Equity Research; UK Banks Q3 what happened?

COLLINS SARRI STATHAM
INVESTMENTS

Research Report

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Analyst

Ravi Lockyer MSc Llb ASCI
Collins Sarri Statham Investments Ltd

Key Risks to Price Target

Not applicable

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UK banks Q3 what just happened?

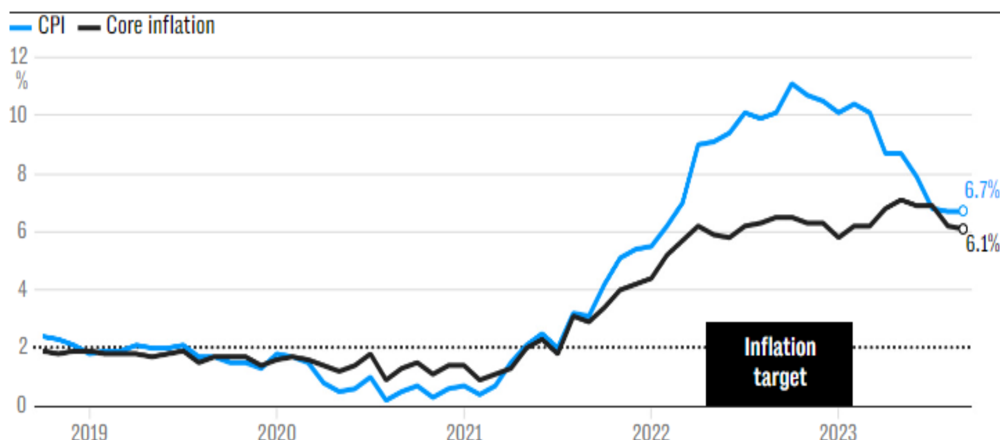
The Q3 reporting season was negative for the banking sector, taking the peer group in rating terms to valuations similar to C-19 pandemic lows.

When the rate hike cycle started in Q4 2021, banks appeared the obvious beneficiaries. Banks had complained about zero interest rates and their impact on lending margins for over a decade.

If we assume the current rate hike cycle has delivered rate normalization, that this is not an interval, and interest rates have returned to pre-2008 ranges then lending rates should be higher for longer. The issue in Q3 is high rates does not guarantee high margins.

The BoE Governor has made clear that CPI objective of 2% will be achieved. Investors have concluded interest rates will remain elevated possibly until H2 2025 when the 2% target should be achieved.

UK core inflation numbers, indicate only slow and relatively modest declines.



Notwithstanding this inflation context, at Q3 all major UK banks said net interest margin (NIM) (the lending margin i.e. difference between interest income and interest expense) had peaked in Q2 2023. This was a negative surprise. Despite high inflation, bank lending margins are down by meaningful amounts and at an early point in the rate cycle.

Bank	NIM (Q3 2023)	NIM (Q2 2023)	NIM (FY 23) guidance	COMMENT
Barclays (BARC)	3.04%	3.22%	3.05%-3.10%	Very sharp drop since Q2 23

Lloyds (LLOY)	3.08%	3.14%	>3.10%	Modest decline
HSBC (HSBA)	1.70%	1.72%	similar levels	Modest decline
NatWest (NWG)	2.94%	3.13%	>3.00%	Very sharp drop since Q2 23
Standard Ch (STAN)	1.66%	1.73%	'to approach' 1.70%	Very sharp drop
Virgin (VMUK)	1.93%	1.91%	c. 1.90%	Stable

source; CSS Investments Ltd

It appears Q3's NIM decline is the start of a new trend. The NIM correction was due to:-

i) Higher deposit funding costs / increased competition for deposits requiring higher rates to retain client cash deposits and hence higher interest costs. **HSBC point out that whilst interest income in Q3 2023 of $27.2bn was up $13.1bn (on Q3 2022) (+92%) this gain was dwarfed by increased interest expense (+205%)**. HSBC said increased funding costs and customer deposit migration were factors driving having to pay more for deposits. The banks all had similar views on the strength of the trend in rising funding costs.

Bank	Interest Expense (Q1-Q3 2023)	Interest Expense (Q1-Q3 2022)	Change	COMMENT
HSBC (HSBA)	$46.6bn	$12.4bn	+$34.2bn	+243 bps
HSBC (HSBA) Q3 2023	$18bn (Q3 2023)	$5.9bn (Q3 2022)	+$11.9bn	+205.1%

source; CSS Investments Ltd

ii) Active customer liability management i.e paying off high interest accounts including credit card, PL's, mortgages using low yield cash. The commentary from leading banks is consumer behaviour has changed with the focus on liabilities likely to stay.

iii) Declining customer 'loyalty' – the commentaries suggest the observed customer behaviour is less loyal/ 'shopping around' and 'incentive driven'.

iv) Ongoing challenger bank activity particularly in deposits. H1 challenger bank worries (Sillicon Valley Bank) had been an assumed positive for larger banks. In Q3 this factor reversed. Virgin Money (Q3 deposits rose 5% to £67.3bn) v Standard Chartered deposits fell 3%, Barclays -2.2%, Lloyds -3%. This suggests challengers are beneficiaries in this environment.

Overall Q3 has informed on principal uncertainties going forward:-

i) the trend reversal/ descent of NIM in Q3 and trajectory over Q4 and FY24.

ii) weaker business fundamentals, some banks reported both deposit and loan book declines i.e accelerated loan repayment. This improves credit quality but reduces margins.

iii) the changing regulatory context i.e. increased FCA regulatory focus on banks 'passing on' rate hike benefits post the new 'Consumer Duty' regulations on 31st July 2023. On this point, assuming UK base rate have levelled off, this pressure should abate.

Big share buybacks had limited impact

Bank share buybacks when executed via ongoing market purchases for cancellation have helped support investor sentiment and deter short sellers. Over Q2 2023, it seemed at times, the main buyers of UK bank shares were the banks themselves. Whilst the buybacks are EPS enhancing and will work long term if continued, so far (YTD 2023) despite their size, they have had limited impact.

Bank	Buy Back FY23	Buy Bank (% of share cap)	Buyback completed	COMMENT
Barclays (BARC)	£500m/ £750m	8.6%	23 Oct 23	-10% since end of buyback
Lloyds (LLOY)	£2bn	6.5%	29 August 23	Await FY23 for new mandate
HSBC (HSBA)	US$2bn/ US$3bn	3.5%	16 Feb 2024	Q3 – new $3bn buyback
NatWest (NWG)	£1.26bn + £500m	c.11.1%	14 March 2024	Q3 no new / top up buyback
OSB (OSB)	£150m	c.13%	Q3 almost completed	-44% since buyback started
Standard Ch (STAN)	$2bn	9.8%	c.$200m remains	Q3 no new/ top up buyback
Virgin (VMUK)	£175m	8.6%	Small balance left	To conclude 23 Nov 23

source; CSS Investments Ltd

At the Q3 results, only HSBC added to their buyback. The rest are on pause until FY23 (mid-February 2024). The lack of share buyback support has been taken badly and suggests boardroom reticence given this new environment. Buybacks tend to delay a correction. Nevertheless one has taken place. This suggests sector valuations will reach their lows faster, than in conditions where a share buyback is underway.

Valuations are at rating lows

Post Q3 the bank sector has noticeably de-rated with valuation drops that

normally occur in the event of i) financial stress/ bank failure/ global crisis ii) large increases in LLR (loan loss rate)/ impairments iii) imminent recession. Over Q3 none of these took place, loan losses were low and within guidance, and there was no major bank failure/ rescue. What did happen was a de-rating to P/E's of 4x-5.5x.

Bank	Q3 TNAV (p) (Δp)	LLR (bps)	RoTe (%)	FY23 EPS (p)	P/E (x)
Barclays (BARC)	316 +30	42	12.5	31.5	4.1
Lloyds (LLOY)	47.2+2.7	25	16.9	7.4p	5.4
HSBC (HSBA)	$7.96+ $0.12	32	19.7	$1.06	6.8
NatWest (NWG)	271+9	24	14.7	44.2	4.0
OSB (OSB)	491 (H1)	130	5	71.8	4.0
Standard Ch (STAN)	$12.83 +$0.40	20	7	85.7	7.2
Virgin Money (VMUK)	350.5 +37.3 (H1)	40	6.1	30.7	5.0

source; CSS Investments Ltd

Given LLRs have not spiked, TNAV's have moved up and returns on equity have remained similar, the only moving part that can be attributed to the sell off is the adverse NIM movement and in some cases both loan book and deposit declines.

Conclusion

The banking sector bent over backwards post re-opening to increase shareholder returns as the rate environment improved over 2022/2023. However the concern now is this benefit has been and gone. There would be a negative impact on shareholder returns in FY24 if lending margins are squeezed, whether due to changing client behaviour, competition, regulatory oversight or a flat base rate. UK banks appear oversold, but a sustainable rally requires investor confidence that lending margins have stabilized. The trading performance right now appears fluid, with sharp cash and loan movements being the norm. Where will margins settle? Investors may have to wait until mid February 2024 for a clear answer to this question.

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Collins Sarri Statham Investments Ltd. 138 Fortis Green Road, Muswell Hill, London N10 3DU

T +44 (0)20 8 057 6380 **W** www.css-investments.com **E** info@css-investments.com

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