

PILLING & Co

STOCKBROKERS LIMITED



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Reputation trumps reality? Don't bank on it.



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If you want to get a better than average risk-adjusted return you need to be prepared to do something which average investors are not doing.

Ask a room of investors who likes UK banks, and you will not see many hands in the air. This is probably because many had their fingers burnt in the early 2000s, assuming 'bank exceptionalism' would save them from the worst treatment market forces can mete out. It was not long after the worst of the credit crunch in 2008 that the undoubtedly wise Anthony Bolton of Fidelity opined that one ought to buy a basket of UK bank stock to reap the reward of the upcycle to come.

It did not come.

Instead, bankers were pilloried and their equity trashed by a succession of cash calls, bail outs and tightening capital regulations. Furthermore, just when it looked as though dividend payments might once again be possible, a wave of PPI compensation hit. These payouts concluded just in time for Covid-19 to dash investor hopes yet again. Banks have seemed incapable of even buying a friend amongst all of this!

It followed that their shares just kept getting cheaper relative to their ability to earn a crust. To be fair, the UK was not alone. The pattern of seeing smaller or regional retail banks going to the wall was repeated in Europe. And in America some of the biggest names were humbled with Lehman Brothers and Bear Stearns shutting up shop. However, in the time since the Great Financial Crisis the fortunes of banks seem to have varied depending upon where they are located.

As I was putting pen to paper on this, a detailed report on the UK banking sector dropped into my inbox from Deutsche Numis. It pointed out that in the last 2 years the sector has seen its market value decline by £18bn - remarkably similar to the £22bn paid out in dividends and share buybacks - to leave it worth around £72bn. In the next 3 years the same analysts reasonably forecast total distributions of almost £30bn. Is bank equity going to decline by a similar amount to leave it lower than where it was in 2008? Despite the threats of reduction in net interest margin, increases in loan delinquencies, windfall taxes and changes to reserve remuneration this seems unlikely. Therefore, we have a major blue-chip sector of the market that is profitable, paying fat dividends and yet is particularly under-supported.

Of our four domestic UK banks - **Barclays**, **Lloyds**, **NatWest** and **Virgin Money** - the share price relative to tangible net asset value ranges from around 45% to 95%¹. In the US that figure is 200% for the median large cap bank². In the major European regions that figure would be around 100%². So, this allows us to view UK banks as cheap by international comparison. It also justifies using spare cash to buy back their own stock.

When it comes to their capital base, UK banks have had a long punishing road towards building up their reserves to a 14%¹ Basel Common Equity Tier (CET) 1 rating, which is similar to many European banks and within a few % of the Nordic banks², long held out as being the most conservative. Large US banks get by on figures in the 7 - 11% range meanwhile².

The median US bank share yields a 3.9%² dividend whilst our four domestics are in the 5.5% - 6% range. However, dividend is only part of the story and this is where comparisons get harder to make. Suffice it to say, UK banks are well in the swing of buying back and retiring their equity, undoing some of the dilution that occurred with the rights issue a decade earlier. Surplus cash, not paid out as dividends means that **Barclays** bought back 4% of the shares they had in issue in 2023 and could well do the same or more in each of the next few years.

Reputation trumps reality? Don't bank on it cont'd.

Lloyds retired about 6% of their equity last year and are projected to take about 30% more out over the coming 4 years¹. **NatWest** is thought to be somewhere between the two. **Virgin Money** could conceivably go further, provided we do not see a slowing economic recovery because it is more exposed to personal banking, mortgages and credit cards than its more diversified peers. If banks can continue to produce good free cash flow and are able to buy back their shares in this way then it continues to remind recalcitrant buyers that the number of shares is dwindling and therefore each represents a larger slice of the business as each year goes by and makes it easier to increase future dividends per share, something of a virtuous cycle.

Although **HSBC** and **Standard Chartered** are headquartered in the UK and listed in London they are not domestic banks, and their international operations expose them to a range of opportunities and risks that make them even harder to summarise. For purposes of comparison, HSBC is priced at around 90% of tangible net assets, is expected to produce a dividend yield of 7.9% in the current full year and buyback around 5% of its shares. Those same numbers for **Standard Chartered** are, respectively, 65%, 2.8% and 9%¹.



15/01/2019 - 15/01/2024 Data from FE fundinfo2024

Taking all of this into account, which is the one to go for? All four UK banks have support amongst analysts but the one that gives a good combination of broad appeal and upside to the current share price is **NatWest**. Although estimates for the current full year dividend are around 8% (calculated at a 221p share price) the total amount expected to be used to pay for dividends and share buybacks equates to more like 17%. Its share price is about three-quarters of its tangible net asset value and its return on equity employed is around 15%. All of these numbers¹ are more favourable than the peer group. A derisory share price for this medium risk bank may well be the consequence of poor reputation since the Fred Goodwin era ended over a decade ago, but it was not helped by the circumstances of Alison Rose's defenestration last year. That is probably a fair sum-up: public opinion conflicts with cold, hard numbers.

For investors the choice seems plain enough: which will you rely on to invest your money?

Source data: Numis¹
JP Morgan²

Important Information

The value of investments and income can fall as well as rise and your capital may be at risk. Past performance is not a guide to future returns. Any opinions are not advice, if you are unsure about suitability, you should take independent advice. Any relevant HMRC or tax rules may be subject to change. Opinions and information are correct as at the time of writing and sources are believed to be reliable. Staff members and/or the author may hold the investment featured and receive remuneration linked to transactions in the recommendation. Where featured, prices are the most recent market price, not price targets for investment decisions. All investments are subject to our current terms and conditions. Whilst every effort is made to ensure accuracy, we cannot be held liable for errors or omissions.