COVID-19 and SA banks: Recovering from the lows

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KEY TAKE-AWAYS

- *SA banks were as well-placed as possible to cope with stress arising from the impact of the Coronavirus, with all-time high provisioning and tight lending criteria already in place.*
- *Lower retail transactional income was offset to some extent by higher revenue from facilitating client risk hedging.*
- *Although loan impairments have risen, client support in the form of repayment deferrals, government financial support and interest rate cuts helped mitigate the deterioration in banks' loan books. Banks have not been as hard-hit by the crisis as could have been expected.*

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South African banks have certainly not been immune to the impacts of COVID-19. The first half of the year was characterised by uncertainty, with markets expecting banks to post significant losses and potentially needing to raise capital. The second half of the year saw these fears moderating. The banks have proven to be resilient, with the conservative standards of the Basel capital accords and our own National Credit Act allowing the banks enough headroom to deal with the negative impact.

While the devastation of the pandemic continues and the chances of further severe lockdowns cannot be overruled, the banks have built up some of the largest provisioning buffers on record (see Graph 1) thanks to the forward-looking accounting principles embedded in IFRS 9. Lower interest rates, while hurting banks' net interest margins, have boosted the ability of borrowers that were not impacted by job losses or COVID-19 disruptions to repay. They have also improved affordability, and we have seen an uptick in retail asset growth demand. The banks' operations in the rest of Africa (excluding South Africa) have proven to be more resilient than the domestic franchises. In our view, all is not lost, the businesses remain resilient and we expect to see a continued recovery in earnings off the depressed bases.

Digital adoption accelerates

Earlier in the year, as concerns over how rapidly the virus was spreading set in, many banking customers were forced out of branches and onto digital channels. While this transition was already in progress, its pace was dependent on the willingness and digital enablement of clients. Particularly marked accelerations were noted in Europe among the older population, where digital adoption was historically slow. While this will not result in overnight cost savings for the banks, the higher level of online engagement does improve their ability to cross-sell products. It is also linked to lower costs; however, the banks still sit with physical branch infrastructure that needs to be serviced. As the branch leases are renewed, the banks can reduce their cost bases either with complete closures of certain branches or a reduction in floor space. These benefits will filter in over the next few years.

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One may be forgiven for thinking that this gives new (digitally advanced) entrants like Tyme or Discovery Bank a substantial advantage, but that would discount the huge strides already made by the big incumbents. Most of the existing banks' online branches are already by far their largest contributors of new business. With the cost of the existing physical infrastructure already in the base, there is substantial opportunity for savings for them into the future.

Trading volumes remained robust

While transactional revenues on the retail side were depressed during the early period of the lockdown, these have started to show signs of recovery. Large-ticket items relating to travel have been notably absent and may take longer to recover, but the banks have recorded consistent growth since the trough in April 2020. All was not lost as banks also made more money in parts of their trading businesses amid the heightened uncertainty. As investors and corporates hedged out risk, banks as market-makers capitalised on the underlying activity. This boosted earnings into the mid-year June 2020 results reporting, and will contribute to the full year as well.

Into 2021 we would anticipate rising retail transactional revenues to more than compensate for slowing trading volumes as hedging drops from peak levels.

Impairments will take time to work through

As lockdowns were introduced and countries around the world were bracing for the impact, not only on lives but also on their economies, the banks were forced to deal with the uncertain consequences of a new accounting standard - IFRS 9. While forward-looking models are always best for addressing uncertainty, they can have their drawbacks in a global downturn where very few sectors are left untouched. Given the economic woes in South Africa pre-COVID, the South African banks were bracing for rating agency downgrades and potential domestic stress. As a result, their credit-granting criteria was already quite tight heading into the crisis. Provisions-to-advances ratios were at some of the highest levels on record prior to COVID. Banks were as well-placed as possible for any impending stress. Over the interim reporting period mid-year, the banks continued to increase all-time high provisioning

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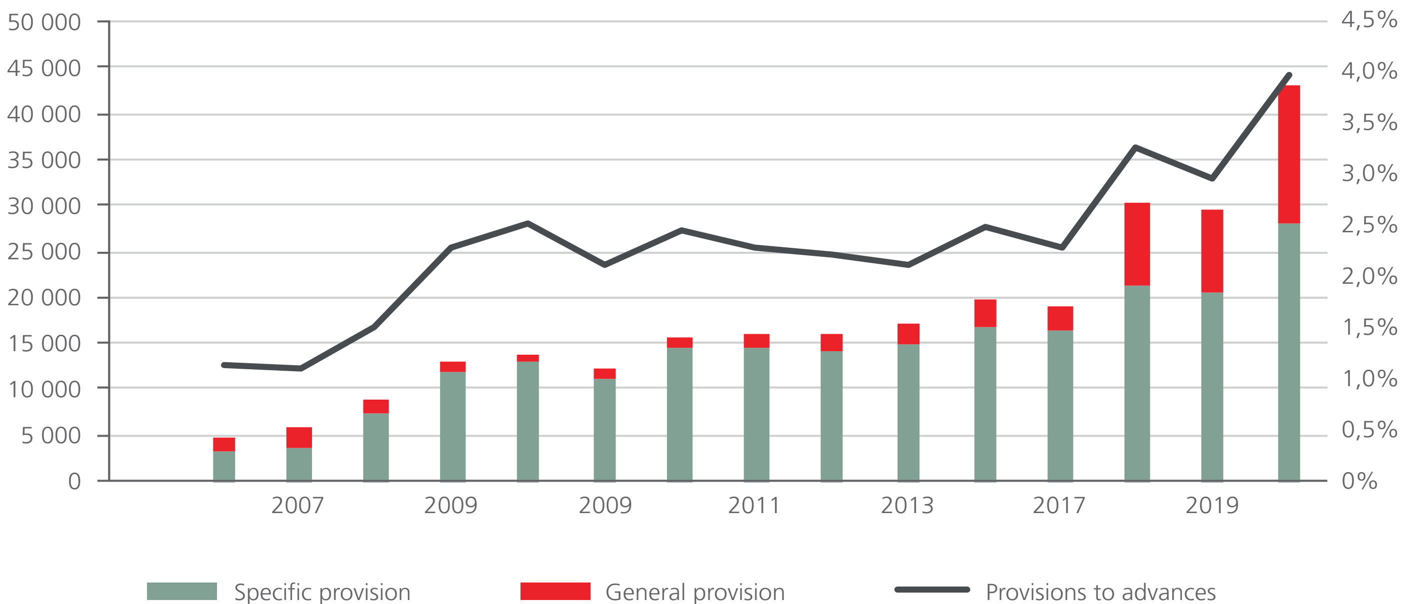
and tighten their lending criteria even further, but the approximate 300bps (3.0%) reduction in interest rates has improved affordability.

Retail clients working in impacted sectors were aided initially by blanket deferrals on their loan repayments or, in the case of FirstRand, by a personal loan. The assistance was subsequently moderated as industries reopened and the lockdown eased. Most banks now require at least partial payments of instalments. While some clients are still receiving payments in the form of government support, as this support is wound down, non-performing loan (NPL) levels may increase. Pleasingly, as the economy reopens, the percentage of assistance provided by banks continues to reduce dramatically from the highs of April 2020. While some clients are still being supported and some risk remains, many loans are protected by underlying collateral such as vehicles or homes. The banks continue to operate in a pragmatic manner and will offer support where needed in future lockdowns.

Graph 1: Absa's provisions at all time highs



SOURCE: Company data, Prudential Investment Managers

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The number of corporates in distress has also decreased; banks continue to track high-risk sectors such as aviation, hospitality & tourism-related industries, commercial property finance and construction. Some companies in these troubled sectors have recently had rights issues, passing the risk onto shareholders and in turn reducing their bank debt exposures. We anticipate more of this to come in due course.

Going forward, the banks will continue to increase their collection capacity in order to support the orderly repayment or work-out of loans. Thankfully the banks have realised that it is in no one's interest to merely evict non-paying customers from their homes and repossess their cars. They have learned many lessons from the 2008 Global Financial Crisis, including trying to assist consumers as best possible with selling their various assets, rather than out right repossession. Similarly, on the corporate side they can earn fees from their clients' capital raises or planned work-outs.

Consumer affordability aided by interest rate cuts

The SA Reserve Bank's interest rate cuts totaling some 300bps have boosted consumer affordability. Given the restrictions imposed by the National Credit Act, these lower interest rates have helped consumers to qualify for higher loan amounts, previously out of reach. Despite banks being cautious about lending too aggressively in this environment and raising their credit granting criteria, the substantial reduction in the repo rate has allowed banks to lower their lending rates but still see an increase in lending volumes. The high activity levels will unlock liquidity from the housing market and continue to boost top-line revenue for the banks. Historically, some of the banks' most profitable business was typically written during the worst economic periods, as banks remain acutely focused on credit risk and margins, and this should hold true going forward as well. The benefit of the lower interest rates has also aided those who have not been financially impacted by the pandemic. The banks have seen consistently better payment trends in the non-impacted sectors.

Africa regions performing better than South Africa

In the rest of Africa, the impact of the pandemic on economic growth and banking sectors in various countries

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has been more muted. Many of the banks posted either limited declines -- or in several instances even profit growth – in their African operations during the period, with low levels of penetration and more resilient economies supporting the bottom line. While the Africa regions are not immune to impairment risk, transactional activities and deposit-ed franchises still make up the bulk of the underlying businesses; earnings from lending activities are less important. However, it is notable that the best-performing franchises still have as diversified a portfolio as possible.

In our fund positioning we favour those banks with strong franchises built up in the rest of Africa. These are extremely hard to replicate given the unique operating environment and political risks embedded in the various geographies. With the growth outlook in the rest of Africa better than the domestic outlook, we think this will prove supportive for continued earnings diversification and higher profitability for banks. We have seen the rest of Africa make up an increasingly greater share of group profitability, and the region could make up the bulk of bank profits in due course. Both Absa and Standard Bank continue to have standout franchises in the rest of Africa.

Capital remains robust as regulators consider a return to dividends

In what is a positive development globally, regulators are retracting the blanket bans for banks on the return of capital (or dividend payments) imposed at the start of the pandemic. While initially concerned about the uncertain impact from COVID, most of the banks have proven to be much more resilient post the Global Financial Crisis. In our view, the signal this is sending is more important than the actual payment of a dividend; regulators would not allow banks to return capital to shareholders if there were material concerns over future losses. If a bank rather elects to retain its capital, it still aides in increasing the book value of the bank, and the capital could be returned at a future date.

In Graph 2, we can see how Standard Bank's total capital adequacy ratio (CAR) and its Tier 1 capital ratio have fallen only slightly from the beginning of 2019 through June 2020, remaining at robust levels on par with, or higher

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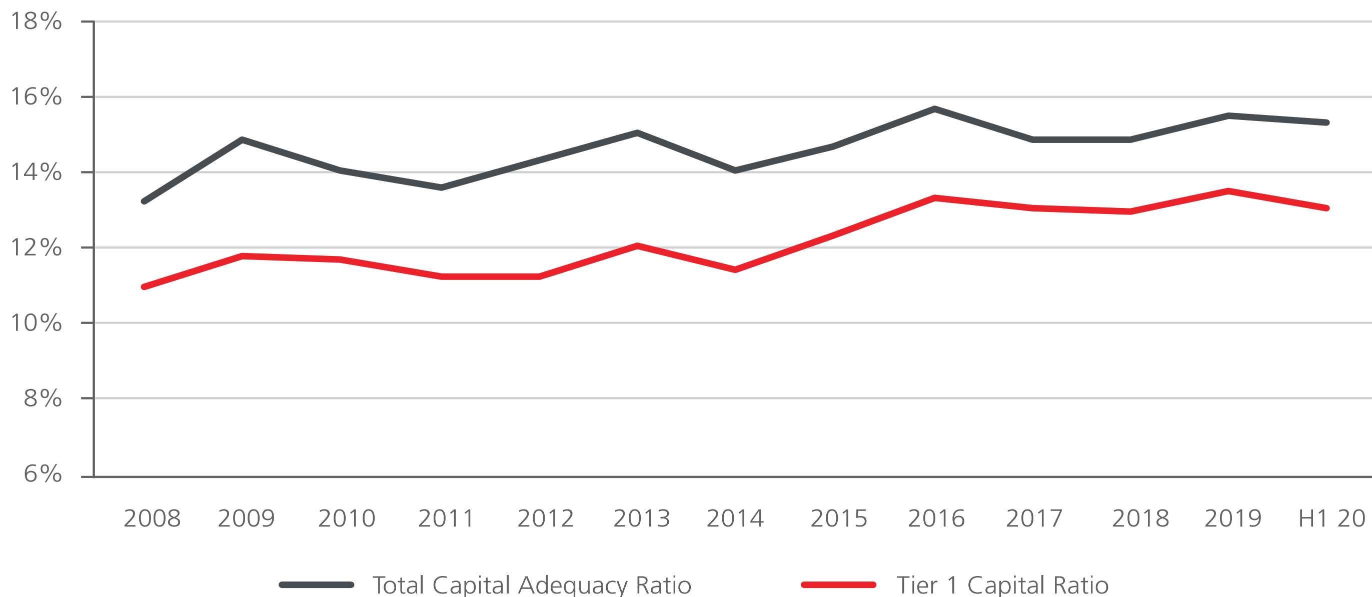
Graph 2: Standard Bank's robust capital level could support a dividend



SOURCE: Company data, Prudential Investment Managers

than, those it maintained in 2018. As the potential impairment risks abate, this would suggest that from a financial health perspective, it could afford to pay a dividend without endangering its financial strength.

Based on the extent to which the banks are trading at discounts to their book values, we think that dividend buybacks would be a preferred way to return capital in due course. The South African regulators have not removed the guidance note issued earlier this year discouraging the payment of dividends; however, they have reminded the market that it is just a guidance note, and the decision ultimately sits with each company's board. In our view, these trends all point to the fact that the worst has passed and the risk of any potential capital raises has been vastly reduced.

A strong indicator of this was the recent upgrade of South Africa's largest five banks' National Long-Term credit ratings to 'AA+' from 'AA' by Fitch, which it said reflected an improvement in their creditworthiness relative to

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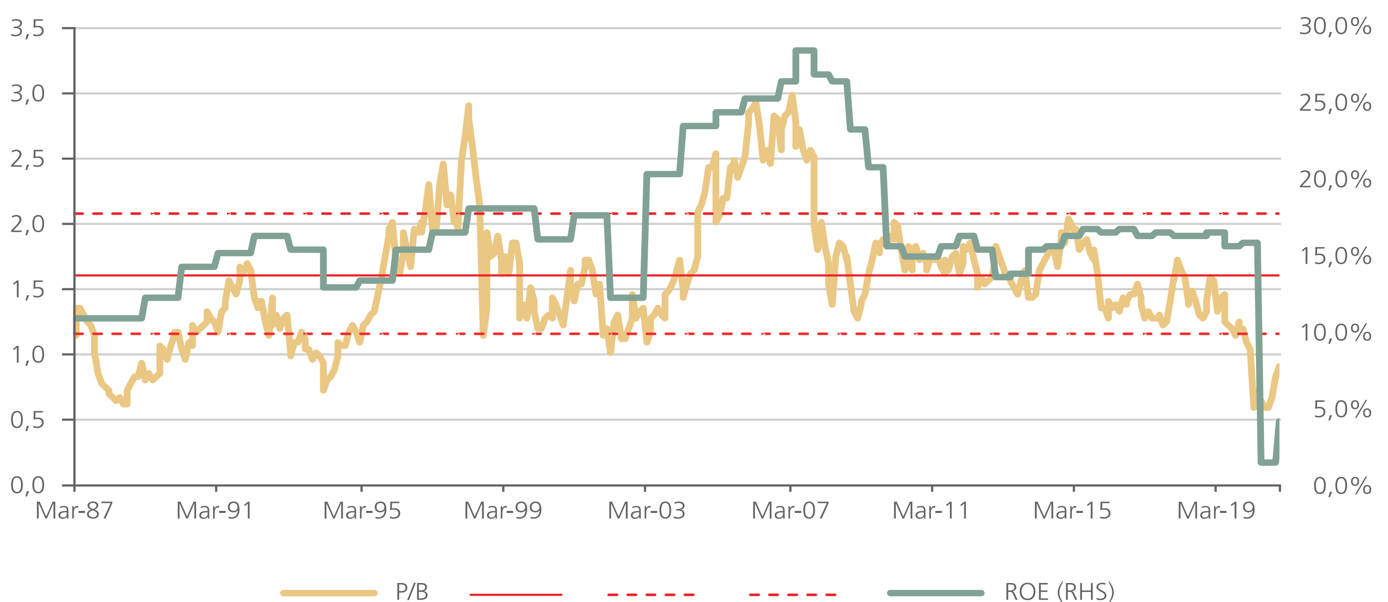
the best credits in the country.

Banks still offer value

Throughout the Coronavirus crisis, South African banks have remained well capitalised, and all signs in the final weeks of the year have indicated that impairments have peaked. Importantly, bank profitability has been robust enough to absorb the high levels of provisioning. None of the big banks posted losses over the period, and net asset value has been preserved. While we are not entirely out of the woods, the risk of a further deterioration in banks' financial health is now lower and signs are pointing towards a better credit experience than what is being provided for presently. This contrasts to equity valuations; for example, Absa trades at a discount to its book value as the market is expecting high levels of losses to continue for the foreseeable future.

Graph 3 shows how Absa has been trading at a price-to-book-value ratio of less than 1.0 since the market sell-off in March, and has yet to recover much ground. We would anticipate

Graph 3: Absa's P/B vs ROE



SOURCE: IRESS, Company data, Prudential Investment Managers

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that as banks' cost of credit reduces, the return on equity (ROE) would recover in due course to pre-COVID levels. We therefore do not believe it is justified that Absa trades at a discount to its book value. As a result, we think the total returns are attractive, as substantial levels of earnings growth over the next few years (in excess of 40%) could be further boosted by improvements in the ratings.

We think this presents an opportunity. While financial activity levels continue to grow off a depressed base and there are opportunities for future cost savings, banks' ROE may take some time to recover, but should trend to above their cost of equity. We think the banks are cheap compared to their longer-term valuations, and we expect them to deliver returns above the broader equity market and greater than their own historic average over time. As such, we are overweight the sector and more specifically, shares like Absa, Standard Bank and Investec, in our best investment view portfolios and many of our unit trusts that hold equity. Our preference for these banks over the other banks is informed by the relative value of the shares. While we rate FirstRand more highly in terms of quality, it is substantially more expensive than other banks in the sector. ■

With 15 years' experience in financial services, Stefan joined Prudential in 2019 as an Equity Analyst focusing on Banking as well as select Property, Speciality Finance and Insurance companies. Stefan was one of the top three rated analysts covering Banks and Specialist Financial Services companies on the sell-side. Prior to that Stefan was on the buy-side focusing on Financial Services companies. He completed his articles at PwC in the FS Banking division and is a qualified Chartered Accountant. His qualifications include B.Com Accounting (cum laude) and B.Com Accounting Hons.

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