



FROM THE ANALYSTS

SOUTH AFRICAN BANK VALUATIONS—WHAT CAN WE LEARN FROM US AND EU BANKING STOCKS

By Marco Barbieri (Director SA Equities)

Global bank profitability, as measured by the sector return on equity (ROE), has never recovered to pre-global financial crisis (GFC) levels despite a supportive global growth and interest rate environment over the past decade.

As Figure 6 below shows, US banks (S5BANKS Index) had a Return on Equity (ROE) of 11.74% at the end of October 2019, compared to a pre-GFC average of 16.2%. EU banks (SX7E Index) were at 6.6% against a five-year pre-crisis average of 14.1%. By comparison, the ROE of South African banks (JBNKS Index) was around 18.0% compared to a five-year pre-crisis average of 24.7%.

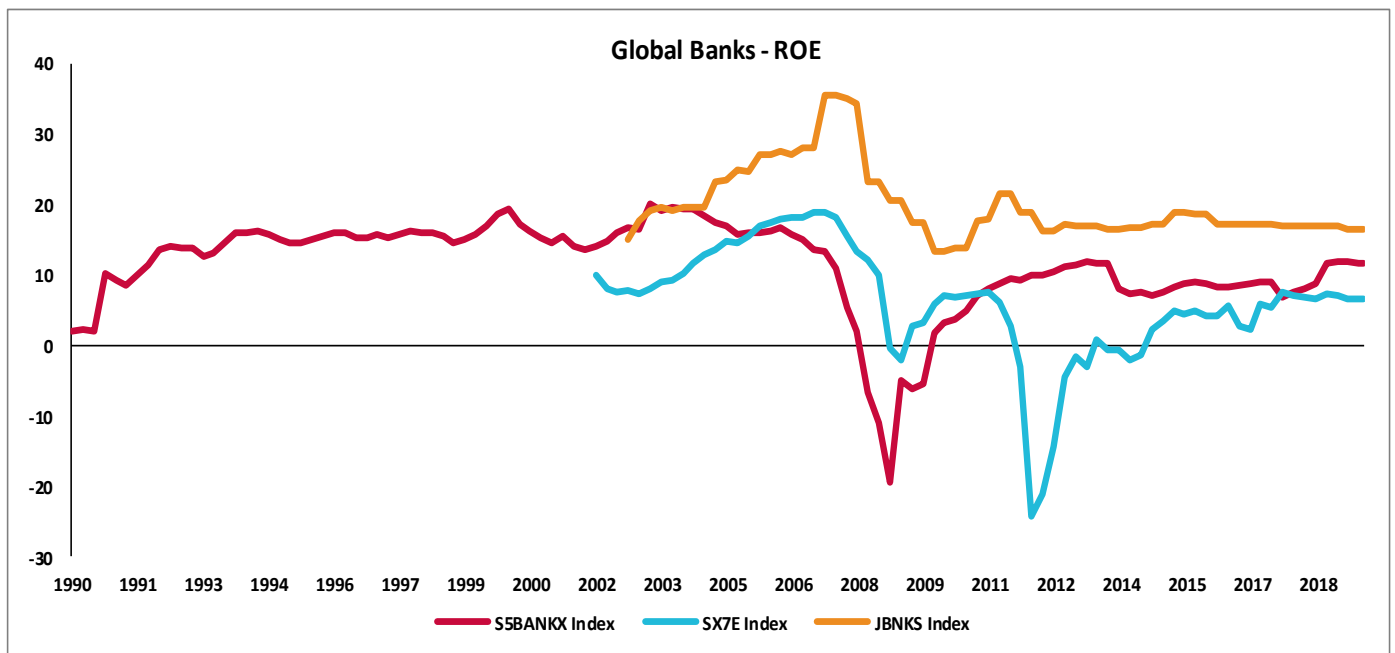


Figure 6. Global Bank—ROE. Source: Bloomberg and Northstar 2019.

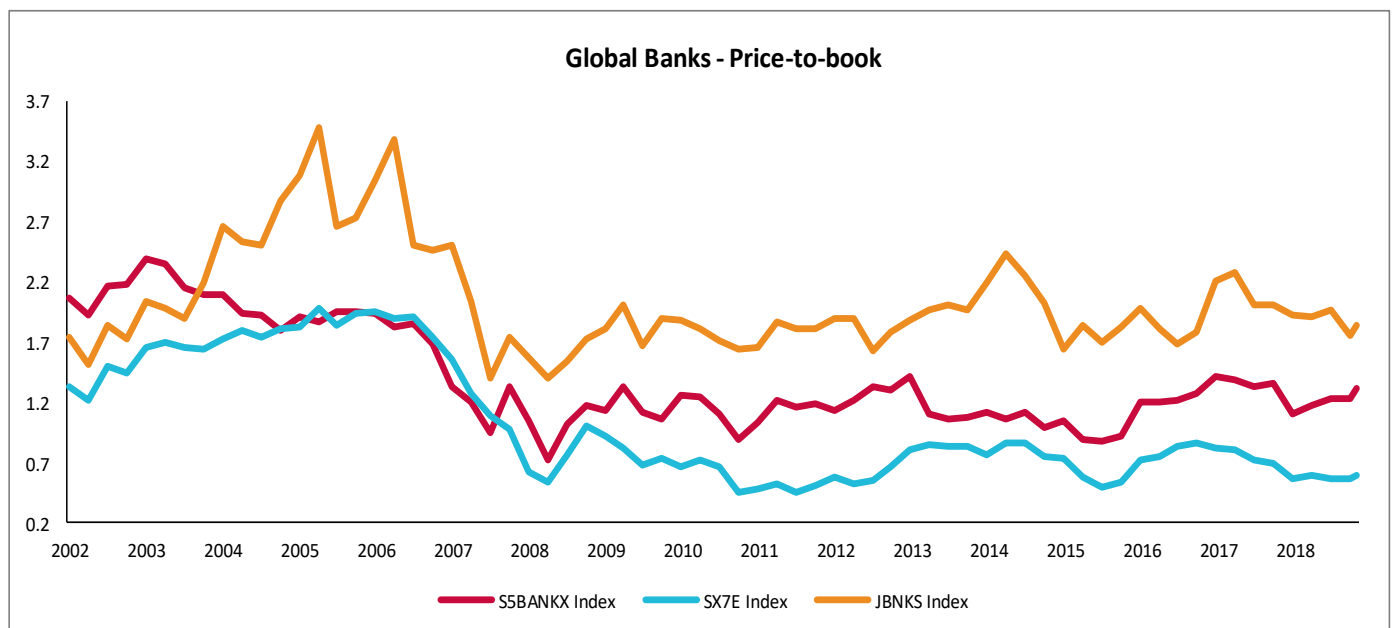


Figure 7. Global Bank—Prices to book. Source: Bloomberg and Northstar 2019.

Bank valuations have moderated to reflect this new reality with price-to-book (P/B) values coming off significantly both in absolute terms as well as relative to market indices. European banks are currently faring the worst and are now trading well below book values, reflecting the expectation of a continued decline in revenue and profitability.

While US banks have rebounded better than their European counterparts on an absolute basis, both of their P/B ratings relative to the market have dropped consistently to approximately 0.40 compared to their 20 year highs of 0.8 to 0.9.

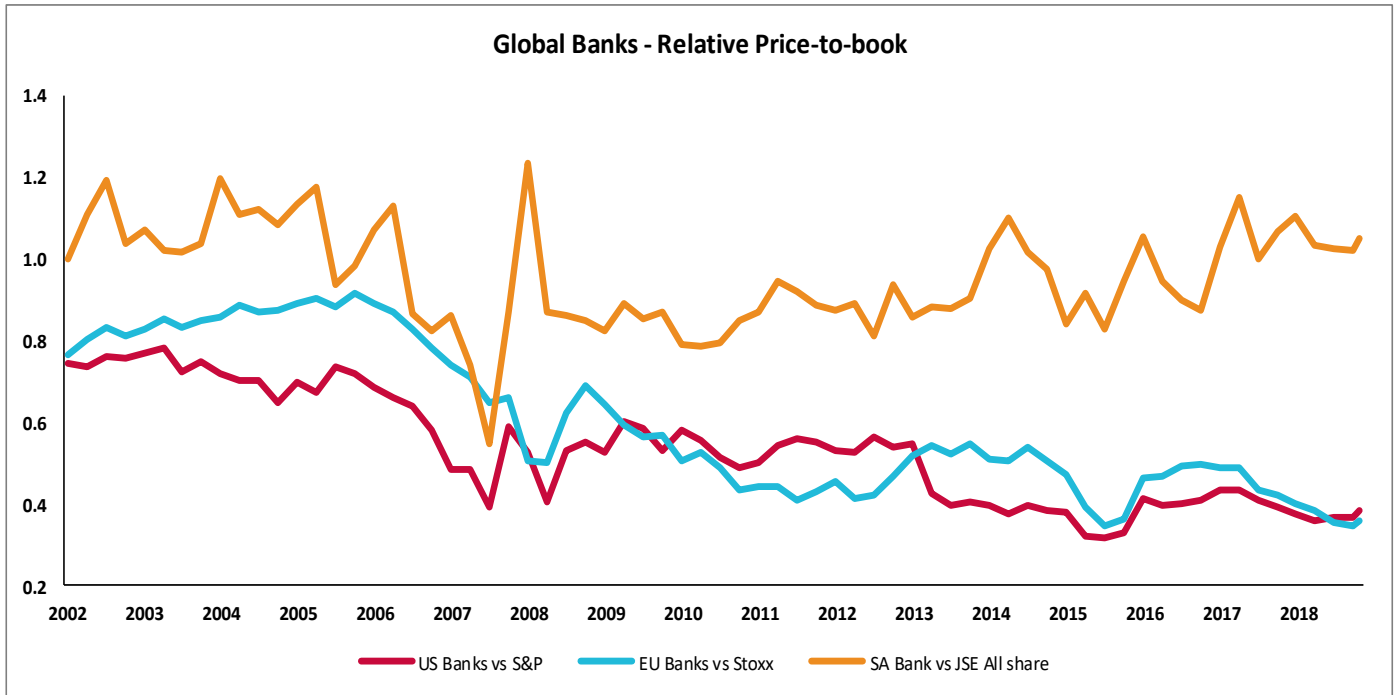


Figure 8 Global Banks—Relative Price to book. Source: Bloomberg, Northstar. September 2019.

In contrast, South African banks have been particularly resilient and in fact re-rated against the market to trade at a price-to-book premium.

Investors in Northstar's local equity funds have some exposure to South African banks as both Standard Bank and Investec form part of our Top 10 holdings in these funds. This article unpacks the likely causes of the derating of US and European banks, and assesses whether banks in South Africa are likely to follow suit.

Macro-economic conditions, increased regulation and a changing competitive landscape

The decline in global banking profitability has often been attributed to three main factors:

1. Pressure on margins due to overall low interest rates;
2. Higher regulatory capital requirements for banks (Basel III) ; and
3. Large legacy cost bases for existing banks.

While we agree that these factors have been crucial to lower industry profitability, current bank valuations reflect a much worse environment than is suggested by reported banking profit lines. The sector's implied future growth rates using a simple Gordon Growth Model are in fact negative for both US and European banking sectors.

This grim outlook, in our opinion, stems from a strong view that banking barriers to entry are reducing and increased competition is expected to inevitably reduce industry profitability as large incumbent players continue to lose market share to new entrants.

Beneficial funding costs and customer switching inertia remain enduring competitive advantages for the established banking franchises, but industry barriers to entry have definitely decreased due to a number of trends. The most significant of these are:

- The high scale requirements of incumbent banks due to their bloated legacy cost structures. For example, UBS employs over 66 000 people, HSBC 85 000, RBS 71 000 and ING 54 000. Challenger financial services companies are far smaller, for example OakNorth (a London bank) with 130 employees and Klarna (a Swedish payments company) with 2 700 staff;
- Fintech innovation and lower costs for banking platforms and infrastructure start-up; and
- Increased availability of customer data from other sources is reducing the credit underwriting edge of incumbent banks.

Our view is that these landscape changes are permanent, largely structural and we don't expect incumbent banks to be able to adapt quickly enough to fend off these threats. This process is likely to be gradual, but we expect to see industry fragmentation increasing and the profitability of the incumbent banks continuing to decline over the medium term.

Will South Africa's banking system follow suit or will incumbent banks defend market share and industry profitability?

The South African banking sector is at a different stage of its evolution compared to global developed, and several emerging market, peers. The South African banking landscape is far more concentrated, more profitable and has only recently started to undergo a branchless transition, unlike their European and US counterparts which have been under disruption for several years.

A number of factors are enabling this transition in our opinion, most important of which has been increased smartphone penetration which currently stands at 82% (2018 - ICASA) compared to 44% three years ago and 80% to 90% in developed markets

Banking disruption trends are also relevant in the South African context and their effects are already being felt to some degree, although not quite to the same extent as developed markets. Branchless digital banks have started to gain traction in the South African market with 15 banks (in addition to the five major banks) currently offering retail or business transactional services.

While we note that a number new entrants have been relatively successful in attracting customers, this trend has been mainly at the lower-end of the market in low cost offerings and is not yet evident across the full LSM spectrum and over all lending categories.

The main risks for traditional banks in South Africa relate to increased competition in the high end transaction retail environment, card, overdraft and business banking spaces, where banks earn high margins and competition has been particularly low.

While we believe industry profitability will decline over time, we expect South African banks to defend their turf for an extended period of time. Funding costs, in our opinion, will continue to be an important barrier to entry for new entrants and a significant edge for large banks in various lending categories.

Our base case view is that competition over the next three to five years will be broadly contained by a number of initiatives from traditional banks, such as pricing drops and banking innovation. We do however think that the sector will likely experience pressure on fees and resulting margin pressure as the focus will continue to be on reducing costs and increasing efficiencies.



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