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# Are bank stocks a good bargain?

Market conditions make it look like Irish financial stocks are undervalued. Closer analysis may tell us otherwise

It is widely believed that, after falling 46 per cent, the Irish financials sector presents a once-in-a-generation buying opportunity. The headline valuation numbers, both dividend yields and price/earnings (P/E) ratios, do indeed look remarkably cheap.

Based on stockbroker analysts' consensus earnings forecasts, the forward P/E ratios for AIB and Bank of Ireland stand at 6.5 and 6.3 respectively, depths which have not been plumbed since the early 1990s. The sector average forward P/E over the past ten years has been 12.0, almost twice today's level.

Surely this presents a valuation anomaly which cannot be sustained? Yes, but perhaps the anomaly lies in the earnings forecasts, not the stock prices. The stock market clearly does not believe the analysts' estimates, and is implicitly pencilling in much lower profit figures for the next several years.

Such a gap is quite normal at the outset of a downturn. Analysts are reluctant to cut their forecasts too far below the guidance given by company managements, guidance which is usually based more on current trading conditions than on pessimistic future projections.

Nonetheless, the analysts have given some recognition in their models to the more difficult environment the sector faces. The credit crunch has pushed up the cost of wholesale funding; lending growth has slowed, and will decelerate further.

The Irish banks have some exposure to US sub-prime through structured investment vehicles and collateralised debt



Joe Mottley

obligations, which are now causing pain.

The previously pristine asset-quality of domestic loan books is now deteriorating. Putting it all together, they still predict some modest growth in sector earnings for 2008 and 2009. Only Irish Life and Permanent, more acutely exposed to funding margin pressures, is projected to show a modest decline (5 per cent) in 2008. If these numbers are credible, then the stocks are truly cheap.

What if the analysts are being too optimistic? Let's look at the big picture, which is what has driven share prices down to current levels. Over the 11 years to 2007, the Permanent TSB Irish House Price Index rose by 314 per cent. Since 1994, Irish commercial property has given a cumulative total return of 852 per cent.

The boom has been accompanied by, and has fed off, a surge in bank credit. In the past five years alone, Irish bank lending has been rising at close to 25 per cent per annum. Loan books are now remarkably

skewed towards the property and construction sector. Residential mortgages are, of course, an important core business for AIB, Bank of Ireland and Irish Life and Permanent, accounting for 24 per cent, 47 per cent, and almost 89 per cent of respective loan assets.

To the detached observer, the two leading banks have expanded aggressively in other property and construction lending, such that total property-related exposures have reached 55 per cent (AIB) and 71 per cent (Bank of Ireland) of their portfolios.

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The stock market is implicitly pencilling in much lower profit figures for the next several years

significant falls in property values in Ireland and Britain, could impose much higher bad debt costs on the sector.

In Britain's last recession, for example, the average bad debt charge for the top four banks reached a 1992 peak of 2.24 per cent. A similar outcome now would be enough to wipe out the earnings of AIB and Bank of Ireland.

This may be an ominous model, but charges rising to, say, 1 per cent for one or two years could be a plausible worst-case scenario. Other things being equal, that would reduce AIB's pre-tax profit by

more than 40 per cent, and Bank of Ireland's by some 70 per cent.

At best, we can conclude that there is great uncertainty around profit forecasts for the Irish banks. Thus, their superficially attractive P/E ratios may not be a reliable valuation guide.

What of dividend yields, which (excluding Anglo-Irish) certainly look interesting? AIB now yields 5.9 per cent, with the dividend covered 2.6 times by earnings. Bank of Ireland stands at 7.2 per cent, with 2.3 times cover. These numbers are encouraging. Both compa-

nies could suffer a halving of profits and still cover the current dividend.

In such a scenario, of course, the lack of retained earnings would stretch Tier 1 capital ratios, which are already quite thin. However, dividends are so important to market confidence that cuts would be a highly unpalatable last resort for management. On balance, then, it would seem that Irish bank dividends are safe at the current level, for all bar the most calamitous of profit outcomes.

While AIB and Bank of Ireland might now look attractive

to the income-oriented investor, the stocks could continue to trade at high yields for a long time to come. They are not alone. Many international leaders such as Bank of America, Deutsche Bank, HSBC and Lloyds TSB yield as much or more.

The global banking sector has been brutally de-rated over the past six months. Some of this may be attributable to temporary factors which will unwind, but it also reflects a renewed realisation that this is a low-quality industry. Traditionally, banking stocks traded at a significant valuation dis-

count to overall markets. In recent times, that gap narrowed, as the notion grew that banks had finally mastered the credit cycle. Earnings volatility would be better managed thanks to sophisticated risk-scoring lending models, together with the use of secondary markets for selling on or hedging loans. Sadly, events of the last six months have completely undermined this thesis.

Banking is a brutally competitive industry, where brand values count for little, most products are commodity-like, and balance sheets must be massively leveraged in order to produce adequate shareholder returns. With assets that consist largely of financial obligations, a sustained rise in inflation (a distinct possibility) poses a particular threat.

Regulation imposes ever-greater costs on the sector, and yet it remains uniquely vulnerable to employee fraud. It's not hard to see why the prudent investor should always demand a much higher yield from bank shares than most other stocks.

It has been suggested that, at current prices, any of the Irish companies could be vulnerable to an overseas takeover. This is improbable in the current climate. Most of the likely acquirers are struggling to repair their own balance sheets, with the prospect of more damage to come; and, in any event, they would wish to remain on the sidelines while the Irish economic and property downturn plays out.

While low P/E ratios on the Irish banks may prove illusory, the stocks are reasonably well underpinned by current dividend yields. However, don't expect a recovery from these depressed valuations any time soon.