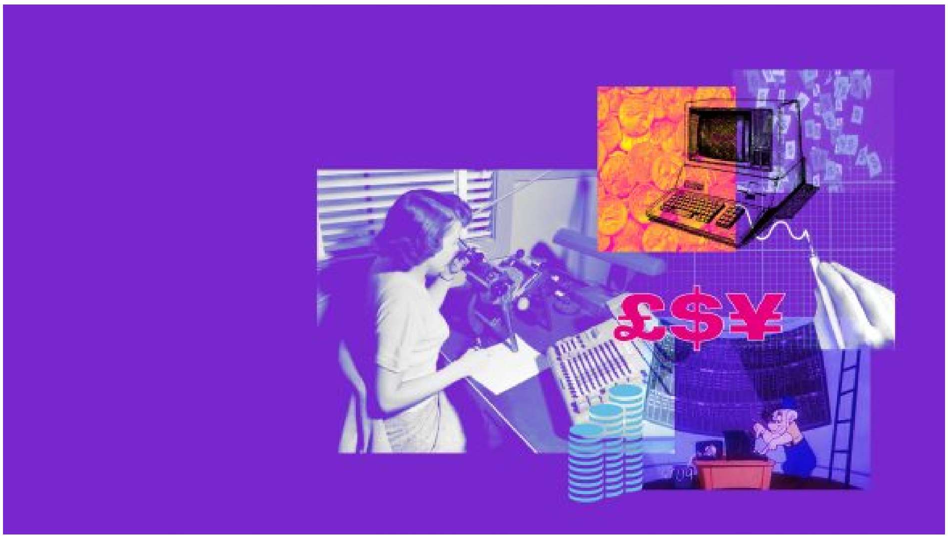
woodford

BANKS BACK IN BUSINESS

Mitchell Fraser-Jones, 29 June 2017

The views expressed in this article are those of the author at the date of publication and not necessarily those of Woodford Investment Management Ltd.



This post is part of a series explaining why we are more positive on the UK economy. Find out more

Neil used to be a significant investor in the UK banking industry, with almost a third of his portfolios invested in the sector in the mid-to-late 1990s. Since then however, with the exception of HSBC, which was a constituent of the portfolios for a brief period a few years ago, banks have barely featured in his mandates for 15 years.

Our stance towards banks in general has been influenced by an evolving macroeconomic view, which has moved from positive in the 1990s to increasingly cautious in the run-up to the global financial crisis. This view towards banks, however, was also influenced by a growing concern about the changing business model in British banking which was leading to increased leverage and made the sector a riskier proposition. In the years leading up to the financial crisis, the UK banking system was being backed by a slowly diminishing capital base, with common equity tier 1 capital estimated to be just 4.3% of risk-weighted assets in 2006[1].

The extent of leverage was fully exposed during the global financial crisis, with the UK banks proving extremely vulnerable to unfolding events. The UK banking system was effectively insolvent, with insufficient capital to absorb mounting losses. During this period, we spent a great deal of time and effort trying to understand the nature of the crisis and how the recovery would play out. This helped frame a consistently cautious macroeconomic view in the years after the crisis, as well as an avoidance of the UK retail banks as they underwent the necessary and protracted process of rehabilitation – rebuilding capital and slowly crystallising the losses that had been incurred.

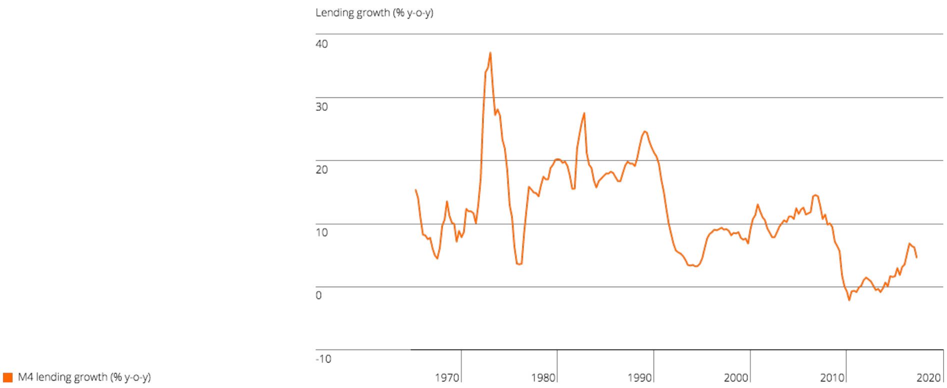
Throughout the crisis and its prolonged aftermath, we have been more interested in what the banks are doing rather than what they are saying and looking for evidence that the banks were beginning to lend again before feeling more confident that the UK banks had substantially completed their healing process.

Importantly, as the chart below illustrates, that pick-up in lending has been evident since late 2016 and this has contributed to an increasingly optimistic view of the UK economic outlook, as well as an opportunity to revisit the investment case for UK retail banking.

BANKS BACK IN BUSINESS

Mitchell Fraser-Jones, 29 June 2017

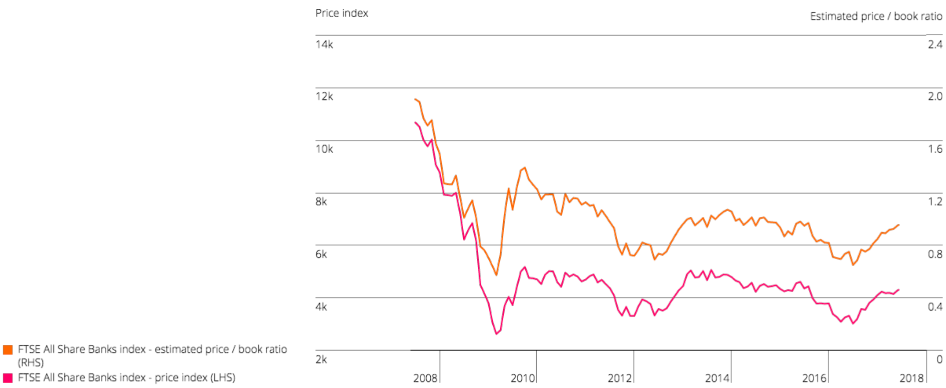
UK banks have recently commenced lending again
Source: The Lazarus Partnership, Woodford



In doing so, we find a banking system with substantially more capital than at any time in recent history. By 2016, common equity tier 1 capital had been rebuilt to represent an estimated 13.5% of risk-weighted assets, implying a much healthier banking system and one which clearly now feels confident enough to lend again.

Furthermore, despite the rehabilitation progress that the UK banks have made, share prices remain surprisingly close to the lows that coincided with the depths of the financial crisis in early 2009. Share prices tend to trade below book value too, which suggests that the stock market has yet to acknowledge the transformation of UK banks' prospects that is now well underway.

UK banks' valuations and share prices do not reflect the progress they have made
Source: Bloomberg, Woodford



Hence, we have been keen to take advantage of this compelling valuation opportunity by introducing Lloyds to the portfolio in recent weeks. This investment decision goes hand in hand with our increasing confidence in the long-term UK economic outlook. The fact that the banks are now extending credit to the wider economy again is an important foundation for this confidence and, in turn, a more positive outlook for the UK economy lends itself to greater confidence in the case for investing in Lloyds.

There are risks, of course. Continued regulatory pressure, the prospect of continued slender net interest margins (the difference between the rate a bank pays to deposit holders and the rate of interest it charges on loans), future fines and litigation all represent risks to the investment case, as would a more challenging economic environment than the one we foresee.

All of these risks are, however, in our view, more than adequately reflected in the stock's low valuation, which already embeds a dismal future for the UK economy. Overall, we believe that the bank has turned an important corner and would point to the completion of the sale of the government's stake in Lloyds as a timely further indication that the bank is indeed now fixed.

Footnotes

1. Source: The MacroStrategy Partnership based on estimated common equity tier 1

capital to risk-weighted assets for the major UK banks.