RE:CM

_REGARDING CAPITAL MANAGEMENT

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ARE BANKS A SENSIBLE INVESTMENT?

There has been a lot of discussion in the marketplace recently on the investment prospects for banks. For what it is worth, we have quite strong views on this subject, and would like to share them with you.

First, one has to realise that banks are highly leveraged businesses, and as such are more risky than normal industrial businesses. Generally, banks only have 10% of their asset base funded with shareholders capital – the rest is financed by debt. Remember, when you deposit money with a bank, it owes you money and is therefore indebted to you, their client. Most of the loans a bank makes to its clients – i.e. its assets - are funded in this way.

The leverage banks employ is a double-edged sword. It makes their financial structure incredibly risky, as depositors can immediately withdraw their deposits, while lenders do not have to repay at the same time. When depositors lose faith in a banks ability to repay their deposits it sometimes results in a run on the bank, as we saw in the case of Saambou. Then assets cannot be converted quickly enough to repay the deposits – resulting in a severe haircut for equityholders.

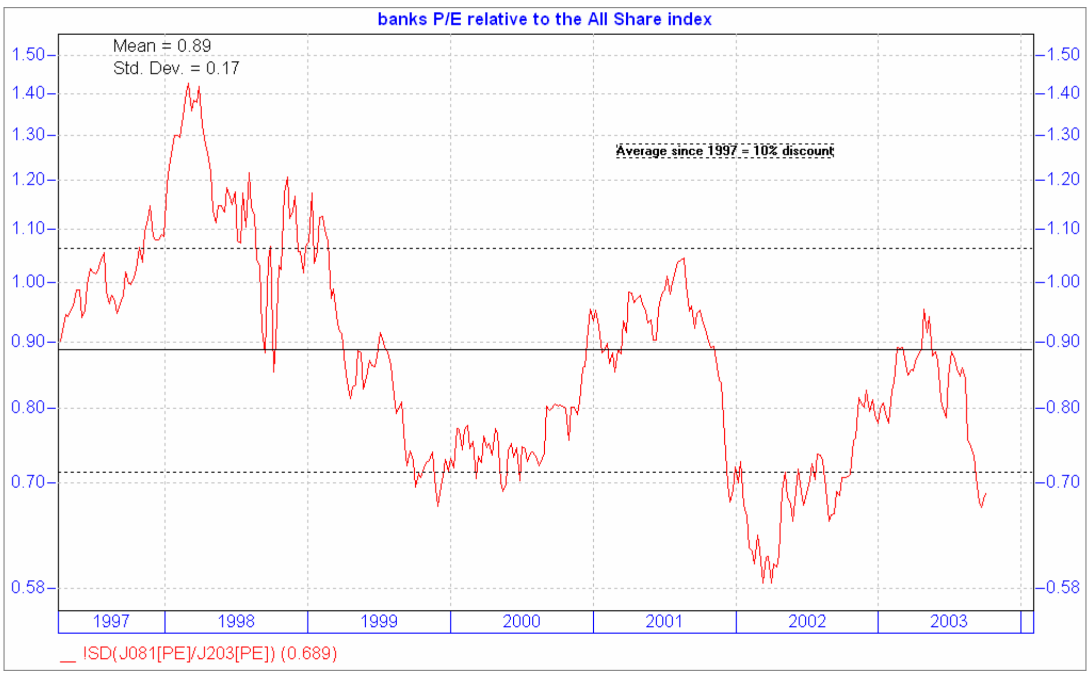
However, the other side of the coin (or edge of the sword, so to speak) is that this leverage makes banks very profitable! On average, they earn a return of just over 1% on their asset base (i.e. the loans they make). A standard, run of the mill industrial company generally earns around 15% on its asset base. The only way banks can earn a decent return on shareholders funds (the type of return we at RE:CM are primarily interested in) is by leveraging the equity. A simple calculation shows what effect this leveraging process has on the return on equity (shareholders funds) that banks earn. (Always bearing the accounting identity in mind: assets = debt + equity)

	Bank A	Industrial company A
Asset Base	R100	R100
Return on assets	1,5%=R1,50	15%=R15
Debt	R90	R0
Equity	R10	R100
Return on Equity	R1,50/R10	R15/R100
	=15%	=15%

Although both bank A and Industrial company A end up with the same RoE, from the point of view of the investor, one RoE is not the same as another RoE! To generate a 15% RoE, as in the above example, the bank has to employ massive leverage. This increases the risk to the investor as well. When you have two very big moving parts (assets and debt) with equity the balancing number, the equity holder (in other words, us, the investors) can very easily get squeezed if something goes wrong.

In addition, the business model of banks is not exactly the best thing since sliced bread. They lend out money, hoping to earn a return in line with the prevailing level of interest rates, but stand to lose all their money if the creditor defaults! In addition, they need to pay the depositor a return for the use of his money. So, if everything goes well, they do not earn very much, and if it goes wrong, they lose everything!

Banks use of leverage, along with a very poor business model, explains why they should always trade at a discount to the broader market, despite showing earnings growth, dividend growth and profitability characteristics which are very much in line with (or sometimes even better than) the market. The question is how much of a discount should investors demand?



From the above chart, it is clear that banks are currently trading at about a 30% discount to the market, on a P/E basis. The historical average is 10%. In our opinion, a 30% discount means that the market is willing to pay investors to take on the risk of investing in the banking sector.

But first, we need to deal with two other problems the banking sector is currently facing. One, they have jacked up their administration fees a lot over the past few years – arguably to augment their poor lending based income. This has, in my judgment, become unsustainable. This has lead to the second problem a lot of analysts have identified: namely that foreign competition will start to increase, attracted by the high level of profitability that SA banks are currently enjoying.

To be sure, these problems are not insignificant. But we would argue that at current pricing levels, they have been factored into the risk/return equation by the market. A period of flat earnings growth would not hurt banking stock valuations – after all, they are currently priced as if they will deliver very slow earnings growth. What would hurt their prospective returns severely would be if asset values were to significantly decline from current levels.

What are the chances of that happening? Our opinion is that we have cleaned up the hangover from our mini-asset bubble in 1997/98. Nedcor is the last bank now going through a repricing of their balance sheet, but we don't view it as significant enough to put equityholders in jeopardy. Once they have cleaned up their balance sheet by writing down asset values to more realistic values – and raised enough capital to resume further asset growth, it might even turn out to be quite a profitable investment, but in the meantime, we prefer ABSA and Standard Bank.

In fact, we think that there are a number of favourable tailwinds out there that will reduce the risk of the business of banking going forward. One is that interest rates have recently been cut substantially. At some point, consumers will start to borrow again in reaction to this. Increasing borrowing is good for banks profitability. A second is that the economy is growing albeit moderately – but it is growing nonetheless. This is generally good for asset values, which further reduces the risk inherent in the balance sheets of banks.

Banks are cheap, and your funds (if they are invested with us!) are heavily exposed toward this sector.

Piet Viljoen
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