SEYMOUR PIERCE

UK Banks

UNDERPERFORM

BUY	Target Price
HSBA	800p

HOLD	
BARC[5]	356p
LLOY[5]	72p
STAN	1740p

UNDERPERFORM	
RBS[5]	47p

UK Bank rel.

Source: Datastream

The Bankers' Paradox

According to "The Bankers' Paradox" those most in need of assistance are the least likely to be given help. With £75bn of cumulative investment banking losses (5x higher than UK retail banking losses) we are rather surprised that UK banks haven't given their markets divisions "the cold shoulder". Our view on the sector is Underperform.

Investment bank partnerships did not have an "eat what you kill" culture

We draw on insights from !Kung San tribe of the Kalahari Desert to argue that when the variance of success is high (as it is in investment banking) co-operative behaviour outperforms maximising self-interest.

Recouping losses through UK Retail bank net interest margin

Our concern is that universal banks are recouping investment banking losses by expanding margins to retail and small business customers. Aside from the "fairness" of UK customers paying for losses in an alphabet soup of ABS, CDO, CDS and CPDOs, we think that this could create an opportunity for new entrants.

What price of "too big to fail"?

UK banks funding remains a concern, the sector needs to refinance up to £800bn by the end of 2012. This changes the investment case versus the previous recession, in our view. It should be clear that the UK government is not prepared to see a large bank fail, but if so, shareholders should be asking what price the politicians will demand in return. We rate the sector Underperform, our least preferred bank is RBS (Underperform, TP 47p). Our most preferred is HSBC (BUY TP 800p).

Valuation

	Price	Target Price	Upside	P/ Sales 11F	P/ Tang Book 11F	P/ E 11F
BARC	325	356	10%	1.21	0.84	8.4
HSBC	654	800	22%	2.56	1.49	9.2
LLOY	70	72	3%	1.80	0.89	9.9
RBS	47	47	0%	1.12	0.95	6.3
STAN	1750	1740	-1%	3.17	2.26	12.4

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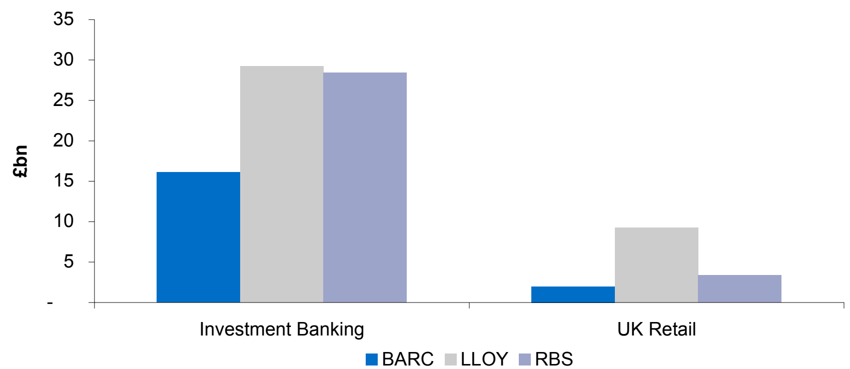
HARD TIMES

Hard times show who your friends really are. The H1 reporting season was notable for some robust defences of investment banking and the universal banking model by UK bank Chief Executives.

Losses 5x higher in investment banking than UK retail banking

However, one aspect not mentioned was that the split of losses at universal banks has been massively tilted to investment banking. At £74bn, investment banking losses have been 5 times higher than UK Retail Banking losses over the last two and a half years at Barclays, Lloyds and RBS.

Cumulative Impairment & Writedowns since 2007



Source: Seymour Pierce Ltd

Wholesale = Barclays Capital for Barclays, GBM for RBS

As if this wasn't bad enough, if we add the goodwill writedowns and "negative fair value adjustments" on acquisitions (ABN, HBOS) losses rise to £118bn cumulatively. Bonuses all round chaps!

Lessons from the auto industry

Unfortunately shareholders can draw no comfort from another global industry which the Government attempted to support and consolidate. In 1967, the British government insisted domestic firms merge to form British Leyland – a business with "critical mass" to be a global player. This was the same year Honda entered the auto market, which went on to be far more successful than the British company.

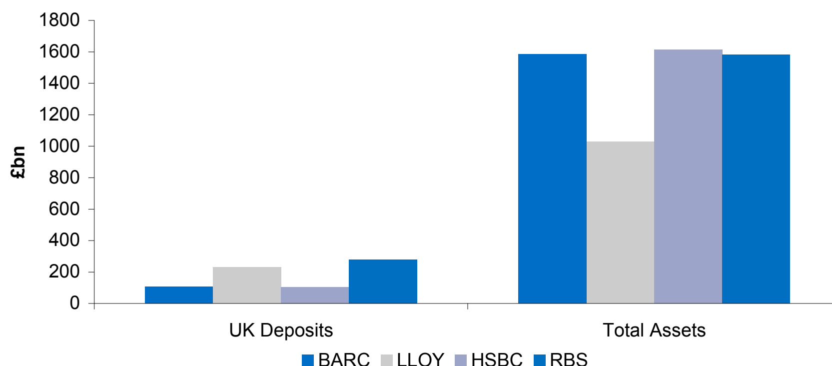
Ingratitude, thou marble-hearted fiend

Rather than cheer government support and watered-down regulation, we believe investors should be putting management under pressure to spin out investment banks. Bankers argue that investment banks could not fund on a standalone basis, without huge capital infusions. Investment bankers who work at universal banks appear to have shown no gratitude for government largesse.

Shareholders only have to look at the auto industry to see that 1) If banks are not providing a product or a service that customers want, they will fail, with or without government subsidies. 2) If weak banks are subsidised and capacity is not taken out of the industry, returns will not equal cost of capital.

Over the longer term our analysis suggests these trends are particularly negative for Barclays (HOLD, TP 356p) and RBS (Underperform, TP 47p).

Bank balance sheets v UK deposits



Source: Seymour Pierce Ltd

Opaque balance sheet liabilities

From both a shareholder and taxpayer perspective, we are concerned about the size of the customer deposit base relative to banks' total balance sheet. The derivative assets and liabilities recorded on bank balance sheets obscure the recovery available to shareholders, bond holders and deposit customers. Because large financial firms have significant exposures to derivatives, as a firm's financial condition deteriorates, assets which are generating losses will also face collateral calls.

By guaranteeing UK deposits, the Government is effectively subsidising the unsustainable levels of leverage in universal banks' balance sheets.

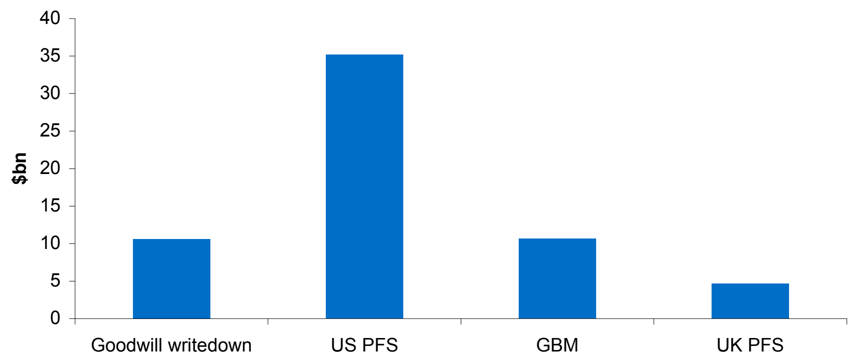
RECAPITALISING THROUGH RETAIL NET INTEREST MARGIN

Our other concern is that banks are recouping investment banking losses by expanding margins to retail and small business customers. Aside from the "fairness" of UK customers paying for losses in an alphabet soup of ABS, CDO, CDS and CPDOs, we think that this could create an opportunity for new entrants (supermarkets? Metro bank? Virgin? peer to peer lending networks such as zopa or funding circle?). In essence, investment bankers are sucking the blood from UK Retail Bank franchises.

HSBC could lose over $30bn in North America without damaging the business model

The exception is HSBC. The bulk of HSBC's losses occurred in the North American PFS division (Personal Financial Services) but the bank is stable enough that is able to absorb this and still offer market leading mortgage deals (albeit with conservative Loan to Value constraints) in the UK.

HSBC cumulative impairments and writedowns



Source: Seymour Pierce Ltd

RBS and LLOY raising net interest margins

This appears not to be the case at the UK government owned banks, LLOY and RBS, where Net Interest Income grew 24% and 16% respectively as the banks widened margins to UK customers to make up for losses in the investment bank.

UK Retail Bank growth

UK Retail growth	BARC	HSBC	**LLOY**	SAN	**RBS**
Net Interest Income	5%		**24%**	12%	**16%**
Income	1%	5%	**18%**	6%	**5%**
Surplus (income less expenses)	2%	17%	**42%**	10%	**28%**

Source: Seymour Pierce Ltd

In absolute terms, annualising this increase in UK Retail Bank Net Interest Income at RBS is worth £538m and £1.8bn at LLOY. Capitalised on 10x (that is assuming operating costs are fixed, and no increase in bad debts) this would be worth £18bn to LLOY and £6bn to RBS. These are significant amounts relative to market capitalisation (LLOY market cap £47bn, RBS market cap £27bn).

But we think shareholders should be wary about assuming the benefits of the margin increases accrue to them in the form of dividends or buybacks. Given continued reliance on Government support, banks may have to "give back" to customers their excess profits, alternatively pressure to generate an earnings recovery may be at the cost of long term franchise value.

"A loan oft loses both itself and friend"

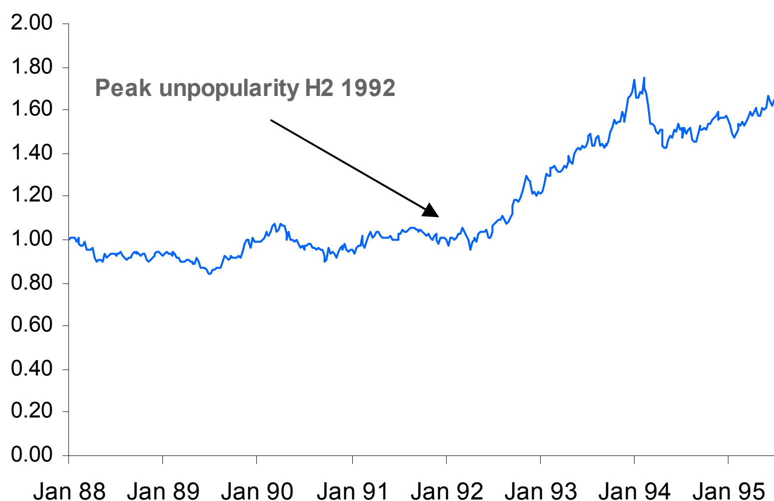
Of course, unpopular bankers and money lenders are a theme of literature going back centuries.

> *The owners of the land came onto the land, or more often a spokesman for the owners came…Some of the owners' men were kind because they hated what they had to do, and some of them were angry because they hated to be cruel, and some of them were cold because they had long ago found that one could not be an owner unless one were cold. And all of them were caught in something larger than themselves… The owner men explained the workings and the thinking of the monster that was stronger than they were… You see, a bank or a company… those creatures don't breathe air, don't eat side-meat. They breathe profits; they eat without side-meat. It is a sad thing, but it is so. It is just so… When the monster stops growing, it dies. It can't stay one size…We're sorry. It's not us. It's the monster. The bank isn't like a man.*
>
> *Yes, but the bank is only made of men [said the tenants].*
>
> *No, you're wrong there – quite wrong there. The bank is something else than men. It happens that every man in a bank hates what the bank does, and yet the bank does it. The bank is something more than men, I tell you. It's the monster. Men made it, but they can't control it.*
>
> **The Grapes of Wrath 1939**

Unpopularity and shareholder returns

In the past though, unpopularity has been no impediment to shareholder returns. At the height of the early 1990's recession banks were deeply unpopular, and they outperformed the FTSE Allshare by 80%. McDonalds has outperformed the S&P500 by 170% since Morgan Spurlock's *Super Size Me* was released in cinemas in 2004.

UK Banks Sector/ FT All Share



Source: Datastream

Buy on the smell of tear gas

It is possible that the anarchist riots in March 2009 when RBS building was ransacked marked "peak unpopularity" in this banking cycle and was the catalyst to buy into the sector. The modern equivalent of Nathan Rothschild's "buy on the sound of gunfire" may well be "buy on the smell of tear gas".

However, the difference between this decade and the early 1990's is that bankers were friendless because they were keen to recover as much money as possible from struggling customers and would only lend out money to customers who could prove they didn't need it. This cycle banks have had to seek Government support, and then paid themselves bonuses.

The Bankers' Paradox

The term "bankers' paradox" was coined by John Tooby and Leda Cosmides in an attempt to reverse engineer the psychology of friendship and support. The fact that banks only have a finite amount of money to lend and every loan carries risk, means that bankers have to avoid lending money to weaker businesses. Similarly, the most successful people have lots of friends, those most in need of friends very often don't have them.

Reciprocal altruism in the animal kingdom

Ironically for bankers, there is an oft cited example of support behaviour in the animal kingdom: vampire bats. Vampire bats lose weight exponentially when they starve, so therefore the same weight of blood costs the donor less time than the recipient bat gains. Mostly regurgitations of blood are between mother and dependent pup. But around one third of observations made by Gerald Wilkinson were adult females feeding young other than their own or other adult females that they had roosted with over a long time period.

This behaviour does not contradict "survival of the fittest" evolutionary theory, because by helping others, the bats were likely to gain in future. Thus, there will be a selection for those who are inclined to be altruistic … to a point. With limited resources bats only help those closest to them and assess "credit risks", of not being paid back in blood. So here again is the Banker's Paradox: (perhaps it should be called the vampire bat's paradox) that those who receive support are those most likely to be able to repay in future.

Speak less than thou knowest

Lend less than thou owest

Now that UK banks themselves are struggling for funding, and need to refinance up to £800bn by the end of 2012 without the help of governments, the investment case changes dramatically. It should be clear that the UK government is not prepared to see a large bank fail, but if so, shareholders should be asking what price the politicians will demand in return for continued support.

There are good reasons to believe that the dysfunctional culture of universal banking will bring more pain to shareholders and taxpayers.

VALUATION

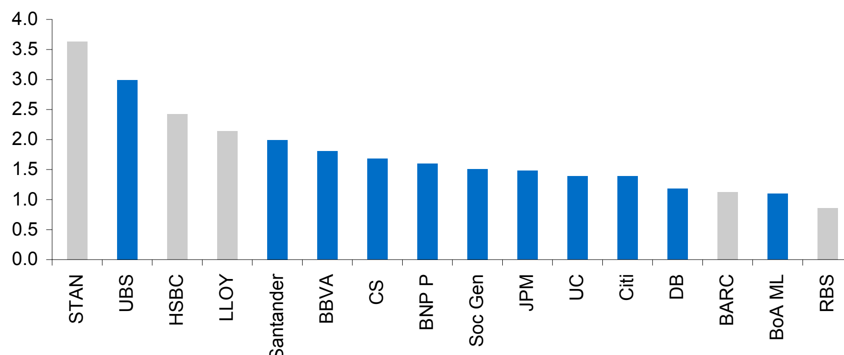
Sum of the parts flawed

With Barclays, RBS and LLOY trading at close to tangible book value, we are becoming nervous that the sophisticated sum of the parts models that bank analysts use are worthless. If investment banking divisions are always going to be supported by their friends in retail banking and the Government, the whole industry will destroy value through the cycle, in our view.

Tangible book value flawed

Moreover, we are not great fans of tangible book value as a valuation metric, in any case. Historically equity in a bank was an informative number, but now the mixture of fair value and historic cost accounting in the balance sheet, not to mention the huge amounts of non deposit liabilities makes tangible book an arbitrary number. Instead we prefer price / total income.

Valuation P/ total income

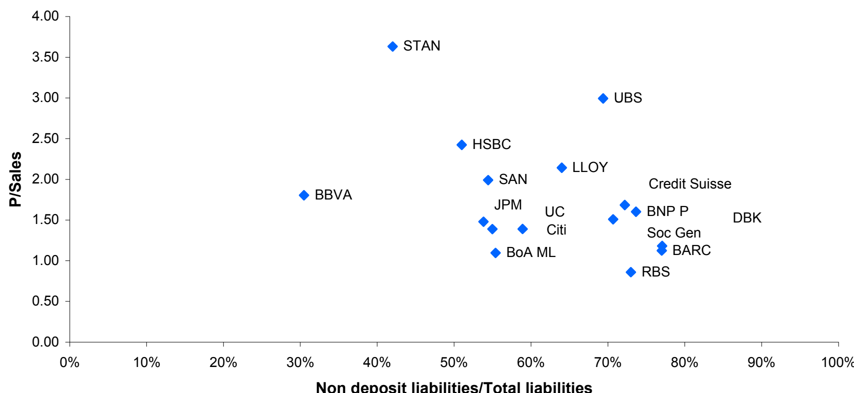


Source: Seymour Pierce Ltd

Price to sales our preferred valuation heuristic

STAN and HSBC look 2 or 3 times more expensive than the likes of Barclays and RBS. This could be down to Asian growth potential. Alternatively the derivative and wholesale banking liabilities at universal banks reliant on investment banking is a concern. Particularly given US banks understate liabilities relative to European banks which use IFRS. Hence JPM, BoA ML and Citi would probably occupy the bottom right corner of the graph if they were using IFRS.

Valuation



Source: Seymour Pierce Ltd

APPENDIX: EAT WHAT YOU KILL

The phrase "eat what you kill" has become synonymous with investment banking. We (as investment bankers) think this is mistaken, to understand why, we draw on a parallel between investment banking and primitive hunter gatherer societies.

Hunter gatherers do not have an "eat what you kill" culture

Hunter gatherers do not have an "eat what you kill" culture, but instead share meat among members of the tribe. This is not out of indiscriminate largesse or commitment to socialist principles. Citing data from anthropological studies as far apart as the Ache tribe in Paraguay and the !Kung San tribe of the Kalahari Desert, Steven Pinker shows that people share when the *variance* of success is high. Some weeks a tribesman may be lucky and have more food than he can eat, but in other weeks be unlucky and in danger of starvation.

How can a tribesman store food when there are no fridges? Better to share meat than for it to rot. In effect, the successful hunter stores food in the bodies and mind of other people, in the form of a memory of generosity the tribesman feels obliged to repay when fortunes reverse. Later, if someone else in the tribe managed to kill an antelope, they would benefit from the reciprocal altruism.

Vampire bats and reciprocal altruism

We see a parallel with this behaviour, and the old paternalistic investment banking partnership structure, which did not have an "eat what you kill" ethos. Michael Lewis pointed out in November 2008 that:

> *No investment bank owned by its employees would have levered itself 35 to 1 or bought and held $50 billion in mezzanine C.D.O.'s. I doubt any partnership would have sought to game the rating agencies or leap into bed with loan sharks or even allow mezzanine C.D.O.'s to be sold to its customers. The hoped-for short-term gain would not have justified the long-term hit.*

They do not share foraged food

Steven Pinker has observed that when it comes to the "gathering" of hunter gathering, humans are far less willing to share, because the foraged foodstuffs (plants and nuts) can be stored and gathering is largely a result of effort: the longer you work, the more you bring home, an empty handed gatherer is more likely to be lazy rather than unlucky. Where food can be hoarded, specialisation of craft, rapid population growth, cities, priestly cults and/or ruling bureaucracies tend to follow, which in turn leads to empire building.

Investment banking is similar to hunting not gathering

For this reason we think investment banking, where there are wide swings in income from year to year, and successful deal making is often a case of "being in the right place at the right time", does not sit well within commercial banking (more like the "gathering/hoarding/empire building").

Ultimately it is shareholders and taxpayers who ended up paying the price for commercial bankers' failure to understand this insight. While shareholders have limited liability, unfortunately taxpayers have an unlimited liability. In the short term share prices may rise, but ultimately we think this will end badly.

Sources: *How the Mind Works* Steven Pinker, *Soil & Soul*, Alastair McIntosh, *The End* Michael Lewis. *Guns, Germs and Steel* Jared Diamond.

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Outperform	Absolute return expected to increase by between 5% and 10%
Hold	Absolute return expected to change by between -5% and +5%
Underperform	Absolute return expected to decrease by between 5% and 10%
Sell	Absolute return expected to decrease by more than 10%

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Outperform	7.7%	42.9%
Hold	19.9%	27.8%
Underperform	1.7%	33.3%
Sell	11.0%	0.0%

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