Philequity Corner (December 10, 2012)

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Banking on Banks

Two weeks ago, we wrote about the possible BPI-PNB-Allied merger (*Hunt for Banking Supremacy*, November 26, 2012). The proposed merger between the country's 3rd and 4th biggest banks is expected to give rise to the largest bank in the country. Though many expected the merger to be finalized shortly after it came out in the news, it seems that the merger may have hit a stumbling block, probably because of one or more of the following:

1. Acquisition price and valuation of PNB-Allied
2. Post-merger shareholder structure of BPI-PNB-Allied
3. Board representation in the merged BPI-PNB-Allied
4. Other personal or family matters that might have affected the proposed merger

Though there have been no recent updates on the proposed BPI-PNB-Allied merger, local banking stocks still continued to move higher. Normally, the stock prices of potential acquirers go down when there is an acquisition in play. Surprisingly, however, the opposite has happened as potential acquirers such as BPI, BDO and MBT continued to make new all-time highs. This is likely due to the market perception that PNB-Allied will probably be a good acquisition for any of the country's three biggest banks.

Local Banks Outperform

Many investors are excited that the possible BPI-PNB-Allied merger might be the start of another wave of M&A activity among local banks. This excitement, along with the continued strong performance of the country's economy, has fueled the stellar performance of local bank stocks this year. In the table below, we show that all listed local banks outperformed the PSE Index year-to-date.

Listed Local Banks vs. PSE Index										
	BDO	BPI	MBT	SECB	CHIB	RCB	PNB	UBP	EW	PSEi
YTD Performance	44.2%	72.6%	49.4%	69.5%	54.2%	90.9%	56.0%	72.7%	52.7%	33.3%

EW's performance is counted starting from its IPO date of May 7, 2012
Source: Technistock, Wealth Securities

For the benefit of our readers, we shall discuss in this article how we value banks. We will explain how we compute a bank's book value and the criteria that we use to assign the appropriate Price to Book Value (P/BV) multiple for different banks.

Valuing the Book

The balance sheets of different banks are more or less similar in composition. They are primarily composed of assets and liabilities that can be valued at market. The book value of a bank therefore reflects its liquidation value. This is why banks are primarily valued based on book value as opposed to other counters or companies, which are valued mostly based on earnings or cash flows.

One can push this analysis further by carefully scrutinizing the financial statements of a bank. Different computations of a bank's book value may be arrived at depending on the level of one's analysis. Below, we enumerate the different ways of computing for a bank's book value.

1. **Book Value.** This is the simplest and most commonly-used computation. Book value refers to the bank's capital that is attributable to its common shareholders. This computation is the one that is primarily used in valuing listed local banks because most of their balance sheets are already clean and strong.
2. **Tangible Book Value.** This computation excludes a bank's intangible assets such as goodwill and deferred charges. Intangible assets are excluded because the bank can neither sell nor earn from them. This is the method used to value US banks because most of them have significant amounts of intangible assets in their balance sheets.
3. **Adjusted Book Value.** On top of excluding a bank's intangible assets, this computation assumes a certain write-off of the bank's non-performing assets, such as loans and repossessed assets. This is the basis that we used when we said that PNB-Allied could fetch a takeover price of P118**,** which is equivalent to 2.0x P/BV of our 2012 Adjusted Book Value per Share estimate of P59. We view this as a realistic estimate of the takeover price for PNB-Allied because it is at the lower end of the 2.0 to 2.5x P/BV valuation range of previously acquired local banks.
4. **Fully Adjusted Book Value.** This usually involves due diligence of the bank's assets and a line-by-line analysis of the bank's financial statements. This is typically used to arrive at a precise valuation of the bank when it is being acquired by another entity.

Even though a bank's book value gives an estimate of the bank's liquidation value, it still does not give a complete picture of what the bank should actually be worth. The book value computation does not consider the ability of the bank to create value for its shareholders.

The Magic Multiple

A bank's management is expected to create value from the bank's assets. Though the balance sheets of banks are really similar in nature, some banks appear to create more value for their shareholders than others. A bank's ability to create value for its shareholders may be quantified by looking at certain metrics and qualities. We enumerate some of the criteria that we use below.

1. **Return on Equity (ROE).** We usually prefer banks that are more profitable than others based on ROE. This ratio measures how big a bank's profit is in relation to its capital. At a steady-state level, ROE gives us an idea about the rate at which the bank is organically growing its capital.
2. **Quality and consistency of earnings.** Among banks that deliver relatively high ROE, we prefer those that have strong core banking operations. We look for banks that can consistently deliver good quality earnings as measured by Recurring ROE.
3. **Size.** In a past article, we explained how size matters and how size is usually an advantage for Philippine banks (*Philippine Banking Giants*, June 13, 2011). This is the reason why the biggest local banks (BDO, BPI and MBT) trade at a premium relative to the other listed local banks.
4. **Growth.** We like banks that make clear efforts to grow their assets and earnings. Asset growth signifies that the management wants to leverage its operations, attain economies of scale and widen its market presence. Earnings growth, on the other hand, shows that the bank's management is optimizing bank operations in order to deliver more profits to its shareholders.

In the table below, we compare the size and profitability of listed local banks.

Size and Profitability of Listed Local Banks									
	BDO	BPI	MBT	SECB	CHIB	RCB	PNB	UBP	EW
Assets	1,174	867	954	253	312	353	321	228	97
Capital	152	96	114	36	41	43	38	47	17
Market Cap	275	339	214	83	72	66	58	73	32
ROE	11.3%	19.0%	12.8%	24.3%	10.4%	15.3%	13.2%	18.8%	12.9%
Recurring ROE	9.6%	16.4%	12.4%	11.1%	6.1%	5.1%	2.4%	5.2%	12.4%

Amount in billions; PNB is shown on a standalone basis
Sources: Company data, Wealth Securities estimates

In the next table, we compare how listed local banks are currently valued.

Listed Local Banks - Price to Book Value & Price to Tangible Book Value									
	BDO	BPI	MBT	SECB	CHIB	RCB	PNB	UBP	EW
2013E P/BV	1.88	2.96	1.85	1.88	1.54	1.64	1.18	1.40	1.60
2013E P/TBV	1.90	3.04	1.96	1.91	1.55	1.73	1.30	1.65	1.72

Amount in billions; PNB is shown on a standalone basis
Sources: Company data, Wealth Securities estimates

Based on these tables, we can see how banks that deliver on the criteria that we enumerated above are generally rewarded with higher P/BV and P/TBV multiples.

Banks Drive the PSE Index

It seems that the local banking sector is ripe for another wave of M&A activity. Local banks currently have relatively higher capitalization ratios compared to their regional counterparts. Moreover, their balance sheets are significantly stronger now compared to the previous times (1999 to 2000 and 2005 to 2007) when the sector experienced heightened M&A activity. Against this backdrop, the merger talks involving some of the country's biggest banks have propelled not only banking stocks but also the local stock market to new highs. This is probably a telltale sign that the stock market perceives these mergers as beneficial not only for the possible acquirers and acquirees but also for the country as a whole.

Secular Bull Market

Last week, the PSE Index closed at 5,794, almost reaching our end-2012 target of 5,800. As we discussed in previous articles (*PSEi, All-Time High*, July 18, 2011 and *5000,* March 5, 2012), the country's fundamentals remain strong, providing an impetus to the continued resilient performance of our stock market. With that said, we firmly believe that the secular bull market is intact and this bull market that started in March 2009 (*Opportunity of a Generation*, November 3, 2008 and *666 on 3-6-9*, April 13, 2009) will continue to surge on for many years to come. Considering this, we would like to re-emphasize what we have repeatedly advocated in previous articles. Investors should continue to use a buy-on-dips strategy and view market corrections as buying opportunities.

For further stock market research and to view our previous articles, please visit our online trading platform at www.wealthsec.com or call 634-5038. Our archived articles can also be viewed at www.philequity.net.