Philequity Corner (April 2, 2012)

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Stress Tests

In 3Q2011, we wrote an article explaining the reasons for the weak performance of the world's biggest banks for most of 2011 (*When Titans Fall, September 19, 2011*). In that article, we cited the concerns on the recovery of the US economy, the legal and regulatory risks that US banks are facing and the worsening EU sovereign debt crisis as the main reasons for the poor performance of global banking stocks. However, towards the end of 2011, the outlook for global banks started to improve. In fact, US banks have led the strong performance of US equities in 2012. Recently, the positive results of the stress tests provided an additional boost to US banks. The stress tests, which were conducted by the Fed, were designed to see how US banks would handle a severe recession.

Not to be left behind, our PSE Index reached a new milestone as it broke above the 5,000 level for the 1st time (*5000, March 5, 2012*). Listed local banks likewise staged impressive rallies and established new all-time highs in the early part of 2012.

Table 1 - Bank Stocks vs. Indices

	12/31/2011	3/30/2012	YTD
S&P 500	1,257.60	1,408.47	12.0%
Bank of America	5.56	9.57	72.1%
Citigroup	26.31	36.55	38.9%
JP Morgan	33.01	45.98	39.3%
Wells Fargo	27.37	34.14	24.7%
	12/31/2011	**3/30/2012**	**YTD**
PSE Index	4,371.96	5,107.73	16.8%
BDO	59.00	66.20	12.2%
BPI	55.20	74.00	34.1%
Metrobank	67.95	87.35	28.6%

Sources: Bloomberg, Technistock, Wealth Securities

In this article, we explain the different reasons for the strong performance of US and Philippine banks. Further, we explore where the US and Philippine banks are in terms of valuation. Lastly, we enumerate the risks, if any, to the continued strong performance of US and Philippine banks.

US Banks Rally

After being hammered for most of 2011, US bank stocks bottomed in 4Q2011 and have so far led the 2012 rally of US equities. Aside from the positive results of the recent stress tests, we cite the following as the reasons for the turnaround in US bank stocks:

1. **Improving US economy.** In 1H2011, there were concerns that the sluggish performance of the US economy might actually lead to a double-dip recession. However, the US economy delivered stronger GDP growth figures in 2H2011. From being concerned about a possible double-dip recession, investors are now looking at US to deliver moderate economic growth.

2. **EU debt crisis patch.** The twin solutions, which involved the EU fiscal pact and the ECB's (European Central Bank) LTRO (Long-term Refinancing Operations), helped ease concerns about the EU debt crisis. The EU fiscal pact directly tackled the fiscal problems of the highly-indebted EU countries, while the ECB's LTRO provided the necessary liquidity to ring-fence the European banks. Further, the recently concluded Greek debt swap assured global investors that real progress is being made in diffusing the EU debt crisis.
3. **Supportive monetary policy.** The Fed pledged to maintain interest rates low until 2014. Through this policy action, the Fed aims to stimulate loan growth. This allows banks to have low funding costs even as US economic activity has started picking-up.

Value with Risks

Even as US banks staged an impressive rally in 2012, they remain historically cheap on a P/BV (Price to Book Value) basis. However, US banks do not look very cheap based on P/TBV (Price to Tangible Book Value). For US banks, it is more relevant to use P/TBV since this excludes intangible and bad assets which came mostly from their participation in the 2008 crisis. As US banks clean-up and strengthen their balance sheets over time, we expect their P/BV and P/TBV multiples to gradually expand.

Table 2: US Banks - ROE, P/BV, P/TBV and PE

	3/30/2012	2011 ROE	2012E P/BV	2012E P/TBV	2012E PE
Bank of America	9.57	0.04%	0.46	0.84	12.76
Citigroup	36.55	6.60%	0.58	0.75	9.18
JP Morgan	45.98	10.66%	0.94	1.48	9.80
Wells Fargo	34.14	12.19%	1.32	2.20	10.67

Sources: Bloomberg, Estimates of Various Research Houses

Though US banks may appear to be a bargain for investors, most of them are still recovering from the aftermath of the Great Recession. As such, the big US banks are exposed to legal risks, as a result of their participation in the 2008 subprime mortgage crisis. Aside from this, the Dodd-Frank Law and the Volcker Rule bring increased regulatory risks as regulators seek to limit bank leverage and proprietary trading.

New All-Time Highs

As US banks staged a strong rally from their 4Q2011 bottom, Philippine banks established new all-time highs. Below, we enumerate the drivers of the continued strong performance of local bank stocks:

1. **Resilient Philippine economy.** Amidst the shocks and disasters experienced in 2011, the Philippine economy delivered respectable GDP growth of 3.7%. This is supported by the steady inflow of OFW remittances and BPO revenues, giving rise to a stronger middle class. These continue to drive consumption and ultimately, economic growth, higher.
2. **No significant regulatory or legal risks.** Unlike US banks, Philippine banks do not have to contend with significant regulatory or legal risks. Further, local banks have cleaned-up and strengthened their balance sheets following the aftermath of the Asian Financial Crisis.
3. **Healthy level of capitalization.** Most local banks have healthy Capital Adequacy Ratios (CAR) and are poised for faster asset growth. In fact, most of the big local banks, compared to the bigger global banks, are in a better position to comply with the stricter capital requirements of Basel III. Further, our banks can readily grow their assets even without raising additional capital.

4. **Ready for PPP.** Since local banks have healthy levels of capitalization, they are poised to take on additional loans if investment spending commences. Banks can participate in this endeavor by providing financing to the PPP (Public-Private Partnerships) projects via loans.
5. **Mergers and acquisitions.** In a previous article (*Hunting the Hunters, February 27, 2012*), we mentioned how M&A activity generally pushes the market up. Recent M&A rumors among local banks, whether true or not, continue to spark strong moves in local banking stocks.

Growth at a Price

While US banks appear to be historically cheap, Philippine banks repeatedly established new all-time highs in 2012. In fact, most local banks are close to the peak of their valuation bands on a P/BV basis.

Table 3: Phil. Banks - ROE, P/BV and PE

	3/30/2012	2011 ROE	2012E P/BV	2012E PE
BDO	66.20	11.40%	1.78	13.62
BPI	74.00	15.20%	2.64	16.70
Metrobank	87.35	12.90%	1.70	15.65

Sources: Company Data, Wealth Securities

Compared to US banks, Philippine banks would look expensive on a P/BV basis. However, our banks are not exposed to the downside risks that US banks are contending with. Moreover, unlike US banks, local banks are consistent in delivering a healthy level of profitability and earnings growth.

Value vs. Growth

This comparison between US and Philippine bank shows that there is more to fundamental analysis than just ratios and multiples. On one hand, US banks appear cheap, but they are saddled with various external, regulatory and legal risks. Most of them are still cleaning-up their books as they recover from the fallout of the 2008 subprime mortgage crisis. On the other hand, Philippine banks are close to the peak of their valuation bands, but they are poised to maintain their growth trajectory with little downside risks. It can be said that local banks went through a similar debacle that the US banks are facing when they dealt with the painful after-effects of the Asian Financial Crisis. Though it may not be clear whether US banks or Philippine banks are the better investment choice, what is important is for investors to closely study the banks that they invest in. Moreover, it is essential for investors to be aware of the risks, rewards and trade-offs involved in investing in bank stocks.

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