Where we are finding value in US and European banks

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Key Takeaways

- The Mackenzie Cundill Team currently sees banks as fertile ground for bargain, value hunting.
- Recent stress tests of US banks held by Mackenzie Cundill funds produced positive results.
- Unlocking capital for shareholders is a key element of our investment thesis.

The Mackenzie Cundill Team has an overweight position in banks in several funds, with this market segment providing fertile ground for bargain hunting. We believe our bank holdings have significant room to appreciate over the next three to five years.

US banks in Cundill Funds

US banks were the poster children for bad behaviour after the global financial crisis (2008-09) and were subsequently subjected to tighter regulations, fines and a rebuilding of balance sheets, as well as consumer and investor confidence. There has been tremendous improvement to balance sheets and profitability in the past nine years, while valuations still remain depressed, but we think that even after a rapid run-up in the back half of 2016, US banks still offer significant runway for several reasons.

The first is the improving economic backdrop in the US, where wages are growing steadily, unemployment is low, interest rates are tightening and consumer and business confidence are strong. The banks weakened somewhat in the first quarter of 2017 on concerns that the Trump administration faces challenges implementing its pro-growth policies. We believe that those policies would only be “icing on the cake” by adding additional support to bank stocks on top of current fundamental drivers in the strengthening US and global economies. At the very least, regulation will not be more penalizing and at best, they could provide some lift. Tax cuts and infrastructure spending would provide additional support for bank stocks, as they are likely to produce higher economic growth, which would allow the Federal Reserve to remove its “life support” and return to a normalized rate environment.

This positive backdrop can help banks substantially increase value. Banks are currently trading at valuations seen during the 1990 recession while having rock-solid balance sheets with capital ratios close to those of Canadian banks, which enjoy valuations closer to 2-2.5x book value. In addition, US banks are trading at price-to-book-value metrics around 1x versus the last peak at 2.2x in 2006 and previous peaks of over 3x.

US banks have significant room to run higher and in our opinion, could double within three to five years, based on accelerating loan growth, higher quality loans, a reduction in non-performing loans, lower capital constraints and higher interest rates. All of these factors should drive acceleration in earnings and revenue growth and result in higher returns on equity – a key measure for bank profits and valuations. Meaningful increases in shareholder returns, in terms of dividends and share buy-backs, are materializing going forward.

Where is the value in European banks?

There are select European banks that look very interesting for their risk/reward potential, such as our recently purchased shares of Barclays. European banks are trading at ultra-low valuations that are, in some cases, much lower than the US banks and for good reason. For example, the bank indices below trade below book value:

- FTSE 350 Banks Index trading at P/B of 0.91X
- Euro Stoxx Banks Index trading at P/B of 0.83X

US banks are further along the path to cleaner balance sheets than their European counterparts, having cleared the system years ago by writing down bad loans. Recently, the European Central Bank found that non-performing loans are a top priority, as it estimates that European banks have €1.2 trillion (about C$1.7 trillion) at the end of September 2016, higher than in 2013.[1] Banks in Italy, Spain, Ireland, Portugal and Greece account for half of those bad loans, which is restraining lending that is vital to economic growth. Any European banks that are slow to deal with bad loans are paying the price, as their stocks get creamed when they go to the market to raise cash that would bolster their balance sheets. Certain European banks are better levered than others and have been clearing bad loans, repairing balance sheets, and improving economic backdrops. This is fertile ground for us to keep looking for undervalued, misunderstood situations.

How unlocking capital could boost shareholder returns

Unlocking capital for bank stocks is one of the key investment reasons underpinning the Cundill rationale for investing in these companies. After the 2008 financial crisis, Basel III and US regulators required banks to hold higher and better quality Tier 1 common equity capital (CET1). This capital is a required cushion, in the event of another crisis, which is sufficient for survival. Every year, US banks go through stress tests and apply to the Federal Reserve for permission to raise dividends and buy back stock. This process is called the Comprehensive Capital Analysis and Review (CCAR). Sell-side research estimates that US banks are holding US$120 billion in "excess" capital.

In June 2017, our investment thesis in the US banks was reaffirmed by CCAR. All of our holdings passed this year's test with flying colours, both quantitatively and qualitatively:

- Citigroup announced it will double its dividend and approved a massive share buyback program of US$15.6 billion. In our recent meeting with Citigroup's CFO, we sensed that the fundamentals of its businesses are improving. In addition, economies around the world are accelerating.
- Bank of America increased its dividend by 60 percent while authorizing $12 billion in stock repurchases. Warren Buffett announced that Berkshire Hathaway will switch out of the preferred shares they own and exercise their option to buy 700 million shares of Bank of America, becoming the top holder of the stock. While this will dilute our shares to some degree, Buffet's willingness to assume greater risk for a (marginally) higher payout on the common is a testament to his confidence in the earnings power of Bank of America.
- Wells Fargo's capital plan was also approved by the Fed, which included up to US$11.5 billion of common stock repurchases. This is especially good news in light of recent negative media regarding sales practices at this bank. We believe Wells Fargo is a solid franchise and the current issues are short-term in nature and fixable.

[1] https://www.bloomberg.com/news/articles/2016-10-31/european-banks-stuck-with-1-3-trillion-of-bad-loans-kpmg-says

The key reasons we like the above US banks are their:

1. Improved earnings outlook
2. Very low valuation
3. Solid capital positions
4. Increased payouts to shareholders

If there are any positive developments in tax reform and industry deregulation, or more interest rate hikes in the US, we believe the banks will stand to benefit further.

Where Cundill is finding value

Wells Fargo

Wells Fargo is one of the largest deposit banks in the US, the third largest US bank in terms of assets (loans) and the third largest retail brokerage. We initiated a position after the Brexit referendum in June 2016 and added more in the fall after news surfaced that some Wells Fargo staff had opened about two million accounts without their clients' permission since 2011. Wells Fargo stock came down as a result, from a peak in the high US$50s in July 2015 to the low US$40s. We believe that the market overreacted in the near term to negative news flow and political fallout associated with the scandal, as well as the subsequent US$185 million fine for Wells Fargo.

Longer term, we believe that the fundamental impact to the bank's earnings power will be manageable. We also expect that the company will maintain its dominant market position across the US, its structural advantage with regards to low-cost funding and higher-than-peer net interest margins, and its industry-leading return on equity of around 15%.

Bank of America

Bank of America (BofA) has the largest retail deposit base in the US[2] and is one of the top three global investment banks by fees[3]. It covers consumer and global banking and global wealth management with Merrill Lynch and US Trust.

In its Q1/2017 release, BofA reported that if there was a 100 basis-point parallel shift in the yield curve increase over the next 12 months, net interest income would rise by US$3.3 billion, with nearly three quarters of the benefit coming from short-end rates. In the US, consumer confidence is rising steadily and hourly wages are growing – both supportive of a healthy consumer, which can translate to increased borrowing and lower loan losses.

BofA's sensitivity to interest rates is important because of its sizeable non-interest-bearing deposits. When rates rise, the additional amount of revenue it will make from loans will exceed the interest expense on liabilities. This provides considerable torque to earnings potential as rates increase.

Bank of America's advantages range from its massive nationwide deposit and consumer lending franchise to the important franchise of Merrill Lynch's brokers and wealth managers. BofA is ready to capitalize on its strengths as American consumers continue to recover. We believe BofA's mortgage-related problems are now behind them, expenses have come down by billions of dollars and profitability is rebounding. The bank generates significant income from mortgage banking, interchange fees, brokerage, investment banking and wealth-management activities.

CEO Brian Moynihan has created a low-cost culture and the company's cost-cutting efforts continued to pay off, with nearly every category of non-interest expenses posting declines over the last 12 months. The bank's return on equity, as well as returns to shareholders, should continue to improve as interest rates normalize and conditions improve for US consumers and the economy.

Citigroup

Citigroup is the third largest bank in the US by assets and trades at a cheap valuation for a global bank, with a book value of US$77.4 at July 14, 2017[4]. The bank's truly global presence differentiates it from nearly all of its peers. With around 55% of sales from outside the US, Citigroup is a global US-domiciled bank.

With significant revenue coming from Latin America and Asia, Citigroup is poised to ride the growth of these economies through the coming decade. The bank has raised capital, shed assets and bulked up its board of directors and management team with experienced bankers. It has built a solid balance sheet.

Citigroup's low cost of deposits and the scale of its diverse geographical footprint are competitive advantages. The bank is exiting markets where it lacks scale to win. For example, the bank sold its consumer businesses in both Brazil and Argentina, where it maintained only a small amount of market share in highly concentrated markets. Card lending appears to be improving in terms of both growth and credit quality. Revenue from Citi's branded card business grew 15% during the year, as the company added Costco business.

[2] Bank of America presentation Goldman Sachs U.S. Financial Services Conference, p. 10
[3] Ibid
[4] Citigroup Q2 2017 Press release

Barclays PLC

Barclays PLC is a leading UK retail bank and a top-tier transatlantic investment bank. The uncertainty surrounding Brexit provided us with the opportunity to acquire the shares with a good margin of safety.

Since 2016, Barclays has been run by a new management team that predominantly came from JP Morgan, which in our opinion, is the gold standard in today's banking management. New management has taken bold actions in restructuring the bank and built capital without having to go to shareholders to raise new equity. This is a rarity among European banks that, in recent years, have had to continually tap the markets for new capital.

Barclays has many attractive characteristics. It has a strong UK franchise in retail banking and credit cards that consistently generate 20% return on equity (ROE). Barclays outperforms peers in both return and risk, plus it runs a pan-Europe transaction processing business that is capital-light and delivers high returns. Lastly, it has a growing US partnership credit cards portfolio. The investment bank's ROE is low at the moment, but we believe there is upside from here, as the entire industry has not earned its cost of capital for a number of years. While the outlook on the UK economy is uncertain with Brexit, half of Barclays' earnings originate outside the UK, and even within their UK retail business, Barclays has been one of the most conservative banks. We believe Barclays is well positioned to manage through the uncertainties of the UK economy.

Summary

We see both US banks and European banks as statistically affordable, but the US banks are ahead of the European banks in terms of their capital ratios, interest rate cycle and ability to increase returns to shareholders. Tailwinds to US banks are more imminent and catalysts are closer at hand; however, we are starting to find opportunities abroad that exhibit value drivers within our three-to-five year time horizon.

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