

Investment basics XVI

The analysis of bank shares

There are certain distinguishing features of banks, particularly in South Africa, that make them different to other commercial and industrial undertakings. Because banks occupy a pivotal position in the monetary economy (in a sense, with the building societies, they are the monetary economy) their balance sheets and income statements are strongly determined by the actions and monetary control techniques of the authorities, particularly the Central Bank. Shareholders in a large bank (unlike other investors) have the ultimate protection that the authorities cannot afford to allow such a bank to go under. See, for instance, the arranged 1977 rescue of Trust Bank.

The accounts

A very major problem in South Africa, as far as the analyst is concerned, is the ability of the banks not to disclose "true" financial information. Only Barclays and Standard of the major five banking groups publish "true" accounts.

See, for instance, note 1.1 to the Nedbank 1984 financial statements:

1.1 "In view of the fact that banking subsidiaries, which are exempt from disclosing certain information in terms of the Companies Act, 1973, constitute the major part of the Group's operations, the Group financial statements are presented in the form applicable to banking companies and in particular: internal reserves and movements therein are not disclosed; taxed income has been arrived at after making transfers to internal reserves."

These inner or contingency reserves will have been built up over the years to substantial proportions. Published balance sheet *totals* are not understated because the inner reserves are buried in the category "deposit, current and other accounts". Transfers to, and in some cases from, inner reserves can be varied to "programme" taxed profits disclosed in the income statement. Most bank managements would claim that profit smoothing is not taken to extremes: thus, if actual profits are down 50% an *increase* of 15% would not be reported but perhaps a fall of 20%. In financial 1984 Trust Bank's income statement showed an increase of 24% in disclosed taxed profit. Separately in the annual report it was stated that actual profits before transfers were up 53%.

The difference between the financial statements of banks on full disclosure is very great. In the latter case three line income statements are presented. See Nedbank:

| Rm | 1984 | 1983 |
|--|-------|-------|
| Taxed income after transfers to inner reserves | 105,0 | 121,5 |
| Less dividends paid and proposed | 61,1 | 60,3 |
| Retentions | 43,9 | 61,2 |

The Barclays income statement is substantially more illuminating:

| Rm | 1984 | 1983 |
|---------------------------|-----------|-----------|
| Operating income (1) | 2 669,6 | 1 853,6 |
| Operating expenditure (2) | (2 466,7) | (1 614,0) |
| Operating profit | 202,9 | 239,6 |
| Doubtful debt provision | (87,1) | (41,2) |
| Pre-tax profit | 115,8 | 198,3 |
| Less tax | 39,0 | 74,5 |
| Profit after tax | 76,8 | 124,8 |
| Add associates | 9,9 | 1,9 |
| Earnings | 86,7 | 125,7 |

References

- (1) Notes to the accounts give details of interest income on investments and advances (86% of operating income in 1984), jobbing profits and commission and exchange earnings (12%).
- (2) Notes give interest paid over a range of deposits (74% of 1984 operating expenditure), staff costs (16%), depreciation, etc.

Interbank ratio comparisons

The fact that some banks disclose "true" earnings and equity while others do not makes comparisons between banks in terms of ratio and profitability analysis largely misleading. For instance, Barclays taxed profits to total assets ratio of 0,81% in 1983 is not analogous to Nedbank's 1,15% because Nedbank's profits are understated. Dividend cover comparisons are not valid for the same reason.

Statutory returns

Ironically, in view of the poor standards of disclosure in many of the published accounts, various documents that have by law to be submitted to the Financial Institutions office in Pretoria for public inspection offer a very wide range of balance sheet data. The BA7 return, submitted monthly, gives a comprehensive breakdown of bank liquid and prescribed assets; the BA8 return, submitted quarterly, monitors the statutory equity position (see comment below); the voluminous BA9 return, also a quarterly document, breaks down balance sheet liabilities and assets in enormous detail. Several hundred asset and liability items can be monitored from the BA9 returns.

Examination of these returns enables the analyst to keep an eye on emergent liquidity or equity strains via the BA7 and BA8s. The BA9 allows liability management to be monitored (including the length of the deposit book) and market penetration trends to be discerned. For example, a particular bank may be falling behind its competitors in current accounts, corporate deposits, HP lending, etc. The exposure to offshore guarantees, where exchange rate movements introduce risk, can be picked up. Bad

debts can sometimes be anticipated by looking at the percentage of advances that are being classified as "overdue".

All in all, these three statutory returns are essential study for the bank share analyst.

Equity ratios

The banks are unlike ordinary commercial or industrial companies in that they are compelled by law to maintain certain minimum balance sheet ratios. Apart from Reserve Bank cash and liquid asset ratios (traditionally imposed by the authorities to prevent excessive bank lending), which apply to the asset side of the balance sheet, minimum equity ratios – currently applying to the liabilities – have to be maintained. Roughly speaking, equity amounting to at least 6% of deposit liabilities and 4% of acceptance and bill liabilities has to be maintained. Other things being equal, this places a limit on banks' ability to expand their balance sheets. If they are at or near their equity minima, they cannot attract new deposits unless they increase their retained earnings or make rights issues. It is important for the analyst to anticipate forthcoming rights issues.

Forecasting earnings

This is not easy, particularly in the case of banks with three line income statements. It is convenient to think of earnings as a function of two things: *volume* and *margin*.

Growth in volume (which means balance sheet quantities such as total funds or total assets) correlates strongly with growth in the overall monetary aggregates or gross domestic expenditure. Individual banks may, of course, be losing or gaining market share in the various categories: hence the importance of the BA9s.

Margin is determined by the ability to generate, amongst other things, profitable fee and forex income, keep staff costs as low as possible (by, for instance, investment in automation), but perhaps most importantly by good liability management – having the right funding mix at the right time. For example, at a rate peak it is not smart to have a very long deposit book; just before rates begin an uptrend the bank should lock in as long as possible. On the lending side there is little scope for being clever on rate because of competitive forces – a bank charging 2% more on overdrafts than anyone else will soon lose a lot of business.

It is important to note that banking is a *low margin* business:

Earnings: total assets (1984)

| | |
|----------|---------|
| Barclays | 0,45% * |
| Standard | 0,73% * |
| Nedbank | 0,82% |
| Bankorp | 0,49% |
| Volkscas | 0,74% |

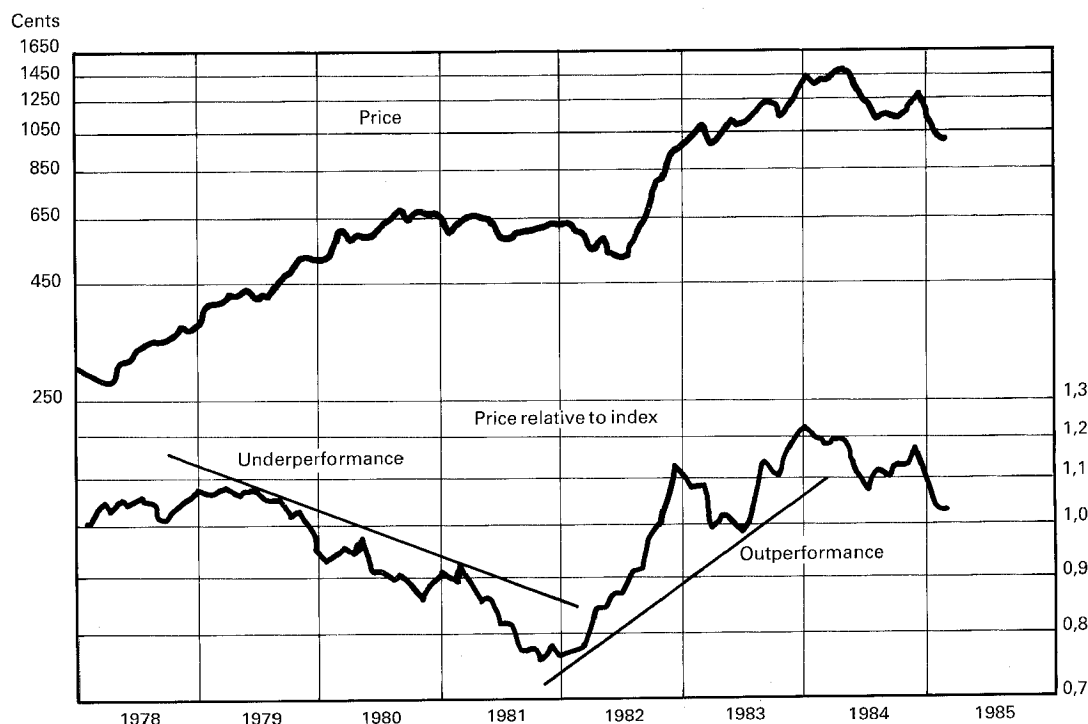
*Full disclosure.

Very small differences in margin can therefore gear profits sharply. For instance, if Barclays had achieved not 0,45% in 1984 but the Standard margin of 0,73%, its earnings would have been 62% higher. Underlying bank profits, particularly when market orientated control methods are being used, are likely to be inherently volatile.

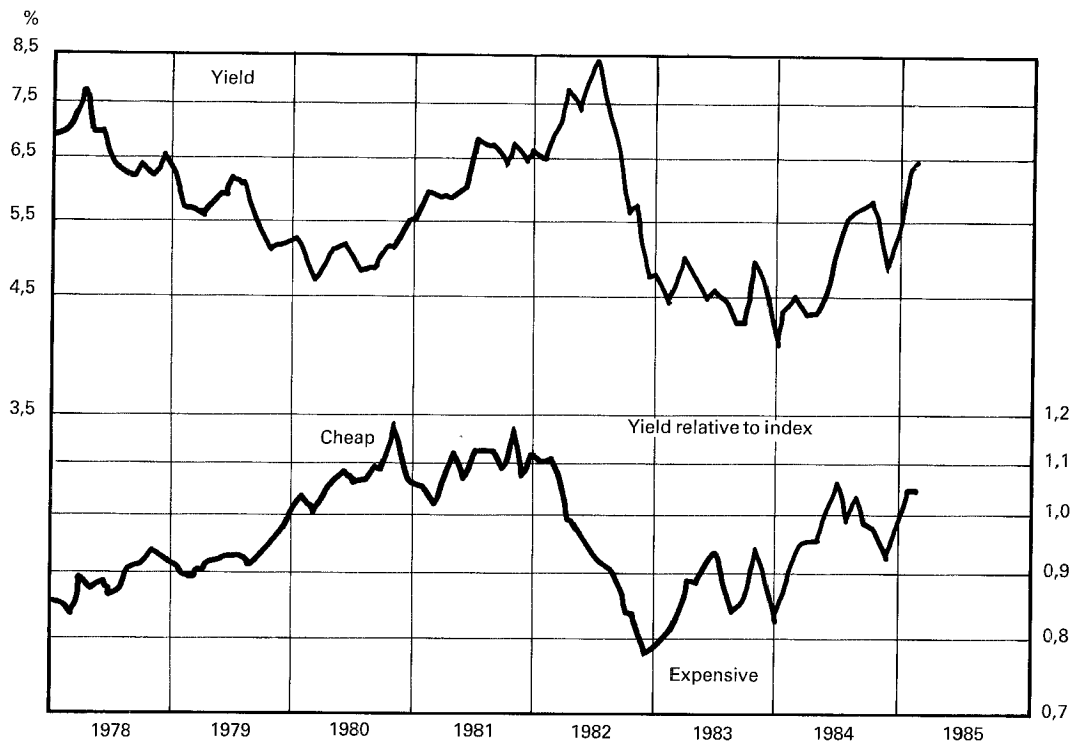
Ratings and relative performance

Bank share ratings, as measured by dividend yield relative to the market, have fluctuated between an optimistic low of just under 0,8 and a pessimistic high of about 1,2.

Banks price index



Banks dividend yield



Share price performance against the market is variable, and clear periods of underperformance (1980/81) and outperformance (1982) tend to be found. This means that portfolio managers, even in very large funds, must be prepared to vary their bank share portfolio weightings over time.