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ANALYSIS

Uncertainty impacts local banking stocks

The jury is out on whether shares in South African lenders are a good bet in the current economic climate.

Even though banking stocks have seen gains of around 60% since their eight-year low in May 2020 – with some analysts predicting that their share prices could rally even further – the market does not appear to be particularly bullish about them.

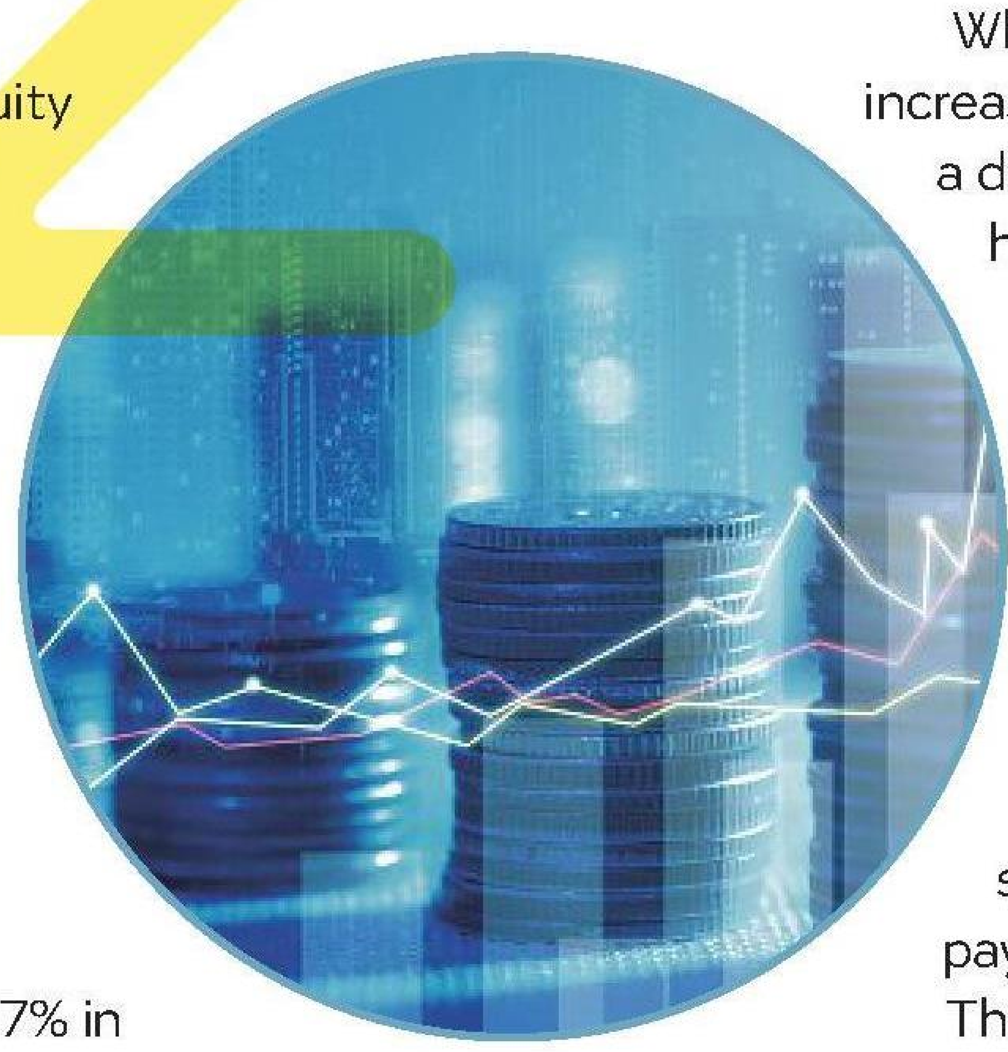
Many reasons present themselves for this, not least of which is continued uncertainty, sluggish economic growth and political volatility in South Africa.

Local banks were hard hit by the Covid-19-induced lockdowns because of debt payment holidays and increased bad debt provisions which had a negative impact on headline earnings and knocked their share prices. Standard Bank, the largest lender in the country in terms of total assets, lost nearly a quarter of its value last year. FirstRand and Absa were down nearly 20%. Capitec, SA's third largest bank, suffered a big sell-off during the year but managed to recover sufficiently to end the year where it had started. Investec lost 38%.

By March 2021, the price-to-book ratios had all improved by between **30%** and **60%** relative to the lows of March and April 2020.

Compared with other sectors, the financial sector – which includes banks, financial services companies and insurance companies – was the laggard in terms of a recovery and rose "just" 25% compared with resources stocks' gains of 55% and the industrial sector which added 35% between May 2020 and April 2021.

The price-to-book ratio and the return on equity in percentage terms provides a mixed picture in terms of valuations for financials. By March 2021, the price-to-book ratios had all improved by between 30% and 60% relative to the lows of March and April 2020. However, they remain below the levels seen at the end of 2019. Return on equity, however, has declined by roughly 50% across the board, except for Investec.



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This is perhaps no surprise given the current operating environment. The SA economy was already in recession even before the pandemic. A national lockdown resulted in GDP contracting by 7% in 2020 accompanied by record-high unemployment and poor consumer and business confidence. Load shedding, political volatility, a slower than expected vaccine rollout and the threat of a third wave of Covid-19 infections, continue to pose risks to the economy.

Bank-specific risks include concerns around elevated credit impairment provisioning – in other words, provisions for bad debt as customers struggle to repay loans. Between 2019 and 2020 most banks increased their provisions for credit impairments. Capitec provided for credit impairments at five times the rate of its peers. Although Capitec had the highest percentage of non-performing loans last year (clients that were behind on their repayments) compared with its peers, it remains one of the better capitalised banks with a low cost-to-income ratio.

Although most banks have taken what appears to be more than adequate provisions, it is uncertain whether they have under or over catered for these provisions. It also remains to be seen whether investors will reward those that have made adequate provisions – by pushing up their share prices once their actual impairment figures are released.

Other risks facing banks include the materially lower endowment effects and lower levels of transactional activity and credit origination. Although banks have largely provided for elevated levels of credit impairment, they have been slower to write off non-performing loans.

According to Reserve Bank data, the ratio of debt to disposable income spiked from around 72% to 74% before the outbreak of Covid-19 and hit 85% during the pandemic. It has subsequently declined to around 76%. Of interest is the fact that the cost of servicing this debt decresed from 10% of disposable income to 8% due to interest rate cuts in 2020. Lower interest rates means that even though SA consumers have more debt now, this debt is costing them less than it did before the rate cuts.

While lower interest rates encourage bank clients to increase their borrowings, it also means that banks see a decline in their net interest rate margins. It appears, however, that we are at the bottom of the interest rate cycle. As soon as interest rates are increased, mortgage bond rates will be re-priced.

Last April the Reserve Bank's Prudential Authority advised that it did not expect banks to make dividend payments or pay bonuses to its executives given that they needed to prioritise capital conservation. In February 2021, the Prudential Authority gave the go-ahead for banks to cautiously start paying dividends on ordinary shares and to start paying their executives cash bonuses again.

The guidance includes a list of factors banks must consider before parting with cash including the adequacy of their current and projected capital and profitability levels; internal capital targets and risk appetite; and the current and potential risks of the pandemic. While Absa and Nedbank chose not to pay a dividend, FirstRand has declared one.

Given the multitude of risks facing banks in a challenging macroeconomic environment, the market's attitude to banking stocks is perhaps, not surprising. ■

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