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SOUTH AFRICAN BANKS: VALUE OR WRAPPED IN RED TAPE?

GLOBAL BACKDROP

There is little doubt that in the years leading up to the Global Financial Crisis (GFC) the world's largest banks were highly leveraged, under-capitalised and poorly regulated. The banking system had become so entwined that when Lehman Brothers collapsed in 2008, neither the regulator nor the bank management teams were able to accurately assess their risk and exposure to each other. The world's largest banks had grown so large that they posed systemic risk to the entire financial system and some required financial assistance from governments to ensure critical operations could continue. A combination of lax regulatory oversight, excessive leverage and poorly aligned compensation structures resulted in banks increasingly relying on higher risk investment banking activities and proprietary trading for profits instead of traditional lending and deposit taking.

The landscape for global banks has changed materially post the GFC. A combination of increased regulatory pressure and reduced investor appetite has forced the banks to reduce risk taking and excessive leverage. Regulators throughout the developed world have looked to put in place various safeguards to protect retail (household) depositors and the financial system as a whole. Despite running lower levels of leverage



and having less reliance on higher risk investment banking profits, South African (SA) banks have found themselves facing similar regulatory scrutiny because they too are integrally linked to the global financial system. More onerous capital structures and a higher required equity risk premium have meant that all banks can no longer access capital as cheaply as before. On the funding front, banks are required to match assets and liabilities more closely through extending the duration of their funding base. On the revenue side regulators have clamped down on the large proprietary trading operations that many banks had put in place. The net result is that banks have been forced to focus on lower risk, more traditional forms of banking.

Valuations have declined as banks have struggled to generate returns in excess of their cost of capital. The situation is compounded by a deteriorating domestic economic growth outlook. The key question for investors now is whether or not these factors are accurately reflected in the prevailing bank valuations?

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REGULATORY LANDSCAPE

The latest iteration of banking regulation has been the Basel III reforms. The Basel Committee is the primary global standard setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters. Its mandate is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability. Principally banks need to hold more capital against their assets. The intention is to decrease the size of bank balance sheets, limit their ability to leverage themselves and therefore reduce the likelihood of failure. In the event of a bank failure, the regulation is designed to ensure that the failed bank's critical operations continue, there is limited disruption to the financial system and crucially that a failure is unlikely to require taxpayer support and/or lead to losses to depositors.

The Basel III proposals are not only focused on the amount of capital a bank must hold, but also on the structural features of this capital. Therefore, despite being well capitalised relative to global peers, SA banks have work to do in ensuring that the structure of their capital meets international standards. The regulators are increasingly focused on the stability of funding sources as well as the loss absorbing features of capital. The challenge our banks face is more of a structural nature and therefore cannot be as easily overcome as simply raising additional capital.

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Under the Basel III framework, call and term deposits placed directly with a bank by a retail client are considered a more stable source of funding than corporate deposits. This is problematic in SA because the retail savings rate is low and the majority of what is saved is directed into pension, insurance and money market funds. As a result the domestic banks have historically relied on cheap corporate funding which is less desirable under the new framework. The second problem facing the banks is the structure and size of the local debt market which is smaller and less established than many of the developed market peers. The banks are going to be required to issue different forms of capital and are at this juncture uncertain about investor demand and the relevant pricing of this capital (in all likelihood it will be more expensive due to it being perceived as higher risk).

Chart 1: SA GDP growth relative to global GDP growth

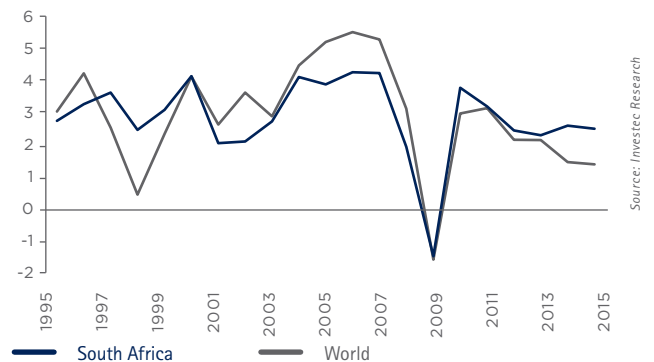


Chart 2: Household versus corporate loan growth

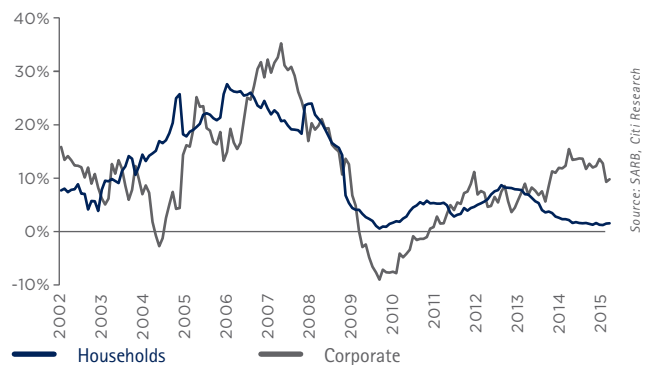


Chart 3: SA unemployment rate versus industry credit loss ratio

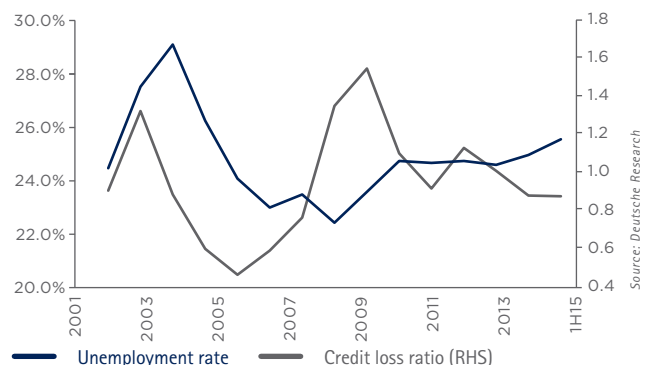
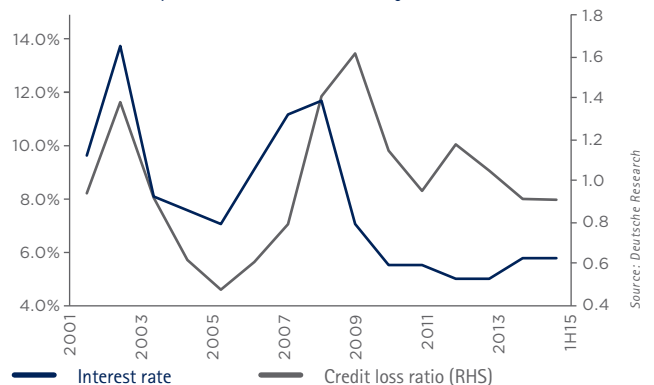


Chart 4: SA repo rate versus industry credit loss ratio





LOW DOMESTIC GROWTH, UNSECURED LENDING AND THE SARB DILEMMA

If regulatory pressure was not enough, banks are also faced with a weakening domestic growth outlook. Both consumers and corporates remain under pressure and banks are going to have to work harder to generate profits as domestic growth stalls and bad debts rise. This fact is illustrated by anaemic retail lending growth across home loans, vehicle financing and other forms of secured and unsecured credit extension. Corporate loans have shown stronger growth although this has been bolstered by government related renewable energy deals and infrastructure projects rather than corporate loan growth. Revenue growth and profit margins will remain under pressure as retail loans are more profitable than corporate lending. Compounding matters is that SA is in an interest rate tightening cycle which has the potential to push an already weak consumer over the edge.

Leading up to the latest interest rate tightening cycle, unsecured lending growth was strong and undoubtedly posed a risk to bank bad debts

Bad debts are at cyclical lows due to a combination of low interest rates and the banks being more risk averse. Historically, bad debts have risen abruptly in periods of increased unemployment and/or strong lending growth followed by a sharp increase in interest rates. Leading up to the latest interest rate tightening cycle, unsecured lending growth was strong and undoubtedly posed a risk to bank bad debts. The deteriorating domestic growth outlook and weaker oil price has, however, provided the South African Reserve Bank (SARB) with sufficient breathing space to ensure the pace of interest rate increases has been slow. This has bought the banks time to reduce their unsecured lending exposure while also increasing the level of bad debt provisions across their portfolios.

Excessive risk taking and inadequate bad debt provisioning resulted in the largest player in the unsecured lending market, African Bank being placed under curatorship in August last year. The SARB was forced to restructure the outstanding debt with senior bond holders required to accept a 10% reduction in the capital value of their investment. This was an unprecedented move by the SARB and has pushed up the cost of funding for all the banks as investors have demanded a higher return to compensate them for this additional risk. This event also created temporary uncertainty as to the quality of the other bank's unsecured loan books and whether or not they would be forced to face large write-downs. Interestingly, in the months following the curatorship, the level of bad debts at the other banks remained relatively muted and seemingly well provided for.

To complicate matters further, in June this year the National Credit Regulator (NCR) and the Department of Trade and Industry (DTI) published proposed changes to the caps on interest rates and fees that can be charged on different forms of credit. The proposed interest rate caps have the largest impact on credit cards, overdrafts and store cards as well as other forms of unsecured credit. The proposed caps were calculated without any initial consultation with the industry. If the banks are unable to price these higher risk loans appropriately they will stop

lending to this segment of the market. The danger is that this pushes lower income consumers who can no longer access debt from the banks to lend from the unregulated shadow banking industry. This seems to be counterintuitive given that the regulator has introduced stricter affordability assessment criteria with the intention of clamping down on shadow banks. There is a fine balance that the regulator will need to tread and until further clarity emerges, this will remain a risk to both the banks and consumers.

Despite these headwinds the weak economic outlook will make it difficult for the SARB to raise interest rates too quickly. This should give the banks time to benefit from higher interest rates on their assets before bad debts begin to normalise from the current cyclical lows. An area of potential concern however, is the mining and energy related exposure within SA and the rest of Africa. We believe that the industry will look to work together to ensure that the local mining companies restructure their debt rather than experience widespread losses. Where we are more uncertain is the exposure in the rest of Africa where the market is fragmented and the role of the relevant central banks less predictable.

There is little doubt that the interest rate banks earn on assets relative to what they pay on their liabilities will remain under pressure i.e. this 'margin' will narrow. This is a negative for profitability and means that banks will need to think of smart ways to drive revenue growth from sources outside of pure lending. The increase in the absolute levels of capital will be a drag on the returns generated by the bank as this capital can only be invested in low yielding and highly liquid assets. By requiring the banks to hold more 'loss absorbing' capital the regulators are also increasing the cost of funding. This is because investors demand a higher return on their investment as it is now considered more risky. The cost of complying with additional regulation is another headwind the banks have to overcome, while weak commodity and energy prices limit the short-term growth trajectory of some of the key African countries outside of SA.

Chart 5: Trailing relative P/E ratios - banks remain attractive relative to the ALSI



Chart 6: FirstRand highest return on equity (ROE) in the peer group but valuation does reflect this

Sector valuation	June - 15	June - 16	
	ROE	PE	PB
FirstRand	24.7%	12.5	2.7
Barclays	16.4%	9.8	1.5
Nedbank	16.0%	9.5	1.4
Standard Bank	15.1%	9.9	1.4
Average	18.1%	10.4	1.8

GROWTH LEVERS AND VALUATIONS

The difficulty as an investor is determining whether or not these headwinds are accurately reflected in the current bank valuations. Aside from FirstRand and Capitec, the prices of the remaining banks have lagged the broader market over the past five years. Considering the outlook one needs to assess whether this is likely to continue or reverse. Given that all the banks face similar pressure from a regulatory perspective we are of the view that those that are able to mitigate the downward pressure on their interest margin's (interest earned on assets relative to that paid on liabilities), drive revenue growth outside of lending and control costs as most likely to outperform the other banks. In our mind, the bank with the biggest levers to pull is FirstRand.

Within FirstRand, the FNB franchise has been able to take market share and drive transactional banking revenue via its loyalty eBucks reward program. The group's return on equity is well above the peer group and much of this has been driven by the FNB franchise. The improvement in returns has been a function of generating consistently higher returns on their assets rather than through the use of leverage. The one criticism levelled at management has been the bank's over reliance on the SA market. Barclays, Nedbank and Standard Bank have more established African franchises and there is no doubt FirstRand do lag in this regard. Commodity and energy price weakness has softened the medium term growth expectations in the rest of Africa but longer term exposure to the region should provide an additional growth lever to established players. Despite this FirstRand remains the quality name in the sector. It is priced at a premium to the other banks which we believe is justified. The management team is best in class, has a proven ability to cross sell and importantly, in a weak revenue growth cycle, has a flexible cost base. While the bears will argue that the returns generated on equity will need to normalise to within the banks medium term target range of between 18-22% (currently 24.7%), we are of the view that the bank has sufficient levers to pull to remain best in class within our forecast horizon.

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There is no doubt that earnings growth for the domestic banks will be under pressure over the medium term but what gives us comfort is that investors are not being required to pay a demanding price for what we feel is a relatively predictable, albeit unexciting earnings stream. The risk to this view is that unemployment increases and/or the SARB raise interest rates more quickly than is currently anticipated. We remain vigilant to this threat.