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Holland Views – Lloyds Banking Group plc (Price: 75p, MCap: £54bn)

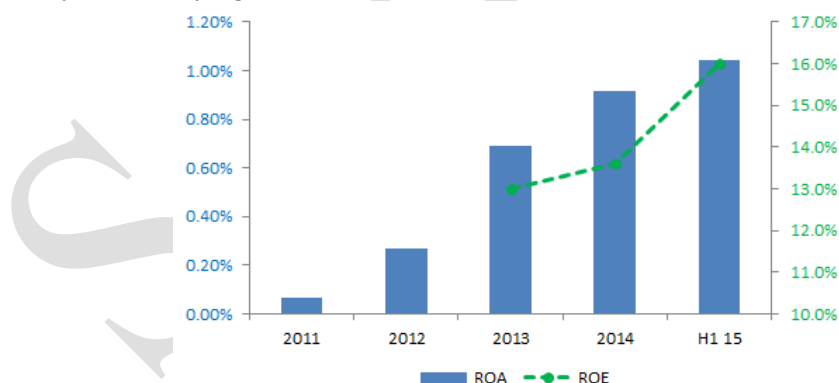
A great compounder – Oh, and a bank!

We have extolled the virtues of ‘Compounders’ for many years now. Those capital intensive businesses that generate good returns and whose management have the opportunity and nous to reinvest those returns back into the business at those same good returns. That great industrial companies such as Berkshire, Becton Dickinson, Ryanair, JD Wetherspoon + DaVita fit this mould is fairly obvious when you look closely. Yet, what very few seem to acknowledge is that, by definition, the best banks in the world are also potential compounders and regular readers will know we rate several US banks as such.

Much closer to home, today we highlight a surprise candidate: Lloyds. In summary:

- Lloyds Banking Group has a lot more capital at its disposal than UK investors realise.
- It has high quality of earnings due to its sticky deposit base.
- Its current ROA (1.05%) and ROE (16%) are noteworthy and impressive considering current low interest rates and demonstrate the company’s earning power.
- There is significant hidden value in deferred tax and other assets that build regulatory capital.
- Lloyds’ marginal returns (or excess free cash flow) in the next 5-10 years could be very high as little incremental capital needs to be retained.
- On 9x earnings, we suggest its shares are undervalued by Mr Market who fails to see the group’s compounding capabilities through the fog of past uncertainties.

Fig.1: Lloyds ‘underlying’ ROA/ROE since 2011



Source: Holland Advisors

“Banking Franchises” - not a common phrase this side of the Atlantic

For some years now we have favoured investing in many of the biggest names in US banking (Wells Fargo, JPMorgan, Bank of America, BoNY, Goldman Sachs). Our enthusiasm continues unabated on these US names given that they possess that rare combination of:

1. High quality, hard to replicate franchise assets and brands
2. Prudently funded, well established business models
3. Great management
4. Low valuations (PE’s 10-12x)

More recently we have been spending a significant amount of time closer to home on Lloyds Banking Group. Our conclusion, for those that like to keep things brief, is that our US banking enthusiasm and the reasons for it is mirrored in our analysis of Lloyds Banking Group's shares. We see particular analogies with Wells Fargo and outline our assessment and the attractions of Lloyds below (noting the risks also). We are aware of the legions of bank specialists penning daily missives and models with great complexity on each UK bank. As a result in areas where we feel there is already a wider understanding we are brief, but on the points we feel we have a different view from Mr Market we dwell a little deeper. We remind you that we are not sector specialists although much of the time, we find that this is to our distinct advantage.

"Everything should be made as simple as possible, but not simpler" – Einstein

Lloyds vs. Wells Fargo

Whilst we will not claim Lloyds is quite as high-quality a bank as Wells Fargo, having studied the latter in great detail we do note a not-insignificant number of similarities as outlined below.

1. Lloyds ROA (at c.1.1% in H1 2015) is still not as good as Wells (1.5%) but notably it is back nearer the levels it achieved in the 10 years to 2007.
2. Net interest margin (2.62% in H1) is holding up well in a low interest rate environment.
3. Lloyds has an enormous, sticky and low cost deposit funding base.
4. It has a simple deposit-funded business model and high market share.
5. It looks to be well managed by a team with a focus on returns and shareholder interests.
6. It has a history of cross selling to its sticky customer base.
7. It is already making an acceptable ROE (c.16%) again despite lower interest rates.

The last point is an important one as it means that like JPM, Wells Fargo (but unlike say BAC or many other banks globally), Lloyds does not need higher interest rates to make acceptable returns and compound well for shareholders. This level of ROE is arguably underpinned by the ROA it is now making being close to that of its history (c.1.1%). i.e. a solid return on equity is a function of a good business model ROA, not due to leverage.

It seems that the CEO also has Wells' impressive model in mind also.

"Lloyds should become the British version of Wells Fargo" – Antonio Horta-Osario (Dec 27, 2013)

Lloyds' political backdrop

Part of our motivation in turning to the best companies in the US banking sector was motivated by our assessment of where the US was in the economic cycle i.e. we made the conclusion that a severe trough had been passed and thus the outlook for many of the drivers of banking profitability were extremely good. By contrast, we had a little less certainty in the UK economic cycle largely due to housing valuations. These reservations remain given their lofty levels, however a few points must be considered objectively today:

1. Post the outright Tory majority in the May 2015 general election, the political risk to the UK banking sector is surely reduced (and possibly significantly so).
2. Equally, economic mismanagement risks that perhaps could have led to a collapse in Sterling (and correspondingly a spike in interest rates) are now reduced
3. Regulatory risk is arguably reducing also. We note with interest the sacking (for that is what it was) of Martin Wheatley as head of the FCA.

To view the remainder of this in-depth report, please contact Andrew Hollingworth, Andrew@hollandadvisors.co.uk for a complete PDF copy.

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