INTUITION
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Standard Bank: It Can Be!

Banks generate lots of emotion. You either love them or hate them, and most consumers can regale you for hours with stories of how inefficient their bank is. Yet we cannot live without them. They fulfill a crucial role in the economy and facilitate millions of transactions every day. They literally keep the economy moving forward, which incidentally used to be Standard Bank's motto before they changed it to "It Can Be." The banking sector has experienced a tough few years thanks to Covid and the regulatory response thereto. But banks are bouncing back. This article will focus on Standard Bank, being our most widely held banking share, but the trends are similar across the sector.

Michael Porter

SPEED READ

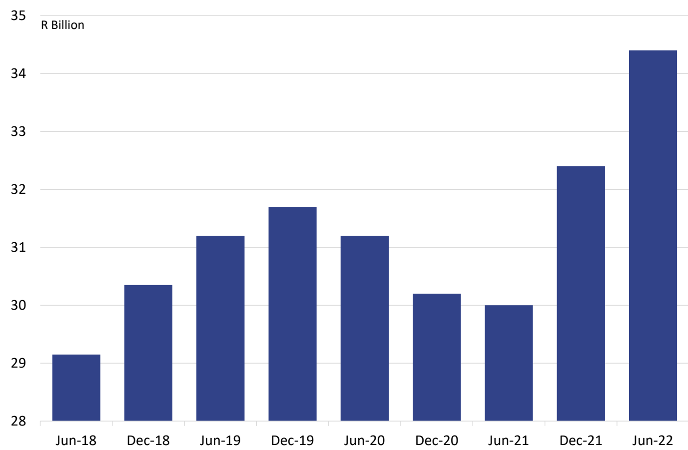
- **From the outside, banks often appear to be complex companies. But generally, they are driven by a few core factors which we will explore.**
- **Diversification is key, both in terms of product and geography. Africa offers opportunity for those willing to build a long-term presence.**
- **Regulatory intervention during Covid prevented banks from paying dividends. That restriction has fallen away, and dividends are rising fast.**

The banking sector was hard hit during Covid. Given their crucial role in the economy and as custodians of people's savings, it is paramount that banks are seen to be trustworthy and reliable. If not, depositors would withdraw all their funds, and the bank would collapse, leading to a domino effect across the sector and economy. That is why banks are so tightly regulated – and rightly so. In response to Covid, the Reserve Bank issued a directive that banks could not pay any dividends to shareholders. The last thing the SARB wanted was for banks to be poorly capitalized when the economy was under such pressure. That was the right decision, but banking shares took a hammering. The sector fell 60% from its peak. Two years later, that nightmare is firmly in the rearview mirror. Banks are on course to report record profits this year. Patient shareholders have been vindicated.

From the outside, banks appear to be complex and opaque organisations. In reality, their profitability can be whittled down to just a handful of factors. This article will focus on Standard Bank – given that it is our most widely held banking share – but the trends are largely the same for its peers as well.

The first factor is "net interest income" (NII) – the amount of interest earned less the amount paid away on deposits. This lies at the heart of a bank (it contributes almost 50% of Standard's total revenue) and is influenced by the level of interest rates, the size of the loan book, and the margin that the Bank can charge its customers. NII fell sharply during the Pandemic as interest rates plummeted. Remember that the repo rate was cut by 3% over the first few months of 2020. That, together with the fact that demand for new loans dried up due to Covid uncertainty, saw NII contract.

STANDARD: NET INTEREST INCOME



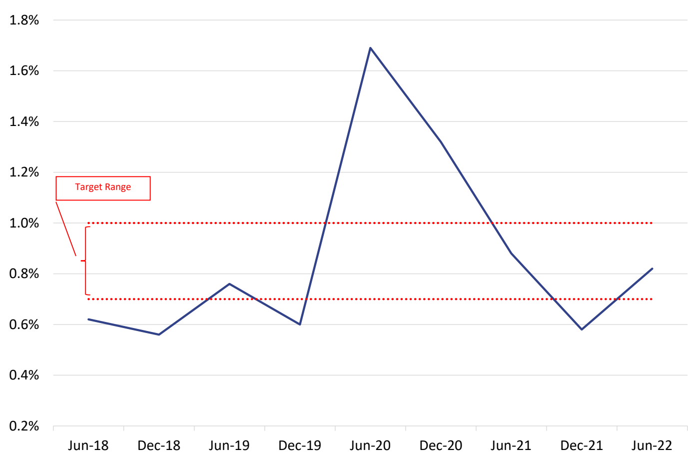
Thanks to rising interest rates and strong client growth, especially in mortgages, net interest income has reached an all-time high.

That trend has now reversed. Interest rates are rising, and so too are interest margins. Furthermore, Standard Bank continues to dominate in the local mortgage market, with a market share of 35%. That will underpin NII growth in the years to come given that mortgages have a typical duration of twenty years.

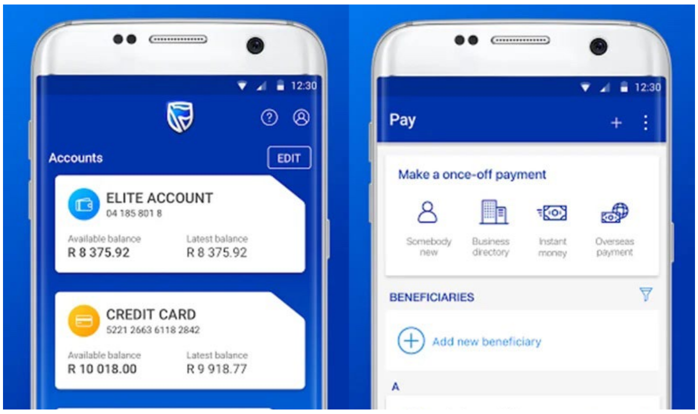
The second factor is "non-interest revenue" (NIR) – all the other fees and commissions that banks charge and which are usually the subject of such emotion, as well as trading revenue. Standard Bank grew NIR by 13% over the same period last year – a good effort given the higher base when volatility and trading income was high. There is no doubt that Standard Bank benefits hugely from its dominant position in Africa – a position that it has built steadily over the past twenty years. Their strong and diversified client base across the continent creates a steady flow of transactions that other banks cannot match. Consequently, trading revenue is double that of its nearest competitor, a reflection of its success in building a pan-African brand.

Unsurprisingly, the third factor is "credit impairments" – basically bad debts. This reflects the quantum of loans that the bank writes off. The quantum of bad debts is best expressed in terms of the Credit Loss Ratio – the ratio of bad debts written off to total loans. Standard Bank targets a range between 0.7% and 1% over a normal economic cycle. The ratio ballooned during Covid, to a peak of 1.69%, but is now, at 0.82%, comfortably back into the target range. Equally comforting is that Standard Bank has substantially increased its overall level of provisions. For the decade prior to Covid, provisions raised against possible future bad debts averaged about 2% of total loans. Now its 3.5%. This implies that Standard Bank has plenty of room to absorb a deterioration in bad debts without it having a significant

STANDARD: CREDIT LOSS RATIO



After blowing out during Covid, bad debts have returned to more normal levels, and now fall squarely within the Bank's internal range.



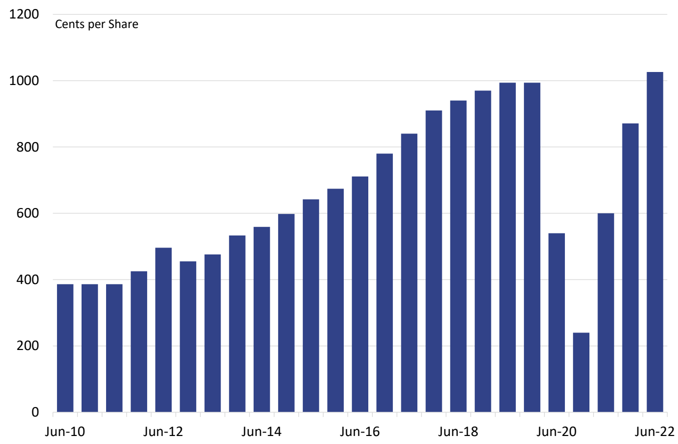
Standard Bank has been investing in its app for customers which reduces the need for expensive branches.

negative impact on its income statement. That conservatism is comforting given unfolding economic conditions.

The fourth factor is efficiency. Like all businesses, higher profits are a function of both revenue growth and cost control. Standard Bank reported good cost control, with overall costs rising at a slower pace than inflation. Notably, staff and IT costs were well controlled, two areas that are of concern for investors given their track record. In addition, cost growth was only 5% in South Africa, but 14% in their other African operations – understandable given the investment to build their African footprint. Furthermore, they have invested heavily in new technology to improve their customer-facing apps and ATMS, which has allowed them to cut their footprint and rental costs. All banks are increasingly moving online and away from branches. Only time will tell whether the reduced footprint will impact on new client growth. Nonetheless, and despite the progress on costs, there is still much to be done. Standard reported an efficiency ratio of 56%, down from 58.3% last year but still high relative to peers. The Bank has targeted a ratio below 50% by 2025, and is confident of achieving it, but investors remain sceptical. Achieving this target would drive significant share price performance, so it is a key metric to watch.

The last piece of the puzzle is the level of capital, and the return that the Bank earns on that capital. The SARB requires a minimum level of 8.5% of core equity capital, whilst Standard Bank has an internal minimum level of 11%. Currently, the ratio sits at 13.7%. It is comforting to have excess capital – especially in tough times – but excess capital also implies that returns on that capital are lower than they might be. Return on Equity has improved from the lows of Covid and is now at 15.3%. This might be an improvement, but its below the peer group. There is a clear positive correlation between ROE and valuation – the higher the returns, the higher the valuation. Standard Bank has set a goal to reach an ROE of 18% by 2025. Again, the market is sceptical, but given that its African operations generate an ROE of over 20% (vs 14% for their SA operations), it is quite possible for them to achieve this given that their African operations are growing significantly faster than those in SA.

STANDARD: ROLLING 12M DIVIDEND PER SHARE



After years of steady growth, dividends collapsed during Covid, partly due to regulatory intervention. Those restrictions no longer apply. On a rolling 12-month basis, the Bank has already reached a record dividend, and this should move higher for the full financial year.

As mentioned in the opening paragraph, bank dividends were one of the casualties of Covid. The recovery in capital levels has removed those shackles. Dividends are back. Standard Bank declared a dividend for the 6 months of 515c, 43% higher than the same period last year. Provided there are no dramatic events over the next few months, Standard Bank should report record earnings and dividends for the full year. That vindicates our patience to hold bank shares throughout the Pandemic.

The fortunes of banks are tied closely to that of the economy. Hence, it is one of the reasons why investors remain sceptical. GDP growth remains weak, and consumers are under pressure from rising costs. In our opinion, this is nothing new. These conditions have prevailed for the past 5 years and banks have continued to grow, albeit slowly. But we believe that banks stand to benefit hugely from electricity reform as a wave of investment is unleashed – investment that will be largely financed by the banks. Furthermore, Standard Bank in particular stands to benefit from its growing footprint across Africa, where its entrenched position gives it a competitive advantage. Despite what we believe to be an increasingly positive outlook, and the recovery so far this year, Standard Bank is still trading at a valuation well below its historic norm. We are confident that this anomaly will not last forever.

STANDARD: PRICE / BOOK RATIO

Both profits and dividends have recovered from the Covid-induced weakness, yet Standard Bank still trades at a lower valuation. Despite the rally already this year, banks still have plenty of potential.

As South Africa approves new energy sources, including renewables such as this solar farm in the Karoo, the banks, including Standard Bank, are likely to be a source of funding . This should drive a portion of future profits.

Through a variety of news channels and daily commentators, investors are constantly bombarded with advice on where to invest their money. The most vociferous debates often occur between those who argue that everything should be offshore, and those who argue the opposite. Our next seminar will explore the merits of both markets, through the lens of our identified core themes, and explain why we feel it is wise to hedge your bets.

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Topic: Why still Local AND Global

Natal Midlands	
Date:	15th September 2022
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg	
Date:	20 September 2022
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am

CONTACT DETAILS:

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HARVARD HOUSE GROUP

3 Harvard Street, Howick, 3290, South Africa

P.O. Box 235, Howick, 3290, South Africa

+27 (0) 33 330 2164

+27 (0) 33 330 2617

@ admin@hhgroup.co.za

W www.hhgroup.co.za

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