to the CEE commission line in 2008 and €43m in 2009.

This split of the income line is confusing, and we believe KBC will remedy it at some point. However, for now it means that **the value of a growing CEE fund business accrues to both the Belgium division and the CEE division**. This should be reflected in the multiples assigned, in our view.

Earnings will accelerate in other areas too

Recently acquired business will boost the latter part of 07

Since it embarked on a shopping spree at the end of 2006, KBC has spent close to €1bn on a series of acquisitions. The majority of these deals have been small, but the cumulative effect of them should be felt as they are consolidated into the business.

The most notable deal has been the acquisition of Absolut Bank in Russia, for €723m (for 95%). **We believe that Absolut will be consolidated in 3Q and that it will be a separately disclosed sub-sector in CEE called 'Russia'**. We do not have a detailed model of Absolut, owing to the lack of disclosure so far. However, we know that it made €20m in 2006, and KBC is targeting €76m in 2011. Based on this data, we can make the rough estimate that at the time of consolidation, Absolut should add around €10m a quarter to the group in net profit, or 6% to our CEE numbers. Some of this benefit is offset by increased interest expense, which is being felt at a group wide level. But, **we believe that the creation of a new 'Russia' division, along with increased disclosure, should help the market focus on the added momentum these deals are giving to KBC's earnings in 3Q and 4Q**.

Table 5: KBC's acquisition spree should add to earnings in the latter part of 2007

Date	Target	Country	Activity	Price	Date of consolidation
15-Dec-06	Romstal Leasing	Romania	Leasing	€70m	2Q
20-Dec-06	CSOB (7.5%)	Czech / Slovak Republics	Banking	€100m	2Q
21-Dec-06	Swiss Capital	Romania	Brokerage	n/a	3Q
03-Jan-06	A Banka	Serbia	Banking	€96.5m	2Q
11-Jan-06	Equitas	Hungary	Brokerage	n/a	4Q
30-Jan-07	DZI Insurance (70%)*	Bulgaria	Insurance	€ 185	3Q
17-Apr-07	Hipbroker / Senzal / Bastion	Serbia	Brokerage	n/a	3Q
18-Apr-07	Absolut Bank (95%)	Russia	Banking	€ 723	3Q
24-May-07	Liontamer (51%)	New Zealand	Asset Mgt	n/a	4Q
01-Jun-07	International Factors (50%)	Belgium	Factoring	n/a	4Q
02-Jul-07	Baltic Investment Co (51%)	Latvia	Brokerage	n/a	4Q

Source: ML Research. Note: an additional 10.2% of DZI has been purchased in the open market.

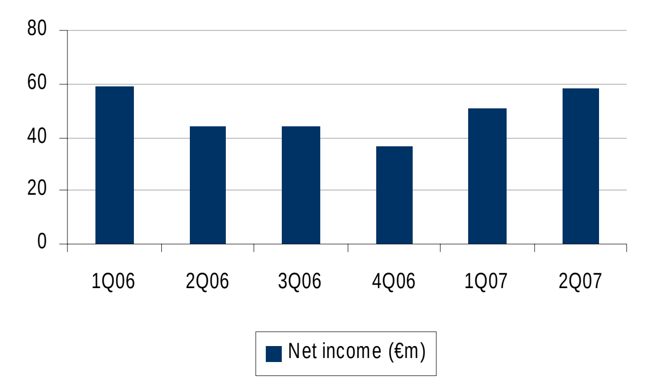
At the time of the Absolut acquisition, we wrote that we felt that KBC had paid a full price for Absolut, a view which we maintain. However, given the de-rating of KBC since that time, we feel that the risks from the deal have now been adequately discounted.

Private bank is turning around

When we reinstated on KBC last year, we cited a turnaround in the Private Bank as a possible upside catalyst. We think the bank is now delivering on this turnaround potential. Profitability has improved in absolute terms since last summer, and this in spite of the sale of Banco Urquijo (in Spain) in 3Q06 and Fumagali (in Italy) in 2Q07.

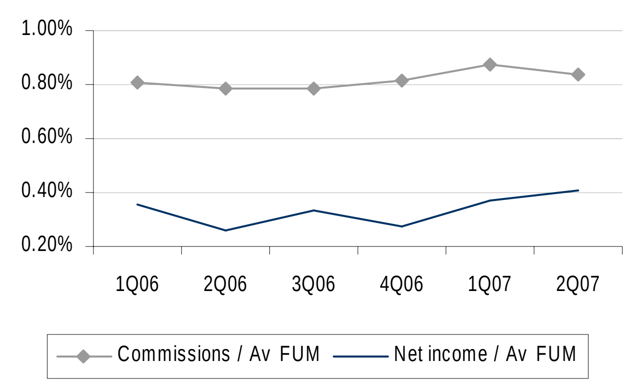
At the same time as this, KBC has been shedding some lower margin FUM, with the result that there has been a significant improvement in the margins the bank delivers, both at a gross and a net level (see chart below, right). Clearly, market volatility in 3Q is likely to hurt KBC, and we are forecasting lower profits in the second half of the year, and relatively muted (13%) growth in net income in 2008. **Given the structural improvements to the Private Bank, we believe that the risk to our estimates is on the upside**.

Chart 16: Private Bank – net income is recovering (€m)



Source: ML Research, Company

Chart 17: Private bank margins have improved



Source: ML Research, Company

Regearing the Balance Sheet will boost returns

KBC's capital position has consistently been a source of strength, and we believe that even with recent acquisitions and share buybacks, the group will still be in an excess capital position by the end of 2008. Based on the disclosure in 2Q, KBC has excess capital (versus its own targets) of €1.3bn in the insurance division and

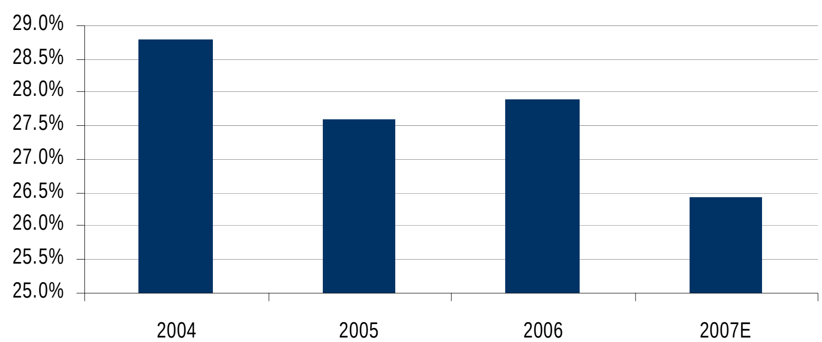
€349m in the bank (on a Basel I basis). We believe that the consolidation of Absolut will impact this in 3Q by ~€500m, but even so, we see KBC ending the year with €1bn in excess capital, and over €800m in 2008.

This capital strength is being used to regear the Balance Sheet in two ways, both of which are benefiting shareholders. First, the acquisitions noted above are leading to increased prospects for net income growth. And second, KBC continues to buy back stock, with a programme of €1bn pa from 2007-2009. This is the maximum KBC can achieve given liquidity constraints in its shares. We estimate that the buyback will reduce the number of shares by 8% 2007-2009. More specifically, **KBC has more than half its 2007 buyback to complete in 2H07, and it seems likely to be completed at attractive share price levels, leading to an enhanced EPS benefit in the next couple of quarters**.

Costs should be controlled in the second half

Expenses in 2Q were a little higher than expected (€1,314m versus €1,263m (e)). We think this was largely due to a shift in the way that KBC accrues expenses which means that there will be less of a seasonal pickup in the fourth quarter. **This should help prevent any cost 'splurge' in 4Q, and lends support to our view of some positive momentum in 2H.**

Chart 18: 4Q costs as a %age of total year



Source: ML Research

Valuation: revisiting our model leads to €109 Price Objective

Belgium: capturing asset management leads to a 12x multiple

Given that we think there are very different businesses within the Belgium division, we think it makes sense to look at each individually before aggregating to decide on a multiple for the division. It is a kind of sum of the parts within a sum of the parts.

KBC AM is worth €5.7bn

Our estimate of net income for KBC AM is €398m in 2008, on a 'standalone' basis (ie as if it were having to pay for distribution). We think that the growth this is delivering, in both Belgium and internationally, deserves a multiple of 14x, a small premium to the peer group of European asset managers of 13x. This gives a value for KBC AM in Belgium of €5.6bn, or 3.5% of current FUM in Belgium.

Table 6: Valuing the asset management business

Valuation	2008E
2008E post tax profit	398
Multiple	14
Value	5,570
as % of FUM (current)	3.5%

Source: ML Research

Belgian insurance is worth €5.7bn

We assume growth of 7% in VANB, which reflects a slower expected outlook for the business following the surge in 2005.

Table 7: KBC EEV model

€m	2006	2007	2008	2009
Opening EV	3,897	4,444	4,689	4,955
Opening VIF	921	1,280	1,325	1,379
Value new business	183	196	210	224
Market variance	190	0	0	0
Roll forward	(108)	(151)	(156)	(162)
Assumption changes	(3)	0	0	0
Other	97	0	0	0
Closing VIF	1,280	1,325	1,379	1,441
Opening net assets	2,976	3,164	3,364	3,576
Growth in net assets (after dividend)	188	200	213	226
Closing net assets	3,164	3,364	3,576	3,802
Closing EV	4,444	4,689	4,955	5,244
Growth in new business		7%	7%	7%
Return on net assets	6.3%	6.3%	6.3%	6.3%
Roll forward / VIF	11.8%	11.8%	11.8%	11.8%
Growth in EV	14.0%	5.5%	5.7%	5.8%

Source: Merrill Lynch Research

When looking at an EV valuation of the insurance business in Belgium, we need to adjust for a number of the items discussed earlier. First, we strip out the CEE net assets: given that we know that CEE is 10% of reserves, we assume that it represents 10% of assets as well. Next, we adjust the VANB estimate to adjust for double counting. And last, we strip €300m out of the VIF, again to avoid double counting with KBC AM. We apply an 8x multiple to our VANB estimate, which implies a total valuation of €6.2bn for the Belgian insurance business.

Table 8: Valuing Belgium Insurance

€m	2008E
EV	4,955
Adjust NAV for CEE	(336)
Adj VIF for KBC AM	(300)
Adj EV	4,619
Value of new business	210
Adjusted VANB	129
Multiple	8
Valuation new business	1,036
Insurance Belgium	5,655

Source: ML Research

One last important point to note here is that this values the non-life business at just 1x book, because the non life assets are included in the EV, but there is no VIF or VANB related to it. This is a very conservative treatment of the non life business in our view.

A boring bank remains....worth €4.2bn

Lastly, we end up with the retail banking portion. By stripping the bank of its asset management and insurance businesses, we are left with net interest income, and also the distribution fees assumed from the KBC AM products. Given that NII remains under pressure – as discussed above – it does not seem correct to assign a very high multiple to this business. We have decided to value this business on a price book basis, at 1.3x. We take the book value of as 7% of the forecast RWAs, or 70% of the total capital assigned to the business. Our valuation implies a p/e of 8.9x 2008E bank earnings, which we believe is a conservative assumption.

Table 9: Belgium bank valuation

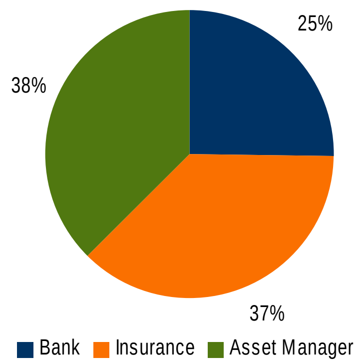
	2008E
2008E RWAs	46,131
Implied book value	3,229
Price / book	1.3
Value	4,198

Source: ML Research

Altogether = 12x

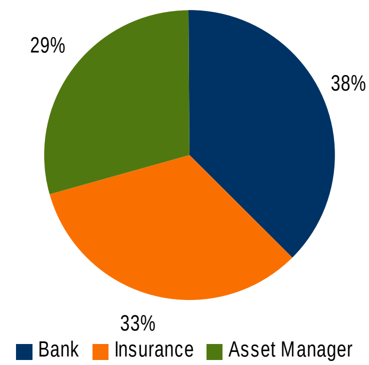
Piecing this together for the Belgian business implies a multiple of 12x for the division, versus our previous 10.5x multiple. Our analysis has (we hope) shown that the value split in Belgium is different to the profit split.

Chart 19: Belgium 2008E - valuation



Source: ML Research

Chart 20: Belgium 2008E – net income



Source: ML Research

Price Objective = €109

Considering all of the above, our 2008E sum of the parts model moves to €109. Combined with a yield of 3.9%, this gives a total expected return of 22%, which leads us to upgrade the shares to Buy. Using the same model would lead to a 2009 valuation of €122.

We would note that the valuation we have placed on the Merchant Bank is in our view very conservative. In line with our more cautious approach to the wholesale banking overall, we have cut our Merchant Bank estimates (more detail on this below), so we feel that this division now has a low multiple and a conservative valuation.

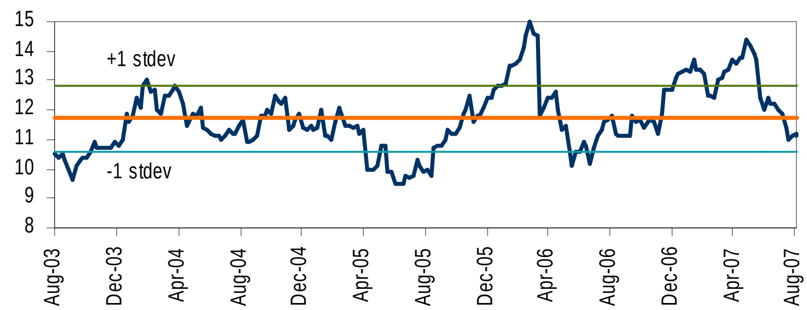
Table 10: KBC 2008E sum of parts

	08e			
EUR(m)	Underlying Net Profit	Adj Net Profit	Multiple	Value
Belgium	1,300	1,285	12	15,414
Central and Eastern Europe	723	713	14	9,978
Merchant banking	825	801	8	6,405
European Private Banking	235	233	12.5	2,910
Group centre	(52)			0
Total	3,031	3,031		34,708
Plus Capital Surplus impact				584
Plus Basel II benefit				632
NOSH 08e				330
Theoretical Fair Value (€)				108.7

Source: ML Research

KBC is currently trading at 10.2x 08 EPS, for an expected 2006-9 EPS CAGR of 12%. We feel that for the first time in a while the shares offer value. They are trading at their cheapest level (on current year p/e) since last summer, despite an EPS growth outlook which in our view is improved by the regearing of the Balance Sheet. Our Price Objective implies that the shares trade at 12x 2008, which is just ahead of the 4 year average of 11.7x.

Chart 21: KBC current year P/E since 2003



Source: Datastream

Risks

CDOs – €150m possible hit in 3Q, but disclosure limits risk

With its second quarter, KBC revealed a €7.1bn CDO portfolio, which was larger than we had expected. Management gave details of a stress test on this portfolio, which it claimed would be hit by €7.9m in a worst case scenario. This analysis, however, is based on the instruments being held to maturity. We think that the bigger – and more immediate risk – comes from the mark to market of this portfolio in 3Q.

Management revealed that this portfolio is 84% AAA rated, and, more importantly in our view, is 80% backed by corporate loans, 10% by prime mortgages and 10% by subprime mortgages. This relatively high exposure to corporate loans versus RMBS should help the performance of these assets. Nonetheless, management said that spread widening in July had led to a €46m pretax loss. We estimate that this implies a spread widening of 22bps (assuming a three year duration on the portfolio). We assume that the portfolio mark to market has had further negative impact in August. A further 50bs move would imply a €152m hit in 3Q.

KBC management made it clear that the €46m loss in July still left the run rate of the Merchant Bank higher than 3Q06. Our numbers now assume that the Merchant Bank is down in 3Q versus what was a very weak 3Q06. We are estimating that the mark to market on the CDO portfolio hits the trading line in the Merchant Bank, from €294m in 2Q to €75m in 3Q. We feel that these numbers represent a severe outcome for KBC, and we think we have adequately reflected the risks implied by the CDO portfolio. **We think the fact that the disclosure on CDO exposure has been forthcoming should reassure investors, as it provides a quantifiable measure of the impact on KBC.**

KBCFP could be a curve-ball

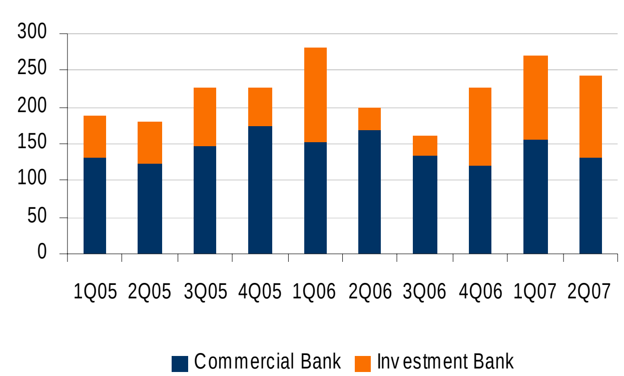
Apart from the on Balance Sheet risks, there is the risk of a revenue slowdown at KBCFP, which has issued €25bn of CDOs over the last few years, including all the CDOs which KBC holds. KBCFP's total net income in 2006 was €124m, derived from significant trading operations in convertible bonds and options as well as CDOs. **Our investment bank numbers reflect risks to the earnings at KBCFP.**

Merchant Bank – slowdown to be reflected in investment bank

Given ongoing market weakness, we have cut our estimates for a number of banks' wholesale divisions, and we are doing the same for KBC's Merchant Bank. We are cutting 2007 by 5% and 2008 by 7%, owing to a combination of slower RWA growth, lower trading income and higher provisioning estimates.

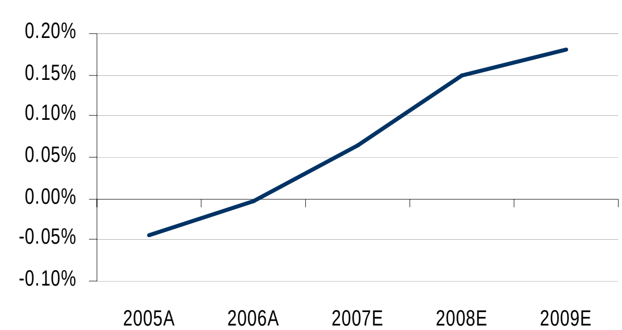
We believe that KBC's Merchant Bank should not suffer as severely as some other banks' wholesale divisions thanks to the relatively high proportion of commercial banking in its business mix. Based on the commercial bank run rate from the first half of 2007, our new 2008 net income estimate of €825m implies that the investment bank will only deliver €253m of net profit, or €63m per quarter. **This would take the investment bank back to its 2005 quarterly average run rate of €61m**. Given the expansion of the Investment Bank, including some of the acquisitions noted above, we think that this represents an appropriately cautious view of market developments next year.

Chart 22: Merchant Bank - net income split by business line



Source: Company

Chart 23: Merchant Bank - provisions as % of RWA



Source: ML Research

Price objective basis & risk

KBC Group (KBCSF)

Our €109 Price Objective is based on a sum of the parts model for KBC. We value the Belgium division on 12x 2008 earnings, based on a blended multiple of bank, insurance and asset management multiples. We value CEE on 14x and the Private Bank on 12.5x, in line with peers, and we place a low multiple of 8x on the Merchant Bank. We then adjust for the excess capital position of the bank. Risks to our view include exposure to the CDO markets, a slowdown in CEE and worse credit quality than expected.

Analyst Certification

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Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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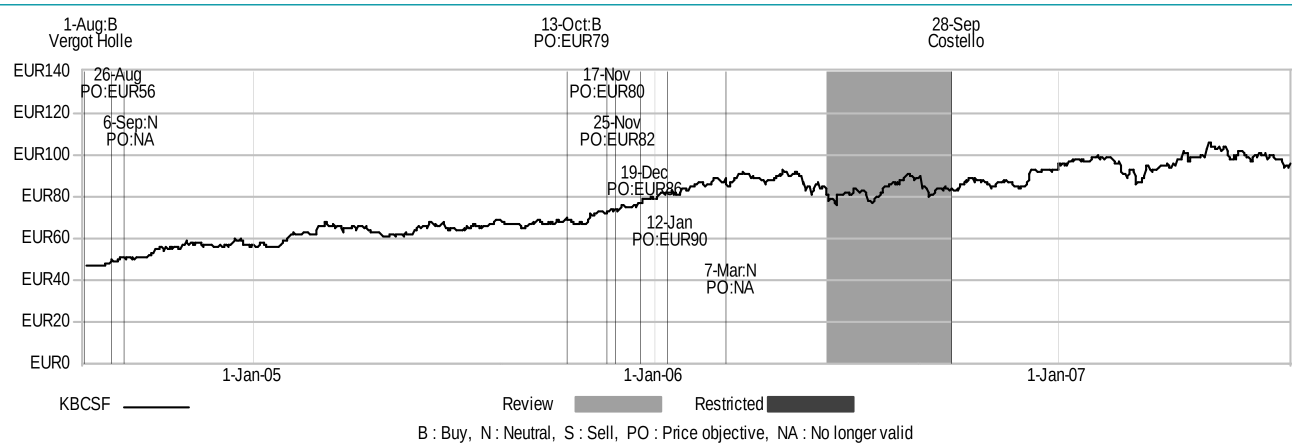
KBCSF Price Chart



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Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	120	46.51%	Buy	52	55.32%
Neutral	111	43.02%	Neutral	54	55.10%
Sell	27	10.47%	Sell	15	62.50%

Investment Rating Distribution: Global Group (as of 01 Jul 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
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Neutral	1633	45.97%	Neutral	438	29.67%
Sell	244	6.87%	Sell	47	21.66%

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