

THE STRAIGHT TALKING

CURVED THINKING

REPORT



TANTALUM
CAPITAL

ISSUE 22

July 2018

BATTLE OF THE BANKS

Bank valuations have fallen back to levels in line with the ANC elective conference on December 20th last year. The positive sentiment and resultant share price rally across South African shares most geared to an improving domestic economic and political outlook benefitted the banks as they too re-rated on “Ramaphoria”. Relative US Dollar strength and resultant emerging market weakness since late March and early April this year, combined with land reform, mining charter finalisation and the need for structural reform within State Owned Enterprises (SOE) has provided the backdrop for weaker price action amongst the banks and financials in general. While business and consumer confidence has received a notable boost post the 2017 lows, corporate results in 2018 continue to highlight limited green shoots in the underlying economy.

At current prices, banks appear to be discounting a relatively anemic domestic growth outlook and/or further relative US strength and emerging market weakness. These two are certainly not mutually exclusive. A stronger US dollar, resultant weaker Rand and higher global oil price could push inflation expectations higher. This could force the Reserve Bank to hike interest rates, curbing the growth outlook, all despite Ramaphosa’s best efforts at structurally reforming the domestic economy.



Despite these global macroeconomic trends, a combination of sound asset quality on the banks’ balance sheets, reasonable starting valuations and positive delta to any domestic recovery provides what we think is a positively skewed risk and return profile for the sector.

Disclaimer: This material is issued directly to eligible recipients by Tantalum Capital (Proprietary) Limited, and is deemed to be proprietary and confidential information. The content is intended solely for the recipient, providing high level investment thinking for illustrative and discussion purposes. It should not be seen as comprehensive investment research, nor should it be construed as soliciting new or further investment into funds managed by Tantalum Capital. Any investors deciding to invest in Tantalum funds should do so solely based on information contained in mandate documents pertaining to each relevant fund. Investors should familiarise themselves with those documents before making any investment. Note that the value of discretionary investment funds may go down as well as up and past performance is not necessarily a guide to the future. Tantalum Capital is an authorised discretionary financial services provider (“FSP”) with the Financial Services Board (“FSB”) under the Financial Advisory and Intermediary Services Act, 2002 (FSP Registration No. 21595). Data in this document is provided as at 30 June 2018 and its source is Tantalum Capital unless stated otherwise. Although data has been obtained from and is based on sources Tantalum Capital believes to be reliable, neither Tantalum Capital, nor the suppliers of such data, can guarantee the accuracy of the information.

A BRIEF HISTORY LESSON

If we go back to the Global Financial Crisis (GFC), SA banks held up reasonably well despite the contagion that spread across developed market banks. Higher capital buffers, relatively conservative regulation and lower overall leverage in the financial system contributed to a more benign credit impairment cycle than the global peers. While they were sheltered from the worst of the crisis, the regulatory backlash from the European and US regulators has had a profound impact on the capital adequacy and return profile of not only the large developed market banks but the domestic banks as well. This is despite having more traditional and less opaque banking revenue streams and lower levels of overall leverage than the large developed market banks.

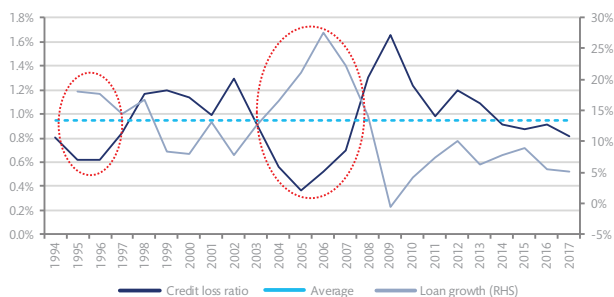
The failure of African Bank in 2014 provided a timely reminder of the speed with which contagion can spread through the banking sector. The once darling of the industry was forced into curatorship on the back of an over-reliance on wholesale funding in the face of an ever-expanding hole of bad debts in its loan book. The National Credit Regulator tightened lending standards and banking credit committees were forced to pull back on unsecured loans. Simultaneously, the political backdrop deteriorated with policy uncertainty and more radical rhetoric causing business and consumer confidence to fall.

A combination of more conservative credit extension and lower confidence caused loan growth to slow drastically. The increased political risk, weaker domestic growth profile and resultant lower bank earnings trajectory kept bank valuations depressed. The constant threat of cabinet reshuffles, particularly in the key finance ministerial post did little to bolster sentiment toward the sector despite some attractive entry points along the way. The steady decay in the government and state owned enterprises' fiscal position meant that even the growth in infrastructure and renewable energy related loans began to slow. This had been one of the few bright areas of growth, albeit lower margin, post the collapse of African Bank.

In-light of this, banks tightened their credit scoring further and tried to minimize exposure to those SOE's with the most questionable balance sheets.

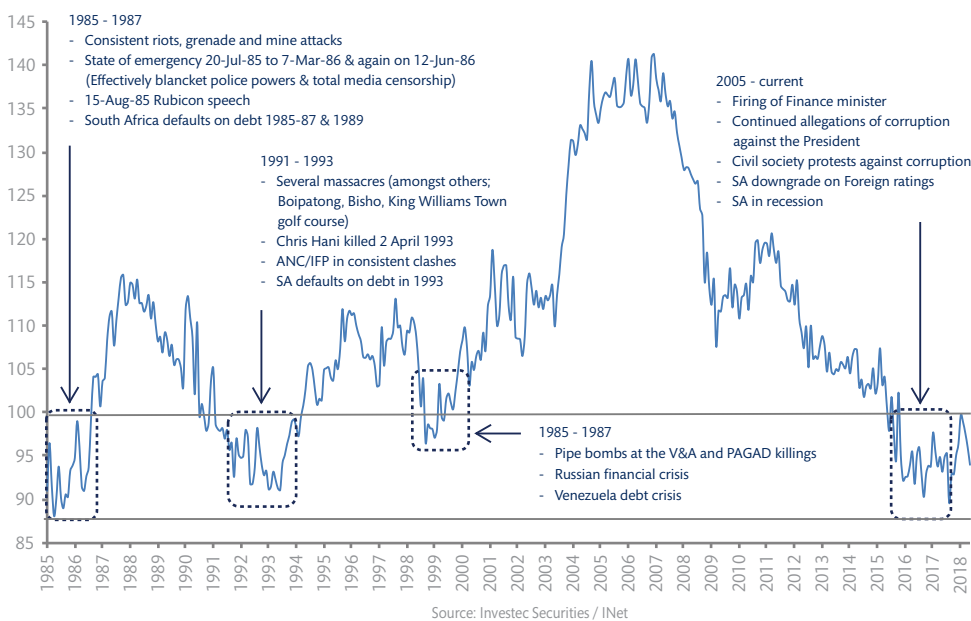
Chart 1:

Anemic loan growth leading to lower levels of impairments



SA banks held up reasonably well despite the contagion that spread across developed market banks

Chart 2: Business confidence



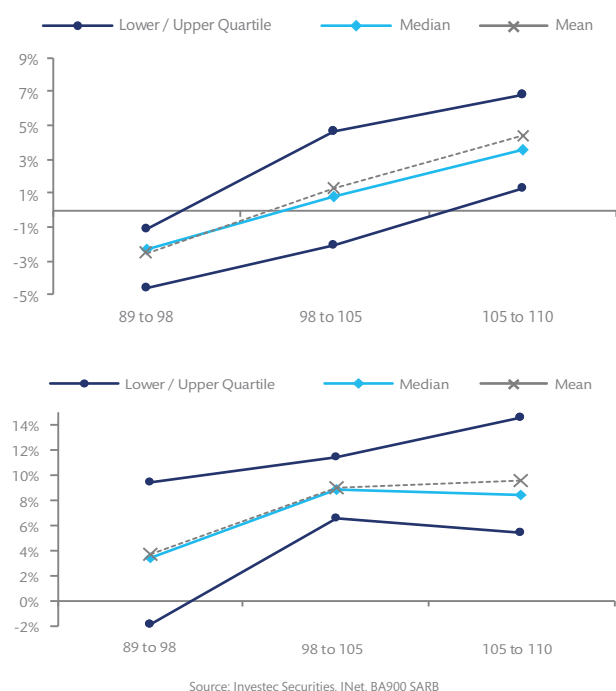
RAMAPHORIA AND THE PATH TO INCREASED LOAN GROWTH

The election of Ramaphosa in December created a platform for real structural change in the local economy. Investors will undoubtedly still need policy certainty on land and resource ownership rights and a path towards stabilization for state-owned entities. Investing in banks provides one of the ways to benefit from higher business and consumer confidence and an improving domestic growth profile. Higher confidence has historically provided the catalyst for increased corporate spend which eventually spills over into a higher propensity for consumers to lend and spend.

Initially, this mix of faster corporate growth relative to retail is negative for banks' net interest margin. Higher levels of cheaper retail deposits and consequent reduced reliance on more expensive wholesale funding post the collapse of African Bank will mitigate some of this pressure. Higher loan growth in the retail segment, particularly in the large mortgage book category will also provide a tail-wind to margins as the lower priced back-books begin to slowly reprice higher.

Improving confidence combined with greater risk appetite from the banks to lend, typically increases the propensity for both consumers and corporates to spend. Consumer and corporate spend are not only key drivers of overall GDP growth but also provide an underpin for transactional revenue growth for banks. The combination of a higher mix of cheap retail deposits as a source of funding and the ability to drive increased transactional revenue growth is one of the key ways to increase a banks return on shareholders' equity. Ceteris parabis, higher returns lead to a higher market rating.

Chart 3:
Improved business confidence leads to higher loan growth in both retail and corporate categories



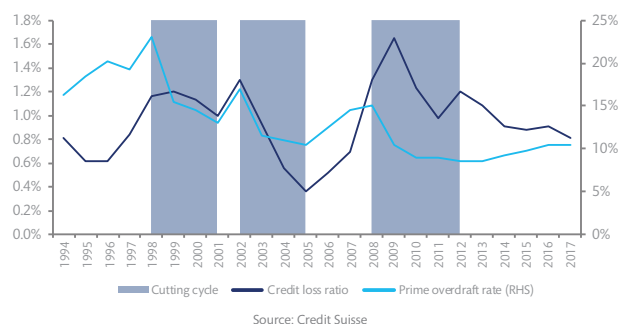
In the last couple of years, with revenues under significant pressure, banks were forced to rationalise costs. While it is clearly important to be able to flex your cost base depending on the economic outlook it is also crucial to continue to invest in the business for the future. With the speed of technological change enabling the convergence and disintermediation of financial services, banks have been forced to embrace investment in artificial intelligence, block chain and robo-advice just to name a few areas. The banks with greater positive momentum and higher levels of economic capital generation are in our view better positioned to keep investing through this period, while those without are left with fewer options and run the risk of under-investing and being left behind. Of course, all of this is happening within a highly

regulated and controlled environment and we are by no means calling the end of the traditional banking models. Instead we are cautioning that cost discipline should be viewed in light of balancing the need to generate profits today with the requirement to position the business to compete in the future. Either way, an improving revenue outlook combined with the aforementioned cost discipline is good for profitability provided credit losses remain under control.

A stronger US dollar combined with higher oil prices will keep inflation expectations elevated

While we touched on the quality of the existing loan books earlier, it is worthwhile considering what could cause these to deteriorate and undermine our investment case. Given the anemic loan growth and stricter credit granting criteria in the past couple of years it would likely come down to a sharp and unexpected increase in interest rates and/or a spike in job losses across the broader economy. While not mutually exclusive outcomes, we think it more likely that interest rates are the more immediate concern. This is particularly pertinent given where the US is in its own economic cycle and the likelihood of a normalization of monetary policy and interest rates over the medium term. A stronger US dollar combined with higher oil prices will keep inflation expectations elevated in emerging markets. In response to this, central bankers, including our own Reserve Bank will stand ready to raise interest rates and stem inflation.

Chart 4: Prime overdraft rate vs Credit loss ratio

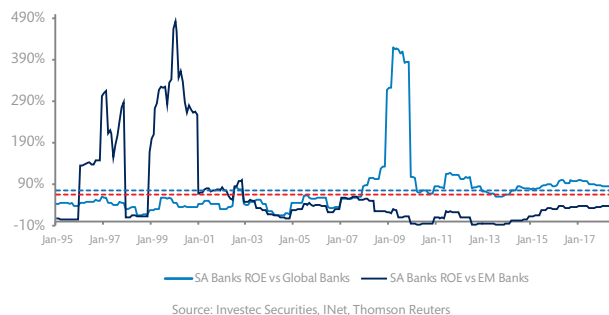


The speed with which interest rates rise is also often the most important determinant in the emergence of higher bad debts. If the cycle is not too aggressive then banks are typically able to manage their books while actually earning higher interest rates as their assets (loans) re-price faster than their liabilities (deposits). On the other hand, if the cycle is aggressive then the risk is that bad debts emerge faster than they are able to re-price.

The regulatory landscape has changed significantly post the GFC and while the return profile of banks globally has typically trended down due to increased capital requirements and a marked reduction in the use of leverage, the SA banks have managed to consistently earn returns ahead of their cost of capital despite this. Not only have returns been ahead of many of the global peers but for a long period of time the SA banks have held higher levels of capital as well. This gap has narrowed over time but

this has primarily been due to the global banks improving their capital bases rather than any deterioration in the SA banks capital profile or generation.

Chart 5:
SA banks ROE vs Global Banks ROE / EM Banks ROE



UNPACKING THE NUANCES OF THE INDIVIDUAL BANKS

Each of the big four banks will benefit to some degree from an improved domestic growth outlook. The size and timing of the improvement will vary depending on the nuances of the individual bank. Despite generating a significant percentage of revenue from outside of South Africa, ABSA potentially has the most to gain from a turnaround in retail confidence and spending. Stemming further market share losses in their domestic retail franchise and beginning to grow lending to this segment will not only provide a strong underpin to revenue growth, albeit off a low base, but also provide a boost to margins as the poorly priced mortgage back-book begins to rollover. The argument could be made that Standard Bank stands to benefit less from a retail turnaround, but that improving business confidence would help their corporate franchise with its large and diverse African footprint. This footprint has helped make Standard Bank a key partner for both local and global multinationals expanding and doing business on the continent. The real longer-term and potentially underappreciated upside for Standard Bank is therefore perhaps more geared to growth in the rest of Africa than SA alone.

Nedbank generates the vast majority of its revenue in SA and therefore along with FirstRand stands to benefit from improving confidence and higher activity levels across most of its business lines. Nedbank's retail franchise is relatively small compared to the others but its corporate book stands to profit from higher business confidence and more clarity around government's renewable energy and infrastructure spend. The base is also low for its African associate, EcoBank where bad debts have decimated profitability in the last couple of years. A more stable oil price and higher commodity prices has already helped stabilize the credit losses and a swing from a loss to a profit will boost Nedbank's earnings by over one billion rand or c.10% of P&L.

Prior to the Aldermore deal, FirstRand had over R20bn in discretionary capital and was predominantly an SA-only focused business. This capital buffer was a clear advantage over the other banks, giving the bank optionality to do a deal in the rest of Africa or return some of this to shareholders via a special dividend. Having now spent the majority of

this discretionary capital to pay for Aldermore, this optionality is off the table. The immediate rationale for the deal is to provide a more stable funding model for its growing UK car financing franchise, MotoNovo. Despite the size of the deal, FirstRand still generates the vast majority of its revenue in SA and therefore certainly stands to profit from increased corporate activity and retail spend. One of the tenets of our FirstRand investment case sits with their best in class retail franchise. A good rewards program, a high relative mix of cheap retail funding and a balanced and diversified product set has provided a platform for the bank to cross-sell products and drive capital light transactional revenue across the retail and business banking franchise.

Outside of the big four, Capitec and Investec's SA banking operations have done well in recent years in the lower and upper income segments respectively. Capitec continues to grow its deposit franchise and drive transactional revenue growth off a low base. Credit extension has slowed drastically as the consumer has weakened and credit granting criteria tightened. There is little doubt that the book began to deteriorate faster than management would have liked about 18-24 months ago but given the subsequent slowdown in book growth it looks like they have managed to stabilise and more recently reduce the size of their rescheduled and bad debt clients. We can't justify the valuation given how big the bank has already grown but don't deny that they do still have some compelling growth opportunities ahead of them. Investec is more nuanced given the Wealth and Asset Management franchises as well as the geographical split of the businesses.

Sizable holdings in both Nedbank and FirstRand remain appropriate

PORTFOLIO IMPLICATIONS

In-light of the above and our detailed bottom-up fundamental research, we have taken the view that maintaining sizable holdings in both Nedbank and FirstRand remains appropriate. We have been gradually adding to both on weakness since the end of March this year. They are conservatively managed, fairly-valued and have clear and executable long-term strategies. While these characteristics provided the underpin as to why they were core bank holdings in the defensive part of the cycle we think that both still stand to benefit as the cycle turns.

ABSA and Standard Bank have also featured in the portfolio post December, although we have been more opportunistic in trading around where we feel price action has become irrational. The Standard Bank longer-term growth profile is attractive, but the share price has been more resilient than that of the other banks in the year to date. A lack of clarity around succession planning has made us wary of adding too aggressively to ABSA. This is despite attractive entry points, a low base and what we view as a reasonable break-up arrangement with Barclays PLC. Longer-term, ABSA should benefit from having full control over the franchise instead of having to report into the PLC. In the years post the Global Financial Crisis, the PLC had undoubtedly constrained ABSA's risk appetite due to its own underperformance and resultant capital constraints. The revenue delta from a combination of increased risk appetite from management and an improving domestic economy is something we are acutely aware of and we would look to increase our shareholding if incoming data begins to corroborate this view.