31 July 2019 | Sector Update

BANKING

***Maintain* POSITIVE**

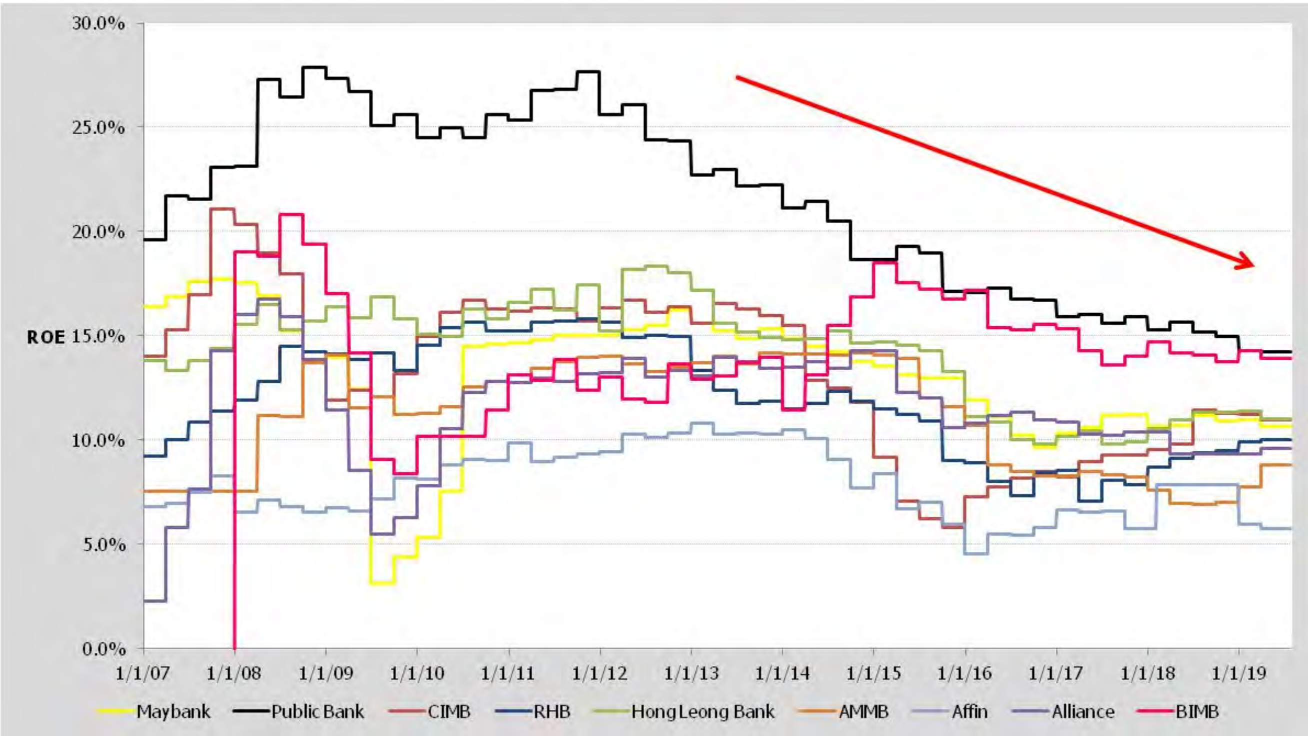
There's more than just downtrend in ROE

INVESTMENT HIGHLIGHTS

- **ROE for banks have been on a downtrend but does not signify decline in profitability**
- **Lower ROE was due to higher capital requirement.**
- **However, share price performance continued to be solid**
- **Price impacted positively by reduction of risk, as illustrated by lowering of banks' cost of equity**
- **We maintain our POSITIVE stance in the banking sector**

Banks' ROE not as it was before but does it signal a decline in profitability? It is a well observed fact that ever since the Global Financial Crisis (GFC) of 2008/2009, banks' return on equity (ROE) in general has been on a downtrend (please refer to Figure 1). For the past year, it has somewhat stabilized with a gradual shift upward or downward. Hence, it is appropriate to construe that banks' ROE will not reach the height it once achieved. However, does this mean that profitability is not what it used to be and should investors be alarmed by this trend?

FIGURE 1: ROE TREND OF MALAYSIA's BANK SINCE 2007



Source: Bloomberg, Various

Banks' ROE more than just a measure of profitability. While we must note that ROE is a measure of profitability, it is also a measure of efficiency. A rising ROE suggests that a bank is increasing its ability to generate profit without needing as much capital and how well management is deploying the shareholders' capital. Hence, we understand all the unease caused by the trend of falling ROEs amongst banks in Malaysia.

Malaysian banks are not the only one. From our observation, the current trend of lower ROE when compared to before the GFC is not confined to our domestic banks only. We took a sample of international banks in the USA, EU, Japan, and regional peers and observed similar trend in a majority of banks in these markets. However, we do note that it had been gradually increasing recently and some banks in the US seem to have recovered but we believe that this could be due to dynamics of that market.

FIGURE 2: ROE TREND IN GLOBAL AND REGIONAL BANKS

Country	Bank	ROE (as at)		
		31 Dec. 2007	31 Dec. 2017	31 March 2019
USA	Bank of America	10.8%	6.8%	10.9%
	Wells Fargo	17.4%	11.5%	11.7%
	JP Morgan	12.9%	9.9%	13.3%
	Goldman Sachs	31.5%	5.0%	13.2%
	Morgan Stanley	9.7%	8.2%	11.7%
France	BNP Pariba	17.0%	8.2%	7.9%
Japan	Mitsubishi UFJ	6.1%	6.5%	6.2%
	Sumitomo Mitsui	10.8%	8.2%	6.9%
Singapore	UOB	11.8%	10.5%	11.6%
	OCBC	16.8%	10.8%	11.1%
	DBS	11.7%	9.5%	11.6%
Indonesia	BRI	26.6%	18.5%	18.5%
	Bank Mandiri	15.7%	13.0%	14.4%
Philippines	BDO	13.5%	11.0%	10.5%
	MBT	10.3%	9.3%	9.2%
Thailand	Bangkok Bank	12.2%	8.5%	8.7%
	Siam Commercial Bank	20.6%	12.4%	10.8%

Source: Bloomberg, Various

Higher capital requirements from regulators. In the aftermath of the GFC, the banks were required to increase their capital. This is to ensure that the banks have sufficient buffer should another potential financial crisis emerges. Indeed, banks' Tier 1 Capital Ratio increased as evident in Figure 3 below. However, the consequence of the increased capital was the lowering of the banks' ROE.

FIGURE 3: COMPARISON OF BANKS' TIER 1 CAPITAL RATIO

Country	Bank	Tier 1 Capital Ratio (as at)		
		31 Dec. 2007	31 Dec. 2017	31 March 2019
Malaysia	Maybank	9.2%	16.5%	16.0%
	Public Bank	7.6%	13.0%	13.7%
	CIMB	10.2%	13.4%	14.0%
	RHB	6.9%	14.2%	15.7%
	Hong Leong Bank	13.1%	13.8%	12.7%

Country	Bank	Tier 1 Capital Ratio (as at)		
		31 Dec. 2007	31 Dec. 2017	31 March 2019
	AMMB	9.8%	12.2%	12.5%
	Affin*	11.3%	15.1%	13.6%
	Alliance	10.8%	14.0%	13.8%
	BIMB	11.3%	12.7%	13.3%
USA	Bank of America	6.9%	13.4%	13.2%
	Wells Fargo	7.6%	14.1%	13.5%
	JP Morgan	8.4%	13.9%	13.7%
	Goldman Sachs	n/a	14.1%	15.3%
	Morgan Stanley	n/a	20.0%	19.2%
France	BNP Pariba	7.3%	13.2%	13.1%
Japan	Mitsubishi UFJ	7.6%	14.2%	13.8%
	Sumitomo Mitsui	6.4%	15.4%	17.9%
Singapore	UOB	10.0%	16.2%	14.9%
	OCBC	11.5%	14.9%	14.8%
	DBS	8.9%	15.1%	15.1%
Indonesia	BRI	14.3%	22.0%	20.2%
	Bank Mandiri	17.0%	20.6%	19.8%
Philippines	BDO	9.0%**	13.1%	12.4%
	MBT	9.2%	11.8%	14.6%
Thailand	Bangkok Bank	12.0%	16.6%	16.4%
	Siam Commercial Bank	10.6%	15.6%	15.1%

Source: Bloomberg, Various

* = Affin Bank

** = as at 31 Dec. 2008

Fall in ROE was not reflected in share price. Theoretically, a fall in profitability would ensue a fall in share price. We did a comparison of the ROE in our sample banks with their share price performance to test this theory. The result was that we did not find the corresponding anaemic share price performance. Instead, there was a divergent trend between ROE and share price performance. We believe that this was due to another element, the lowering of risks.

Lowering of risk reflected in share price. The other consequence in the increased capital was the reduction of risk relating to the solvency of the banks. In Malaysia, this was especially the case as banks increased their capital above the required regulatory levels. We observed the banks' cost of equity (a measure of risk; the higher a company's cost of equity, the riskier the investment) had followed the ROE trend as evident in Figure 4. The lower risk had reflected in the banks higher share price performance. This could be explained by looking at the Gordon Growth Model. Recall, the model state that:

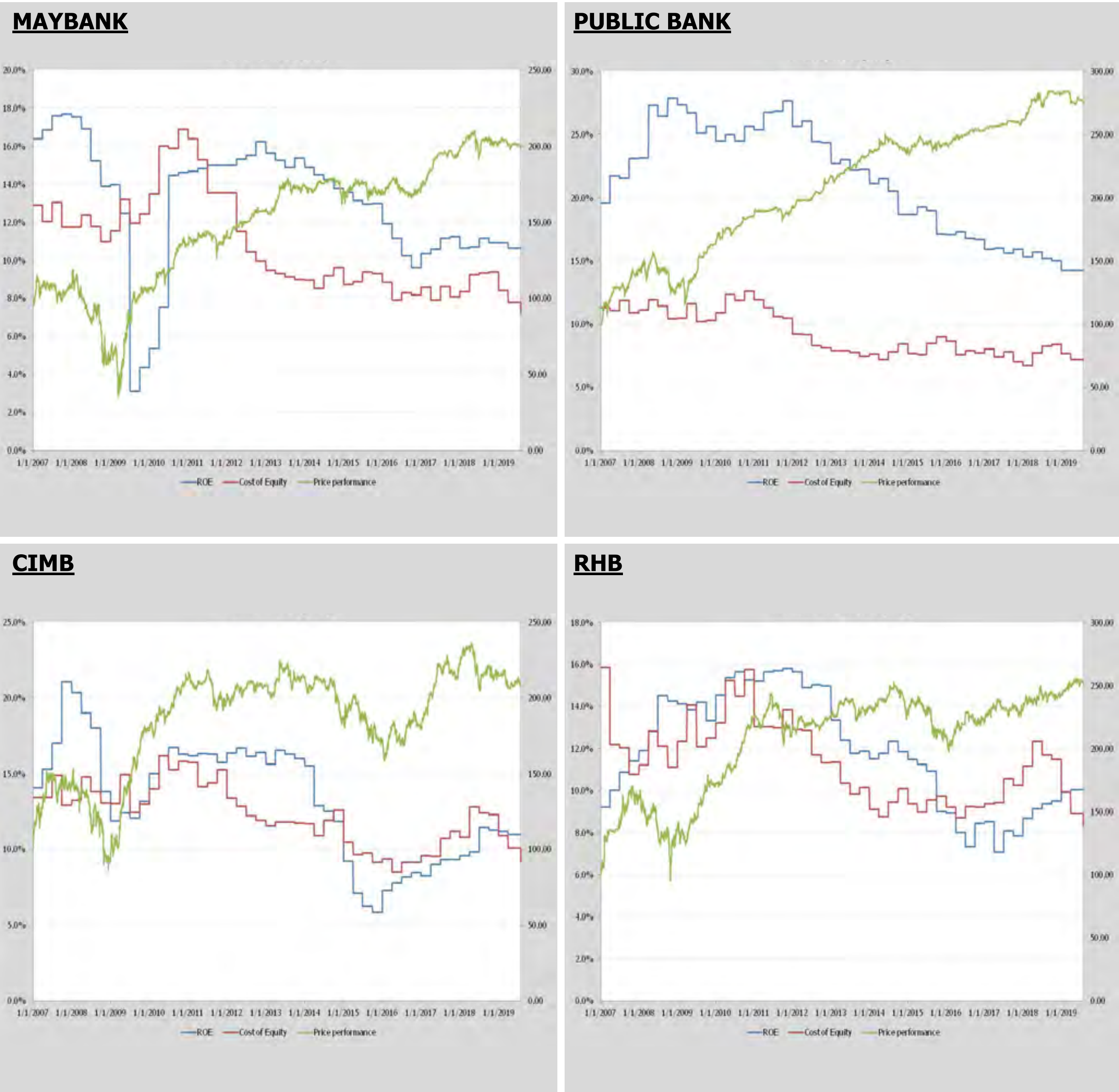
$P_0 = D_1 / (r - g)$

where;

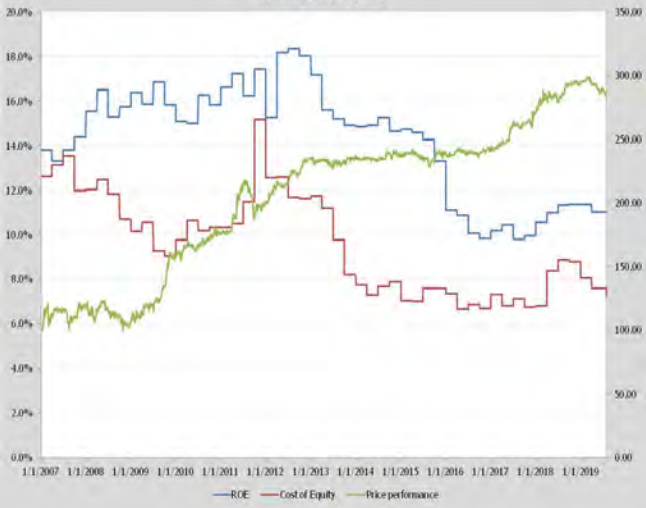
P_0 = Share price
D_1 = Dividend
r = required rate of return
g = growth

Let us assume that dividend and growth will be affected by the fall in ROE. However, due to the reduction in risk, the required rate of return would subsequently be lowered. Therefore, any pressure on the share price will be moderated. We postulate that with the reduction of risk, banks could also command higher valuation multiples and this is evident by the rise in banks' PER.

FIGURE 4: COMPARISON OF MALAYSIA's BANKS' ROE, COST OF EQUITY and PRICE INDEX

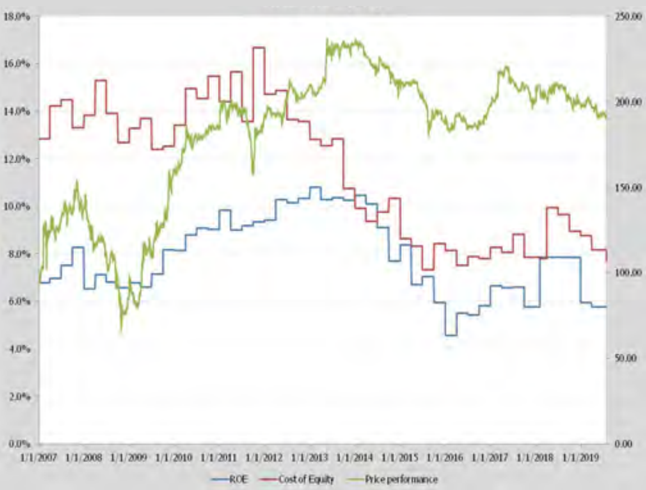


HONG LEONG BANK

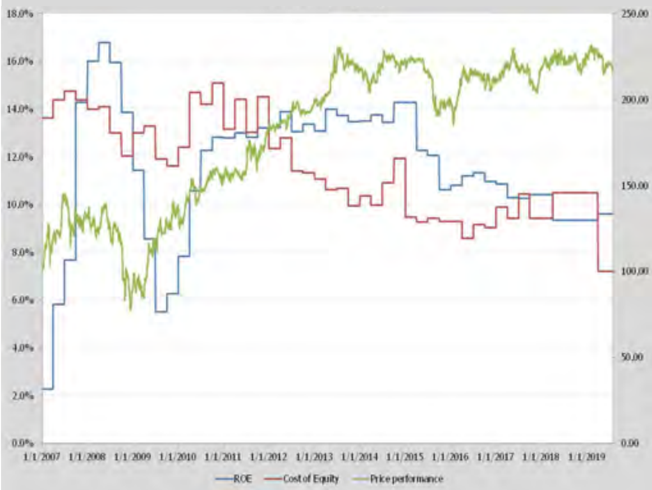


AMMB

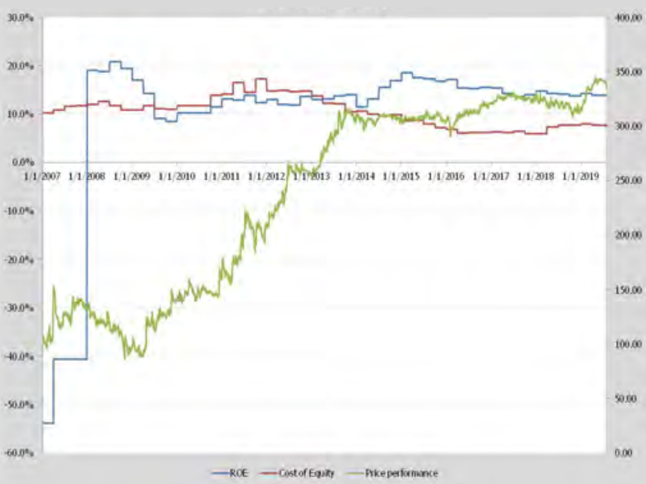
AFFIN



ALLIANCE

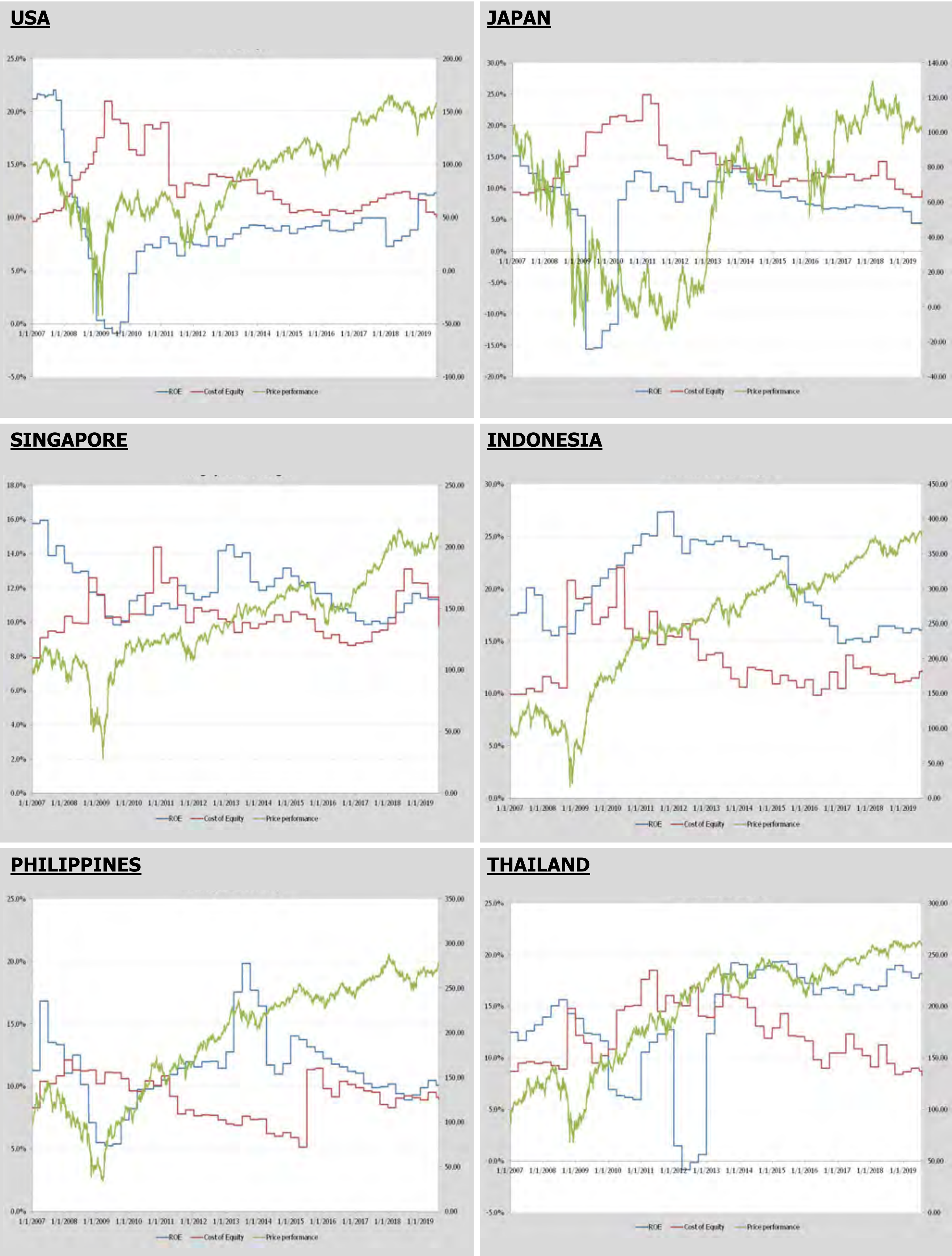


BIMB



Source: Bloomberg, MIDFR

FIGURE 5: COMPARISON OF SELECTED GLOBAL AVERAGE BANKS' ROE, COST OF EQUITY and PRICE INDEX



Source: Bloomberg, MIDFR

Due to lowering of risk, lower ROE is not necessarily a bad thing. While it is understood that there is only a few good alternatives to ROE as a measure for banks, we must be cognizant that these metric do not factor risk sufficiently. While we note that a high ROE is preferable, we believe that it needs to be considered with valuation as a whole. In our opinion, other factors such as asset quality, liquidity and asset growth should be evaluated together with ROE. We believe that the idea that low ROE is bad when comparable to past ROE is not necessarily justified as evident by the share price performance of banks ever since GFC.

A new normal but risk has been reduced. In summation, banks hold more equity now, either being encouraged or required by regulators, or even out of its own accord. The result is a lower ROE. Nevertheless, we opine that this is the new normal environment that banks have to operate in. However, we must be aware that this equity is far less risky than what it was before. Therefore, the returns that investors expect should be lower due to this reduction of risk.

Maintain POSITIVE. Given this new normal, the orthodox conclusion is that our stance should change. However, as we highlighted above, we believe that the reduction in risk should be a reassurance. For Malaysia banks, we believe that there are still positives for banks such as the downtrend of expenses and the low credit cost and should be able to alleviate the weakness in income. Furthermore, we opine that banking stocks in general are currently undervalued given its fundamentals remains intact. Hence, we maintain our **POSITIVE** stance. Given the current market conditions, our top picks for this sector are **Maybank (BUY, TP: RM11.00)**, **CIMB (BUY, TP: RM6.80)** and **Public Bank (BUY, TP: RM27.20)**.

FIGURE 8: PEER COMPARISON FOR MALAYSIAN BANKING STOCKS

	Rec.	Price @ 29/7 (RM)	TP (RM)	EPS (sen)		PER (x)		Net DPS (sen)		Net Div Yield (%)		BV (RM)		PBV (x)	
				19	20	19	20	19	20	19	20	19	20	19	20
Maybank	BUY	8.73	11.00	74.1	73.9	11.8	11.8	58.0	58.0	6.6	6.6	7.1	7.4	1.2	1.2
Public Bank	BUY	22.20	27.20	147.6	151.0	15.0	14.7	72.0	73.0	3.2	3.3	11.2	12.0	2.0	1.9
CIMB	BUY	5.09	6.80	50.0	49.0	10.2	10.4	26.0	26.0	5.1	5.1	5.6	5.7	0.9	0.9
RHB Bank	BUY	5.44	6.35	62.4	67.7	8.7	8.0	22.0	24.0	4.0	4.4	6.3	6.5	0.9	0.8
Hong Leong	NEUTRAL	18.20	20.30	135.8	143.1	13.4	12.7	49.0	50.0	2.7	2.7	12.5	13.4	1.5	1.4
AMMB	NEUTRAL	4.21	4.50	50.0	46.6	8.4	9.0	20.0	20.0	4.8	4.8	5.9	5.9	0.7	0.7
Affin	BUY	2.03	2.50	29.0	29.0	7.0	7.0	5.0	7.0	2.5	3.4	4.6	4.7	0.4	0.4
Alliance	BUY	3.65	4.75	34.7	39.8	10.5	9.2	16.7	18.5	4.6	5.1	3.7	3.7	1.0	1.0
BIMB	BUY	4.14	5.05	43.7	44.0	9.5	9.4	16.0	18.0	3.9	4.3	3.2	3.5	1.3	1.2
Average				**69.7**	**71.6**	**10.5**	**10.3**	**31.6**	**32.7**	**4.2**	**4.4**	**6.7**	**7.0**	**1.1**	**1.0**

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MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS	
STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >15% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >15% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -15% and +15% over the next 12 months.
SELL	Total return is expected to be <-15% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >15% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.
SECTOR RECOMMENDATIONS	
POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.