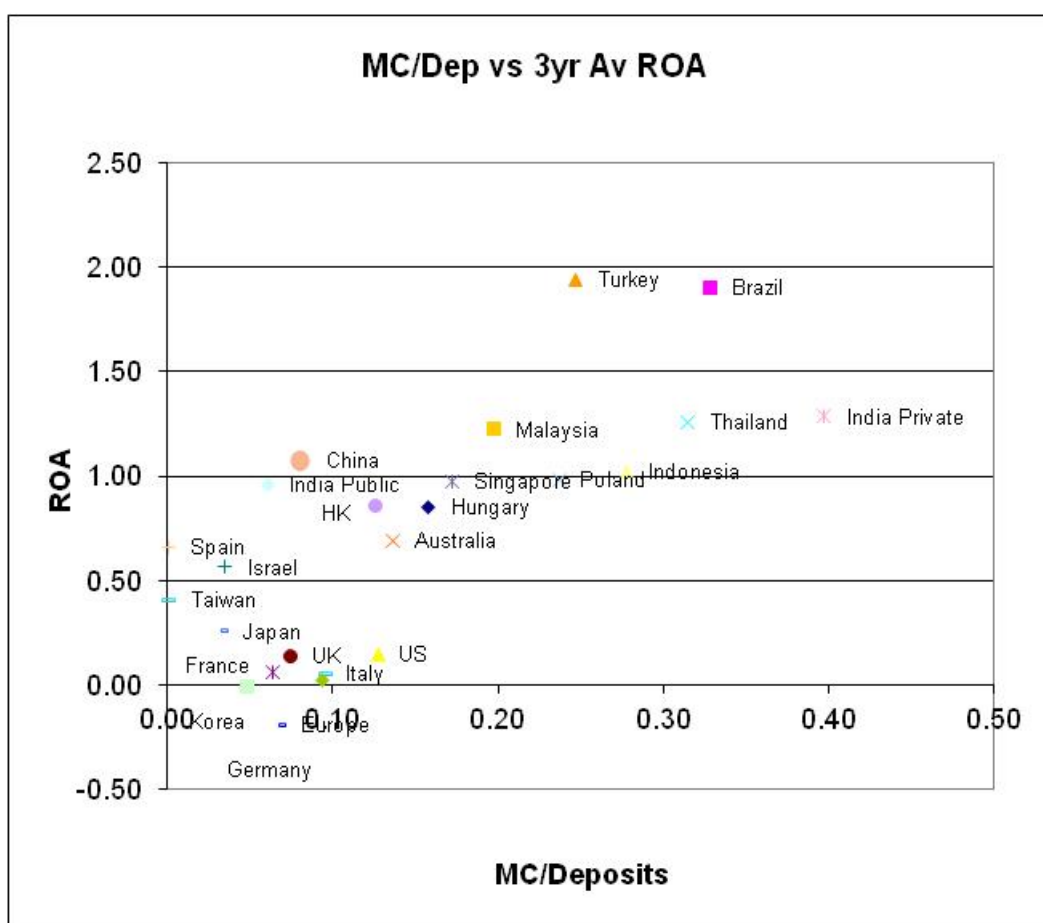




### Valuing banks in a low growth, low yield environment

Retail banks are, or should be, very simple. They do two things, take in deposits, and make loans. Deposits are expensive to gather and are a cost to the bank. Loans are fairly easy to make, and ultimately the interest income of these loans will determine the profitability of a bank. Except in extremely easy credit times, where banks can access wholesale funding to fund loan growth, the size of the deposit franchise is the real value of a bank, as it determines how large a bank's loan book can grow. As we have observed in recent years, while banks can survive sizable loan losses, no bank can survive a loss of deposits.

For many years I have tracked the average valuations of different countries bank industries. The most consistent valuation metric I have found is that of market capitalisation to deposits, compared against the return on assets of the bank. Below are the current valuations.



The above analysis includes both developed market and emerging market banks, and in the case of India, the valuation is split between private banks and state-owned banks. State owned banks in India trade on a much deserved discount. In the 10 years I have tracked this data a largely linear relationship has always held, as banks that can generate high returns on assets can generate higher returns on their deposit base, and will therefore have a higher valuation on a market cap to deposit basis.

As can be seen from above, banks that have distressed balance sheets or low yielding investment outlooks tend to have very low market cap to deposit ratios. Over the last ten years markets that have been consistently in this valuation area are Germany, Japan and Taiwan. Richly valued banks tend to trade in markets where prevailing interest rates are high. Loan growth, deposit growth, or macro certainty are not necessary for banks to achieve a high market cap to deposit ratio. This is shown by the presence of Hungary as the most richly valued of the European banking markets. Local interest rates of 7% and an oligopolistic banking sector is supportive of its valuation.

The key aberration in the above chart is the US. Interest rates in the US are at low levels, and the Federal Reserve has committed itself to keeping rates low for a protracted period of time.

As the chart above shows, US banks trade in line with Australian and Hong Kong banks. Australia has higher interest rates than both the US (for the time being) and Hong Kong, which has seen very rapid loan and deposit growth over the last few years. Unless the interest rate environment changes in the US soon, or we begin to see rapid and sustained loan growth, it seems likely to me that US banks should trade in line with other low interest rate markets like Japan and Taiwan. This would mean that US market caps would need to roughly halve from current levels.

## Information

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- Source: Bloomberg, unless otherwise stated
- Investor Relations: Alain Zakeossian, Carol Brown
- Email: [info@horsemancapital.com](mailto:info@horsemancapital.com)
- Telephone: +44 (0)20 7838 7580
- Website: [www.horsemancapital.com](http://www.horsemancapital.com)
- Business and registered address: Horseman Capital Management Limited, 9 Chester Close, Chester Street, London SW1X 7BE, United Kingdom
- Registered in England and Wales - Company number: 04034280
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