Global developed market banks: unloved and equally undervalued

Lisa Haakman

Lisa is a qualified chartered accountant as well as a CFA charterholder. In addition, she has a Higher Diploma in Taxation from UCT. After completing her articles at PWC, she spent 12 years in financial services, both locally and in London, before joining PSG Asset Management as an Equity Analyst in 2014.

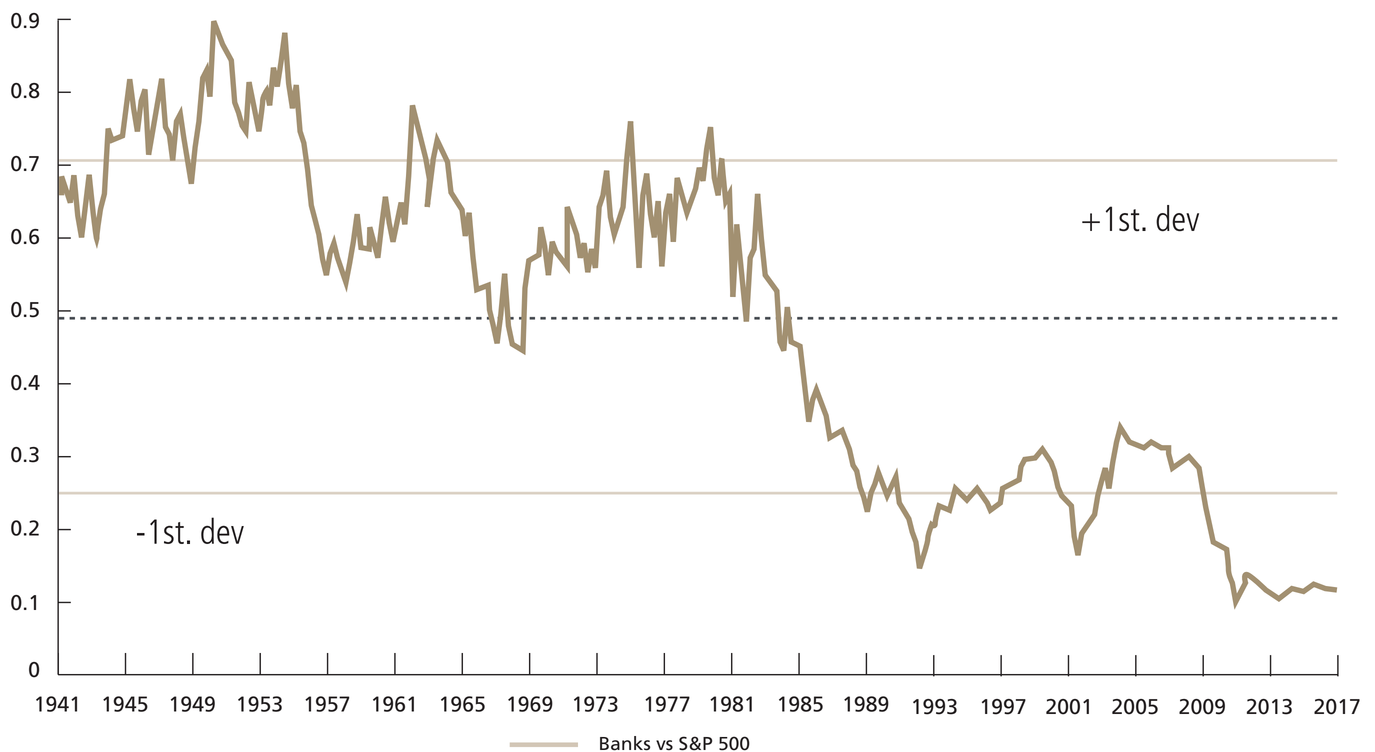
Global banks are unloved

Warren Buffett describes his philosophy to risk in his 2015 letter to shareholders as follows: 'If you can't predict what tomorrow will bring, you must be prepared for whatever it does.' Banks would have been wise to follow this mantra and adopt a prudent approach to risk, but instead we have had numerous bank failures in recent decades, most recently during the global financial crisis. With fresh memories, investors are still shunning developed market banks. As seen in Graph 1, US banks are trading at 70-year lows on valuation relative to the S&P 500 Index.

Looking at a shorter time frame, the US Banks Index and the UK Banks Index have underperformed the MSCI Index by 50% and 69% respectively over a 10-year period, as shown in Graph 2.

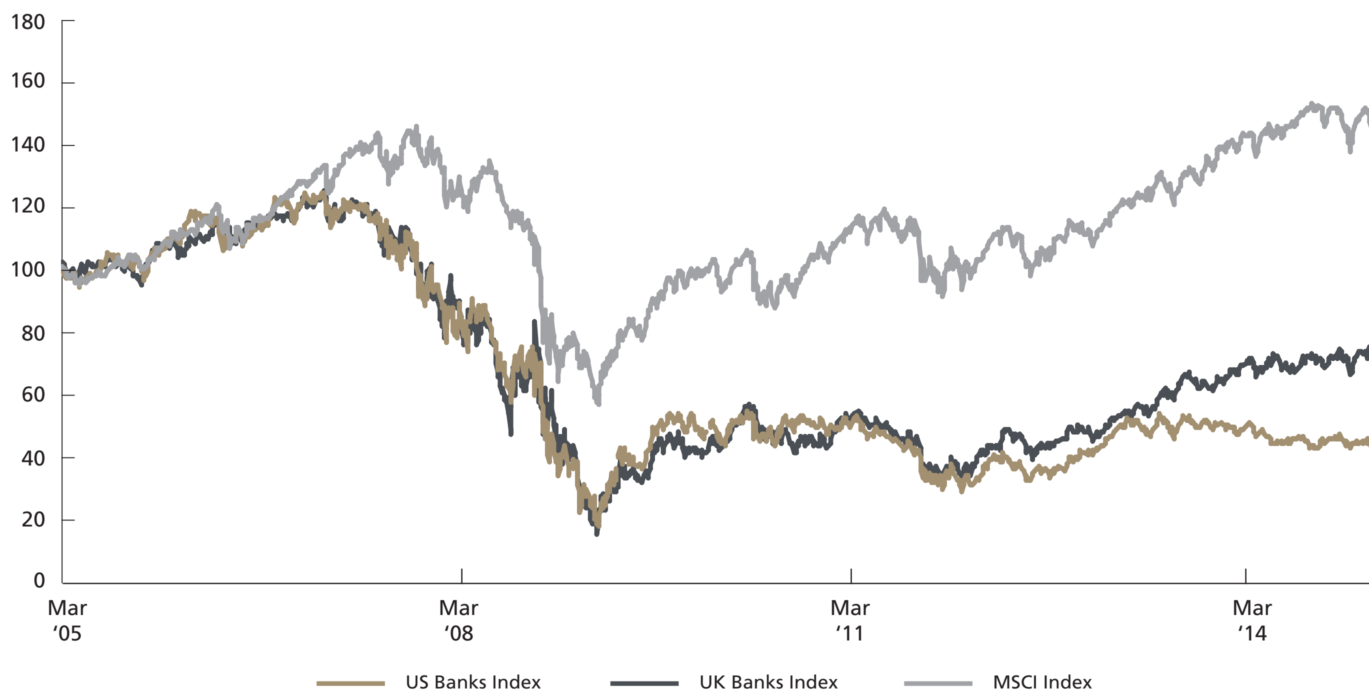
The years 2004 through 2007 were a period of empire building and exuberance in the banking world. Asset prices were rising rapidly, which masked how risky the underlying investments were. Banks were rewarded for risk taking and grew at a feverish pace, expanding into new territories and products without the necessary improvement in controls. Complacency crept in, risk aversion went out, and banks operated with high levels of gearing, as can be seen in Graph 3.

Graph 1: Valuations of US banks versus the S&P 500 Index since 1941



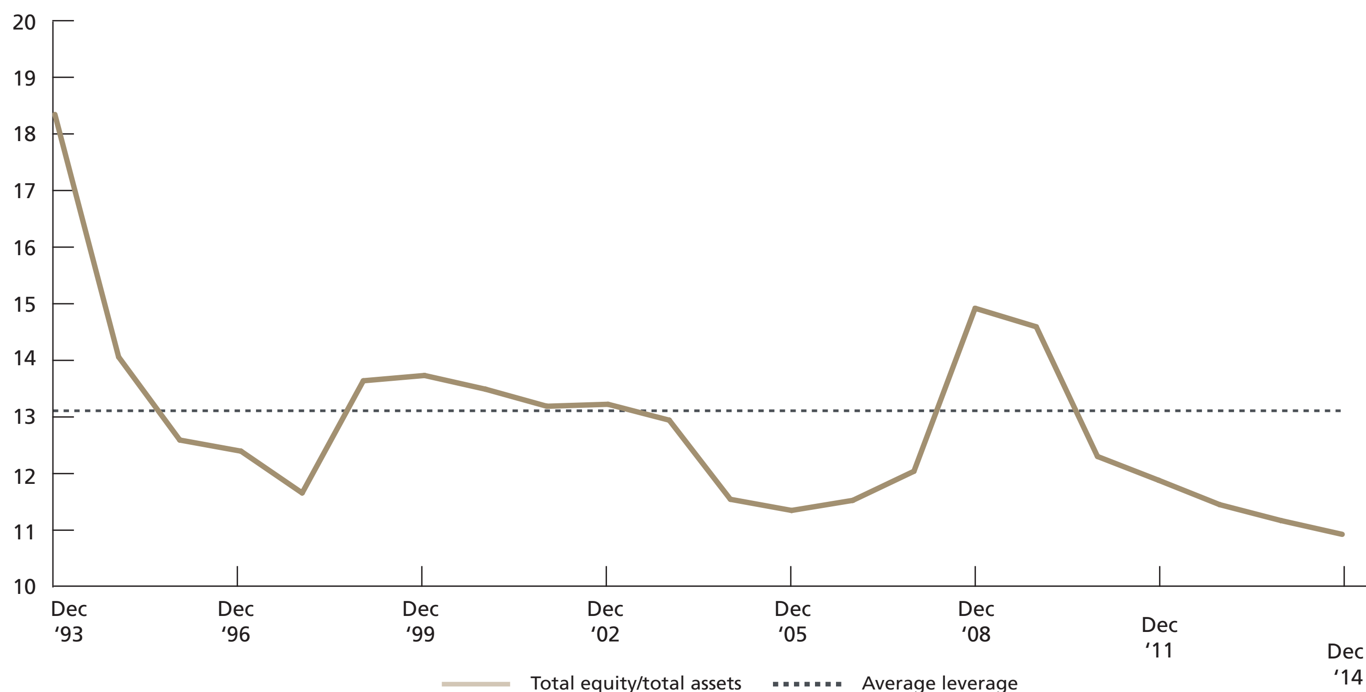
Sources: Bank of America Merrill Lynch Global Investment Strategy, Bloomberg

Graph 2: Relative performance of the US and UK Banks Indices relative to the MSCI Index



Sources: Bloomberg, PSG Asset Management

Graph 3: The leverage ratio (total assets/total equity) of our composite of global banks* (1993-2014)



Sources: Bloomberg, PSG Asset Management
* Our composite includes J.P. Morgan, HSBC, Wells Fargo and Capital One on an equal weighted basisw

Today banks have much lower risk appetites and much higher levels of capital

In the eight years since the meltdown, regulators have attempted to compensate for poor judgement and excessive risk taking by management by codifying a number of rules and principles relating to capital and market values. These rules should, in theory, prevent a repeat of the crisis. Furthermore, they continue to levy fines for the numerous pre-crisis transgressions, and increase regulatory scrutiny to ensure these are not repeated. The net result is that banks have significantly curbed their risk appetite, and are operating with substantially higher levels of capital than for many decades, as can be seen in Graph 3.

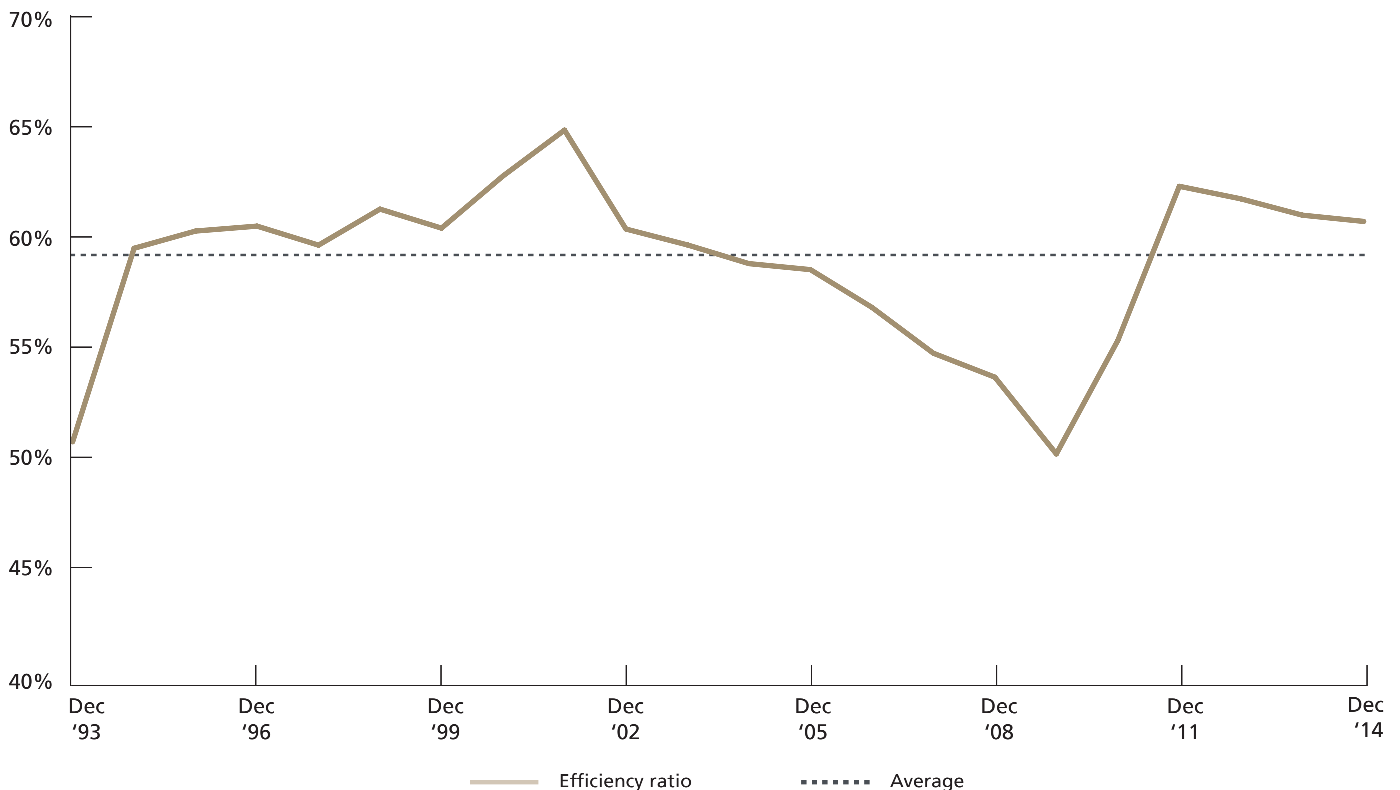
The profitability of global banks has reached multi-decade lows

Bloated headcount (to deal with the raft of new regulations), ongoing litigation settlements, reduced risk appetite and historically low interest rates have combined to generate multi-decade lows in profitability by inflating costs and depressing revenue, as shown in Graphs 4 and 5.

Valuations are severely depressed

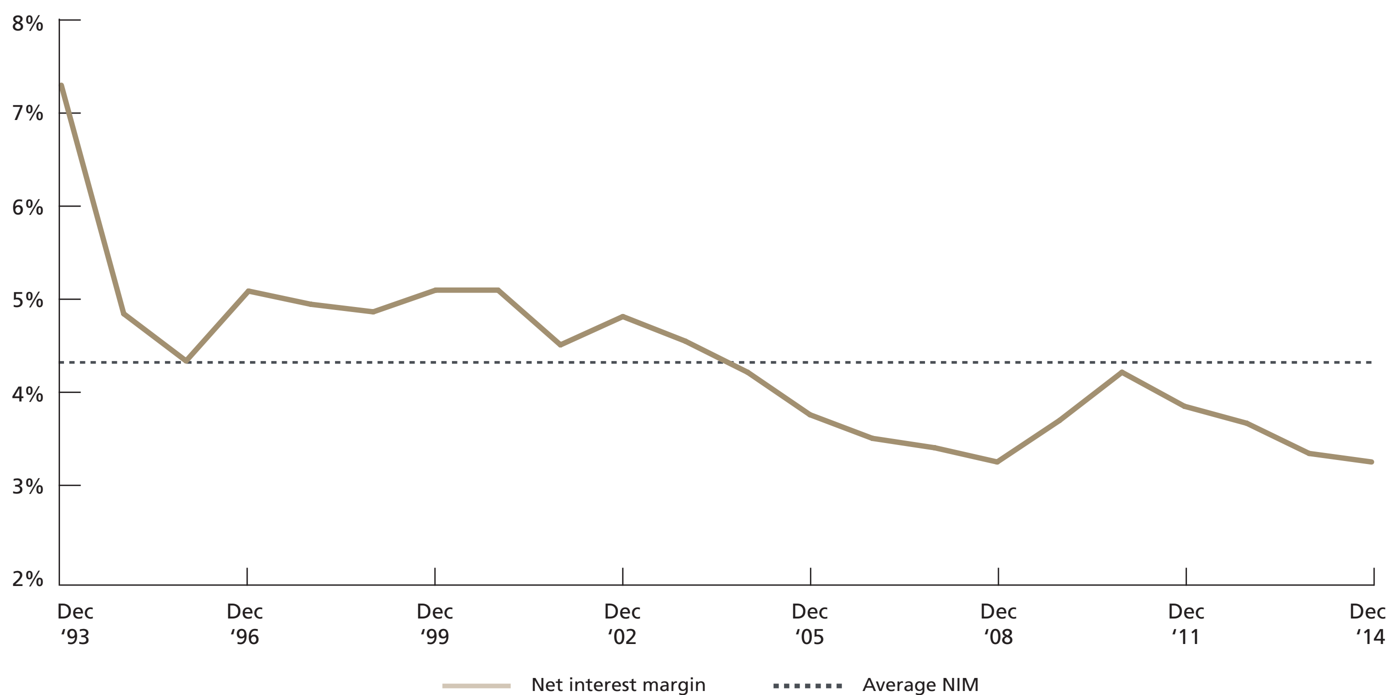
The consequence of higher levels of capital and lower levels of profitability is severely depressed returns on equity. This, in turn, has resulted in decade-low price-to-book (P/B) valuations for the banks in our portfolios, as shown in Graph 6.

Graph 4: The efficiency ratio (cost/income) of our composite of global banks (1993-2014)



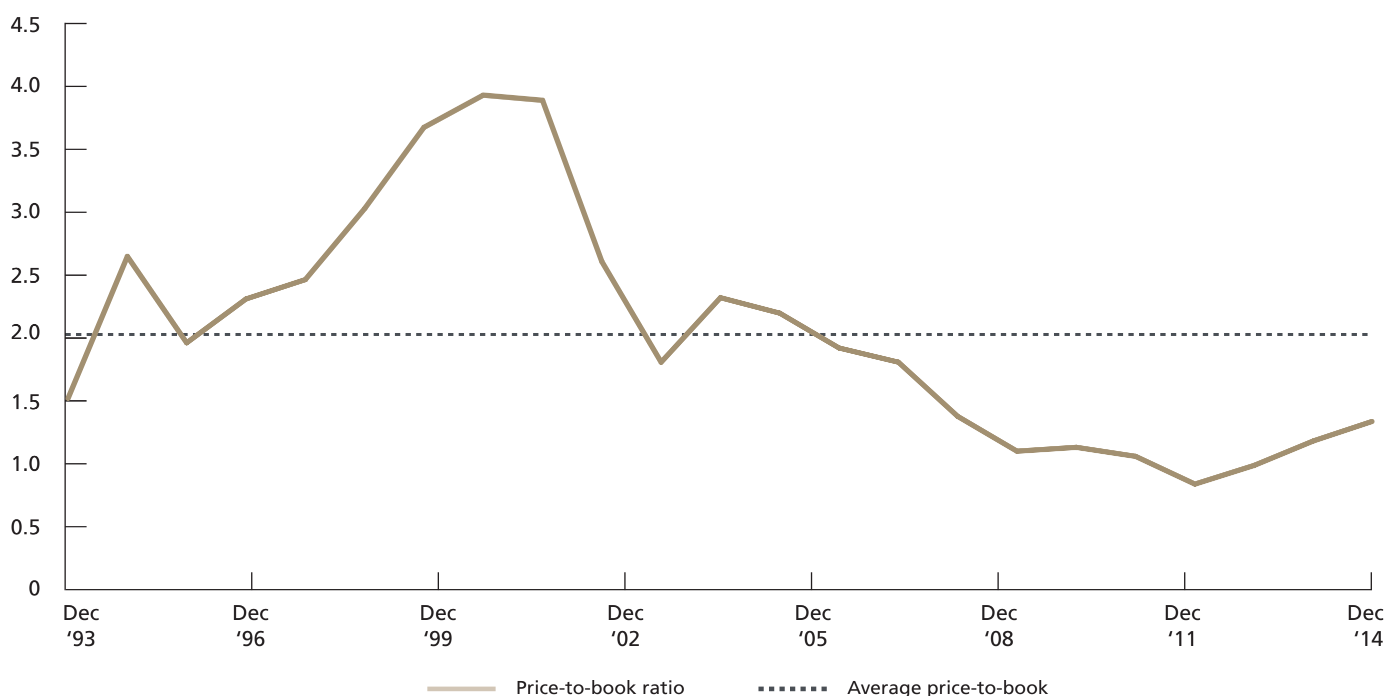
Sources: Bloomberg, PSG Asset Management

Graph 5: Net interest margin (NIM) of our composite of global banks (1993-2014)



Sources: Bloomberg, PSG Asset Management

Graph 6: Price-to-book ratios of our composite of global banks (1993-2014)



Sources: Bloomberg, PSG Asset Management

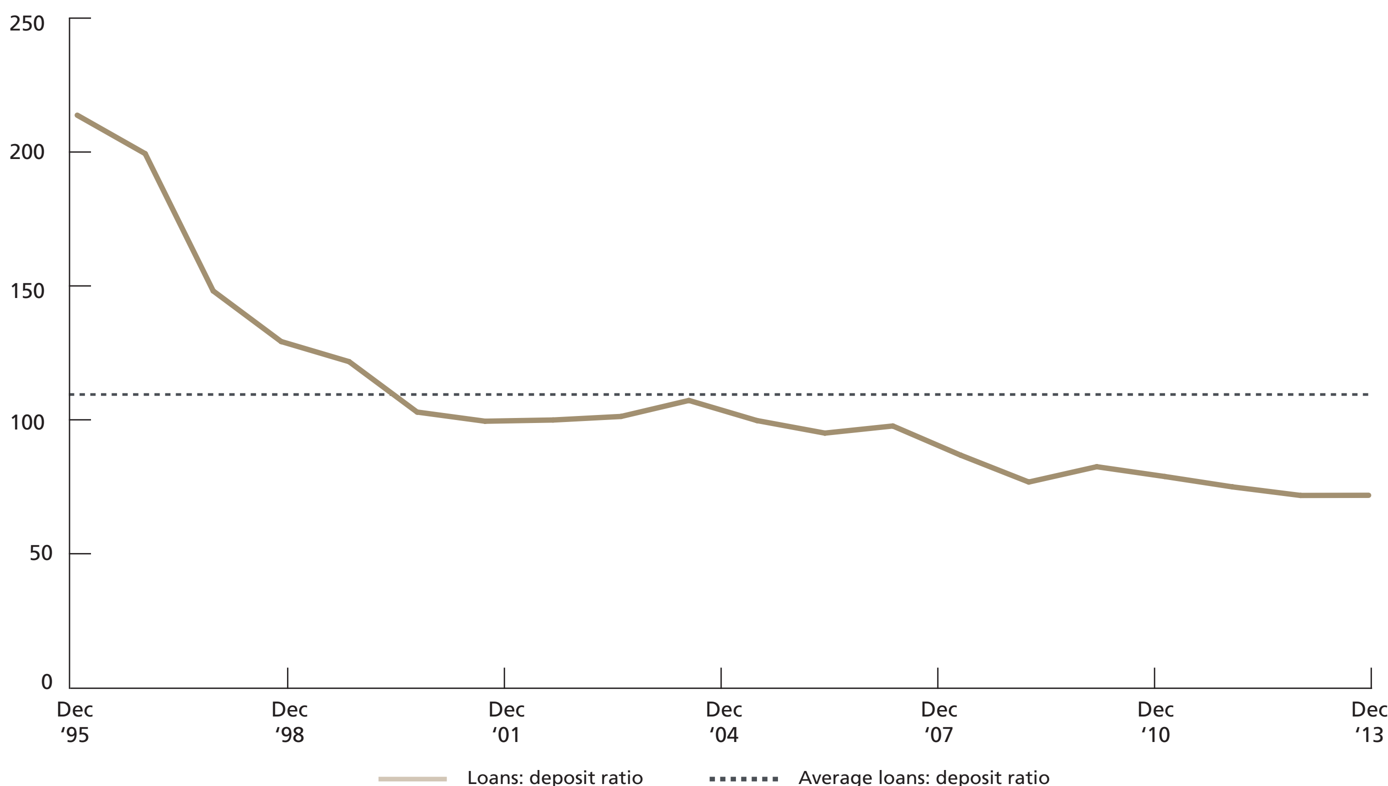
We are invested in superior franchises
Our portfolios are invested in four superior banking franchises that are very difficult to replicate, namely J.P. Morgan, HSBC, Wells Fargo and Capital One. These banks all have a dominant market share in their respective niche areas and are run by management teams with a prudent approach to risk, as evidenced by their superior performance during the financial crisis. To us, they represent some of the best risk-reward opportunities available in the global universe on a bottom-up basis.

Banks with higher liquidity are less risky investments
Our portfolios hold some of the most liquid banks in the world, operating with loans-to-deposit ratios of approximately 70%, as shown in Graph 7.

This means they are significantly less risky investments than they were before the crisis, and significantly less risky investments than many of their peers. However, the market has not yet afforded them a lower cost of equity, and they trade at similar (or lower) multiples to the banking universe.

Banks are highly geared towards an economic recovery and rising rates
Simplistically, a loans-to-deposit ratio of 70% means that 30% of the deposits the banks have taken in are not being lent out productively. In fact, these deposits are currently invested in cash, generating negative real returns and negative carry. In other words, the banks are making a loss by allowing consumers to place deposits with them. When the economy improves, the demand for lending should increase, allowing them to deploy some of these excess deposits. And when rates rise, the remainder that is still in cash will earn a higher yield than before.

Graph 7: Loans-to-deposit ratio of our composite of global banks (1995-2013)



Sources: Bloomberg, PSG Asset Management

The outlook for the banks we hold is positive

Wells Fargo and Capital One both have a predominantly US presence and consequently enjoy low-level status as global systemic financial institutions. This allows them to operate with significantly less capital than HSBC and J.P. Morgan (who are ranked highest in terms of systemic importance), and consequently they generate much higher returns on capital.

Both are very well positioned to benefit from a stronger US consumer in an improving US economy. As inflation fears are virtually non-existent, economists are expecting only modest increases in rates. This produces something of a goldilocks scenario for the banks, as they generate higher margins on their lending without significantly higher credit losses.

In addition, Capital One is predominantly a card company, and is poised to benefit from increased spending by consumers. This is driven by the artificial wage increase that a lower fuel price has given consumers, mild inflation and a migration from cash to card that is only in its infancy in the US.

The merits of being a globally connected bank are currently being hotly debated given the punitive capital treatment they now receive (which is ironic considering the stabilising role both HSBC and J.P. Morgan played in the crisis). This has resulted in very depressed valuations for these two shares.

Building common IT systems and cultivating a common culture proved to be very difficult when these large multi-national banks were growing so rapidly, and it is evident from the number of litigation settlements that these giant firms proved very hard to manage. However, there is undoubtedly a need for global multi-national banks to offer trade finance, currency funding, hedging and cash management to global multi-national companies. Due to irrational competitive behaviour, they are currently not able to price appropriately, and as a universe they are generating sub-par returns. But as their peers (primarily Standard Chartered, Citigroup and Deutsche Bank) exit many of their operations, this should allow J.P. Morgan and HSBC to increase pricing. Also, as the global economy improves, they should generate higher revenue from increased cross-border flows. We are also slowly seeing light at the end of the litigation and regulatory tunnel, which should allow these banks to focus on the task of banking once again, but with a substantially lower cost line.

Our research suggests that there is significant re-rating potential in our portfolio, as shown in Table 1.

Table 1: Re-rating potential of the global banks in our portfolio

Bank	Long-term return on tangible equity	Current price-to-tangible-book	Justified price-to-tangible-book	Re-rating
HSBC	12.6%	1.0x	1.3x	30%
J.P. Morgan	14.2%	1.4x	1.8x	29%
Capital One	17.2%	1.5x	2.0x	33%

Sources: Bloomberg, PSG Asset Management

Furthermore, given the current surplus capital within these banks, they are delivering dividend yields well in excess of cash returns, as shown in Table 2.

Table 2: Earnings pay-outs of the banks in our portfolio

Bank	Pay-out ratio	Forward dividend + buyback yield
Capital One	80%	5.6%
J.P. Morgan	65%	5.7%
Wells Fargo	35% dividend, estimated 37.5% buyback	5.4%
HSBC	65%	6.2%

Source: PSG Asset Management

We expect substantial returns from the banks in our portfolio

We have invested in high quality businesses with difficult-to-replicate franchises at a substantial margin of safety, in a market where such opportunities are not plentiful. We believe that the combination of robust tangible net asset value growth, high dividend yields and a return to normalised price-to-book valuations will generate substantial returns for shareholders of these stocks and for our investors in the years ahead.