

UK Banks Outlook – An Analyst’s View

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Rating: Its UK banks v BNPP not UK market

- Over past 10 years, the key UK bank investors have changed massively.
- UK market comparisons much less relevant:
 - ◆ UK institutions been net sellers of UK equities.
 - ◆ More UK institutional money tracking or near-tracking, and so follows rather than drives the share price.
 - ◆ UK market changed:
 - Now mining stocks driven by Chinese demand for commodities.
 - Oil sector driven by oil price – nothing to do with UK.
 - HSBC used to be one-third UK profits, now c. a fifth.
 - ◆ Hedge funds typically international.
- So you need to attract the international investor to move the price.

UK banks cheap, but not compelling so

Ranking out of 70	HBOS	LTSB	Barclays	RBS	A&L	B&B	HSBC	Stand Ctd
2008 PE (lowest is cheapest)	4	22	5	3	21	10	44	59
2009 PE (lowest is cheapest)	4	23	6	2	24	10	42	60
2007-2009 CAGR EPS	63 (3%)	49 (7%)	54 (6%)	57 (5%)	59 (4%)	67 (0%)	65 (3%)	35 (14%)
2008 PEG (lowest is cheapest)	60	51	49	54	69	58	67	50
2009 PEG (lowest is cheapest)	58	66	50	54	68	59	66	47
2008 P/BV (lowest is cheapest)	17	50	27	9	41	13	40	61
2009 P/BV (lowest is cheapest)	17	53	27	9	43	13	40	62
2008 Div Yield	7	3	5	2	4	1	12	60
KBW fair value (% Euro avg 74%)	81	80	76	61	71	72	102	132

Source KBW estimates, 31 Dec 2007

- Sector generally very cheap on PE measures.
- But low earnings growth means that on PEG measures among the most expensive.
- P/BVs mixed but generally cheaper than average.
- Dividend yield support very strong – 6 of 7 cheapest in 2008.
- KBW Fair value (using long term DCF) has UK around sector average.

What's been driving the share prices

Figure 1: KBW “scores on doors” for factors driving UK bank share prices relative to European banks

	2001	2002	2003	2004	2005	2006	2007	2008 E	2009 E
Ongoing business growth	0	-8	-8	-9	-11	-11	-8	-10	-10
UK sector scores on restructuring	4	1	-1	0	-2	-1	-2	-3	-3
UK sector - Other issues	4	0	-4	-7	-5	-7	-2	-1	-1
Liquidity	0	0	0	0	0	0	-5	-3	0
Capitalisation	0	0	0	0	0	0	-3	-2	0
Valuation	-1	-1	-3	-2	2	3	3	4	4
Total	7	-8	-16	-18	-16	-16	-17	-15	-10

Source KBW estimates

- Earnings is a key driver (a) Growth, (b) Risk / Volatility.
- Core operating environment had been relatively tough for many years.
- But for banks, range of other issues been drag for five years.
- 2007 liquidity much worse for UK banks than peers.
- Valuation attractive but not compellingly so.

Relative operating environment

Figure 2: Detailed scores on the doors for operating environment

	2001	2002	2003	2004	2005	2006	2007	2008 E	2009 E
Ongoing business growth									
UK gearing	-1	-2	-2	-3	-3	-3	-3	-3	-3
Margin erosion	0	-2	-2	-2	-1	0	0	0	0
Housing market crash	-1	-1	-2	-2	-1	0	0	-2	-2
Consumer credit crash			-1	-1	-2	-3	-3	-2	-2
Relative earnings growth	1	-2	-1	0	-1	-1	0	-1	-1
Relative earnings upgrades	2	1	1	0	-1	-2	-1	-1	-1
Regulatory intervention	-1	-2	-1	-1	-2	-2	-2	-1	-1
Consistent	1	1	1	1	1	1	1	0	0
New competition	-1	-1	-1	-1	-1	-1	0	0	0
Sub Total	0	-8	-8	-9	-11	-11	-8	-10	-10

Source KBW estimates

- UK loans to GDP among highest in Europe and penetration of financial services high. Both limit market growth from here.
- Investor sentiment to UK housing negative – big concerns about affordability.
- Unsecured problem was seen as stabilising but now back on agenda.
- Ongoing regulatory reviews with incremental costs let alone redress.
- Overall earnings growth been below Europe.

Restructuring business a positive

Figure 3: Detailed scores on the doors for restructuring

	2001	2002	2003	2004	2005	2006	2007	2008 E	2009 E
UK sector scores on restructuring									
Business/ integration	3	2				1	1	0	0
Capital Buybacks			1	1		1	1	1	1
Others consolidating					-1	-2	-2	-2	-2
Bid interest	2			2	1	1	0	0	0
Acquisition risk	-1	-1	-2	-3	-2	-2	-2	-2	-2
Sub total	4	1	-1	0	-2	-1	-2	-3	-3

Source KBW estimates

- Merger integration benefits at start of decade helped sector, but these run out just as other sectors seen much more consolidation.
- Perceived lack of discipline in acquisitions also a major factor here. Deal junkies and forced to do deals because UK market so slow (per previous slide) both issues.
- Still big banks so bid target intermittent and not sustained.

Other issues little differentiator

Figure 4: Detailed scores on the doors for other issue

	2001	2002	2003	2004	2005	2006	2007	2008 E	2009 E
UK sector - Other issues									
UK institutional selling	-1	-2	-3	-2	-1	-1	-1	-1	-1
Regulation preventing consolidation	-1			-1					
Index weighting	2		-1	-1	-2	-2	-1	-1	-1
Interest rate environment	2	0	1	-1	1	-1	0	1	1
Safety Value	2	2	-1	-2	-3	-3	0	0	0
Sub Total	4	0	-4	-7	-5	-7	-2	-1	-1

Source KBW estimates, * 2007 estimate made at end 2006

- UK life and pension funds been sellers. Closing defined benefit schemes to new members will see this trend continue.
- Uk regulator seen as stopping internal deals.
- Underperformance leads to lower index weighting leads to underperformance.
- Falling rates should be positive but also reflect weaker outlook.
- For 2007, liquidity crunch an issue on safety value.

Liquidity

- Not an issue until 2H07.
- UK banks have a weaker position on liquidity than average.
 - ◆ UK market greater degree of indebtedness.
 - ◆ “Borrowing” banks reliant on US MBS market, which was closed (now tight and very expensive), and not, say, on the Pfandbriefe market, which has remained.
 - ◆ Potentially, lending banks all have large CP conduits and so have been hoarding own liquidity – no large primarily savings banks without cap markets ops.
 - ◆ UK regulator tough love means liquidity hoarded even more. NRK is unlikely to have faced crisis if it had been ECB regulated.
- HBOS loans to deposits (KBWe 2008) at 181% is 14th highest in Europe.
 - ◆ LTSB 30th, RBS 31st, Barclays 44th.
- HBOS conduit has twice been partially bank-financed.

Analysts hate surprises

- We may extrapolate near-term trends to the company's longer-term value.
- Introduces greater uncertainty and consequently a higher cost of capital.
- Dents management credibility and the rating given to stocks.
- Makes us look stupid – bad for our egos!
- UK was supposed to be safe but recent surprises included:
 - ◆ 2007 RBS share price down 36%, Santander flat.
 - Bidding war on ABN. RBS left with bits market doesn't like.
 - Big uncertainty over wholesale exposures.
 - ◆ Sector liquidity crunch relative to peers – NRK bank run.
 - ◆ “Safe” banks still exposed to sub-prime – e.g. A&L bullet proofed balance sheet from own mortgages but still hit.
 - ◆ HBOS retail including lost market share.

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