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Value Investor INSIGHT

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Underwriting Financials

While recent banking upheaval hasn't yet unearthed new pound-the-table buying opportunities for Causeway Capital's Conor Muldoon, that doesn't mean he's not finding considerable value in the sector, particularly outside the U.S.

INVESTOR INSIGHT

Conor Muldoon
Causeway Capital Management

Editor's Note: *Bargain-hunting investors often cite market "dislocation" as a reason stocks they would like to own can become attractively priced. The less discriminating investors seem to be, the more likely inefficiencies in individual cases can arise.*

Dislocation is a fair description of what's going on today in the banking sector, evidenced by high-profile failures and rescues as banks grapple with changed inflation and interest-rate environments. For insight into the recent upheaval, we asked Causeway Capital's Conor Muldoon to offer his perspective on the investment opportunities and risks it may present. A native of Ireland, Muldoon is a portfolio manager at $43 billion (assets) Causeway and heads the firm's research in the global financials sector. While opportunities exist, he says, he's finding them more prevalent outside the U.S. than in it.

Some investors avoid bank stocks because they find them inordinately driven by macroeconomic forces that are difficult to handicap. How do you think about that?

Conor Muldoon: It's hard to find any company that's not impacted by the economic environment, but it is definitely the case that banks tend to be even more impacted by things like the level of economic growth, interest rates and inflation. They're also affected heavily by regulation and changing political climates.

For all companies we drill down to try to understand the level of normalized earnings power. With banks we take the macro into consideration, but don't want top-down calls about interest rates or the economy to drive the investment case. It's typically much more about a bank's ability to clean up its balance sheet or adjust its cost base to improve its sustainable profitability and earnings power. Over our investment horizon we assume the macro environment will be more or less normal, so if we're right about the bottom-up drivers we can be right about the stocks.

We've spoken in the past [*VII*, July 31, 2022] about Italy's Unicredit [Milan: UCG], which we started investing in in early 2017. The company on our screens was trading very cheaply in terms of P/E and price to tangible book value. A new management team had arrived and was doing what we thought were all the right things, focused on finally cleaning up long-neglected bad loans still on the balance sheet, restoring the bank's capital position and bringing the cost structure in line with the revenue environment. That process wasn't going to happen overnight and was obscured at various points by negative interest rates, Covid and Russia's invasion of Ukraine. But the company continued to make significant strides on what was more in its control and the result, particularly as the interest-rate environment has normalized, has been very positive.

While we're talking about Europe, would you distinguish between the opportunities you see in banks there versus the U.S.?

CM: We generally consider European banks better positioned than those in the U.S. against rising rates and a more challenging credit environment. Their deposit bases appear more stable, as European depositors typically have fewer money-market fund alternatives than U.S. depositors. They tend to have stronger capital positions, which makes them better able to return capital to shareholders. We also like that their stocks are less expensive.

Unicredit, for example, is likely to return around €16 billion in capital through share buybacks and dividends in 2022, 2023 and 2024, for a company that a year ago had a total market value of €16 billion. The stock [now around €18.50] has gone up, but even today trades at 5x forward earnings and 60-65% of tangible book. For a bank with what we think is a sustainable return on tangible equity of well north of 10%, benign credit losses and extra capital to deploy for loan growth, that strikes us as extremely inexpensive.

How are you assessing the investment landscape for U.S. regional banks?

CM: What caught investors off guard was the long-held belief that banks should benefit from higher interest rates. But that

assumes depositors leave their money in place, which for someone with $10,000 in their checking account is a decent assumption. The incentive to shop for rates isn't very high. When that's the case, higher interest rates generally translate into increased net interest margins.

This turned out not to be the reality for banks like Silicon Valley Bank, Signature and First Republic. More money was on deposit so it wasn't a surprise that when rates went from 0% to 5% in 12 months that money would move. That became problematic when the banks at the same time were mismanaging their interest-rate risk, and when money can move at the speed with which it does these days. The good news is that there appears to be a limited number of banks with similar reliance on these high-net-worth or business deposits that make them susceptible to a run like we saw at the banks that failed.

What is not good news is that the stress to the financial system raises the probability of recession in the U.S. Many banks face higher funding costs and are highly leveraged to industries under duress like commercial real estate. We also expect many U.S. regional banks to over time face stricter regulatory liquidity and capital requirements. Our take from all of that is that while regional-bank stocks have traded down, that's reflecting shorter-term pressures and a lot of heavy lifting ahead to adjust to tougher regulatory requirements. If the benefits of lighter-touch regulation go away, it becomes more a scale game than ever. None of this is to say we won't find good ideas in U.S. regional banks over the next 12 months – and we should be prepared for that – but for the time being we're still quite cautious.

With the forced sale of Credit Suisse to UBS Group [UBS], Europe wasn't immune to the recent upheaval. Are you similarly reticent in investing around that deal?

CM: We had been monitoring UBS as a potential investment candidate for some time, attracted to its transition to a more asset-light business model, the strength of its wealth franchise, the strength of its position in Asia, and the potential for capital return to shareholders. We actually took a position in it a week before the Credit Suisse deal was announced.

Our initial thought is that UBS got a very good price and that the five-to-ten-year view is quite positive, but we haven't changed our position yet because of the execution risks over the next year or two. Integrating a bank of this size is complicated, from a systems standpoint and also with respect to the wealth-management business, where relationships are important and UBS is going to have to retain the CS advisors coming on board. We'd have to become more comfortable with the execution risks – and/or the stock price would have to become even more attractive – before adjusting our current stake.

Turning back to where you do see opportunity, describe why you're high on the investment prospects for London-based Barclays [London: BARC].

CM: Like Unicredit and other big European banks, Barclays has spent much of

INVESTMENT SNAPSHOT

Barclays
(London: BARC)

Business: U.K.-based "universal" bank, with prominent franchises in investment banking, commercial banking, wealth management, and consumer banking and payments.

Share Information
(@5/30/23, Exchange Rate: $1 = £0.81):

Price	**£1.56**
52-Week Range	£1.28 – £1.99
Dividend Yield	4.6%
Market Cap	£24.21 billion

Financials (TTM):

Revenue	£24.09 billion
Operating Profit Margin	35.3%
Net Profit Margin	26.3%

Valuation Metrics
(@5/30/23):

	BARC	S&P 500
P/E (TTM)	4.8	18.4
Forward P/E (Est.)	4.6	18.5

Largest Institutional Owners
(@3/31/23 or latest filing):

Company	% Owned
BlackRock	8.6%
Qatar Holding	5.1%
Vanguard Group	4.5%
Dodge & Cox	3.8%
Norges Bank Inv Mgmt	2.7%

Short Interest (as of 5/15/23):

Shares Short/Float	n/a

BARC PRICE HISTORY

THE BOTTOM LINE

After 10-plus years of restructuring, the company's balance sheet and capital position are repaired and its business mix should support strong, sustainable returns on equity, says Conor Muldoon. Trading at 4.6x forward earnings and 50% of tangible book value that isn't at all priced into the stock, he says, which just from re-rating he thinks could double.

Sources: Company reports, other publicly available information

the past 10-plus years restructuring. This included cleaning up its balance sheet and restoring its capital position, but also involved refining its business mix in an effort to enhance middling returns on capital. The end result of that is a commitment to three primary lines of business centered around a global investment bank, a U.K.-centric commercial bank, and a consumer-finance business focused on payments and credit cards mostly in Europe and the U.S. Returns on tangible equity have been above 10% for the past three years and in the first quarter hit 15%.

Banks are always exposed to the macroeconomic outlook, which is clearly weighing on the stock today trading at less than 5x earnings. Where the business in the short term is probably most exposed is in the U.S. credit-card business – where they mostly focus on co-brand partnerships with airlines like American and retailers like Gap – and in the U.K. bank. We're not overly concerned with the short-term outlook, but even there we think the diversification of the business will help mitigate the downside. The trading part of the investment bank, for example, is a strong franchise and does very well when markets are volatile and uncertain. In any event, a stock at 4.6x forward earnings isn't building in very high expectations.

Is capital return to shareholders important to your thesis here, as it is with Unicredit?

CM: Barclays' core equity tier one capital ratio is well within management's 13-14% target range, which is safely above required levels. Dividends this year should be 9-10 pence per share and we expect them to buy back as much as £3 billion worth of shares. The total payout from both dividends and buybacks should be well north of 10%.

How do you think about upside for the stock from today's £1.55 price?

CM: Investors are still treating this like it was 2012, capital was in short supply and the next economic downdraft would be devastating. We don't believe any of that is the case today, and as the results bear that out we would expect that rather than trading at a roughly 50% discount to tangible book value the shares should be worth closer to 100% of book. On today's tangible book of £3 per share that would almost double the share price. On top of that, we think book value should continue to more sustainably grow, and we have the benefit already discussed of capital return.

I mentioned this before, but we believe global investors broadly speaking are anchored in a different era when it comes to banks. U.S. banks today are much tighter to targets from a capital perspective, giving them less ability to return capital to shareholders if the economy weakens. That's not at all the case in Europe for the banks we're focused on. The general perception that big European banks are bad and big U.S. banks are good we don't think matches up with the current reality.

Leaving both Europe and the U.S., describe your interest in Brazil's Banco Bradesco [BBD].

CM: This is a newer position that got on our radar after a very tough 2022. The stock derated on the back of credit con-

INVESTMENT SNAPSHOT

Banco Bradesco
(NYSE ADR: BBD)

Business: Private financial holding company based in Brazil, offering a full range of retail banking, commercial banking, insurance and asset-management products and services.

Share Information (@5/30/23):

Price	**3.13**
52-Week Range	2.34 – 4.32
Dividend Yield	5.3%
Market Cap	$31.55 billion

Financials (TTM):

Revenue	BRL 79.54 billion
Operating Profit Margin	21.2%
Net Profit Margin	23.1%

Valuation Metrics
(@5/30/23):

	BBD	S&P 500
P/E (TTM)	9.4	18.4
Forward P/E (Est.)	8.1	18.5

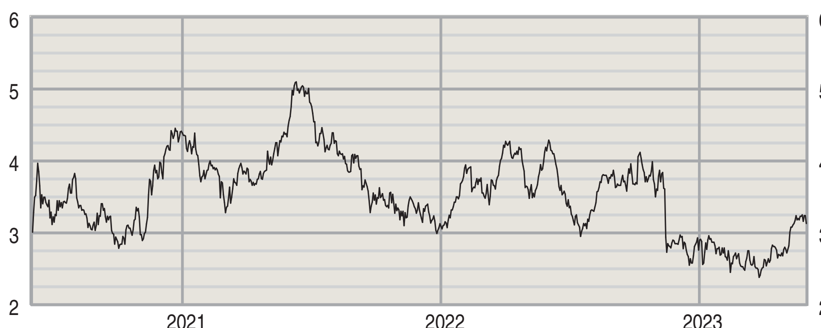
Largest Institutional Owners
(@3/31/23 or latest filing):

Company	% Owned
BlackRock	3.7%
Vanguard Group	2.6%
Norges Bank Inv Mgmt	1.2%
Wellington Mgmt	1.1%
Abrdn	0.9%

Short Interest (as of 5/15/23):

Shares Short/Float	1.2%

BBD PRICE HISTORY



THE BOTTOM LINE

The company is a good example of his general premise that "the time to buy a quality cyclical business is when profits are under pressure and the stock price is significantly down," says Conor Muldoon. As its business normalizes, he expects shareholders to benefit from a return to historical valuation and ROE levels and a 5%-plus dividend yield.

Sources: Company reports, other publicly available information

cerns in Brazil, influenced in good measure by the country's central bank earlier and more aggressively than most central banks increasing interest rates to control inflation. The market also wasn't thrilled with the prospect of Lula [Luiz Inácio Lula da Silva] regaining the presidency and shifting political control back to the left.

While the political environment hasn't yet proven as negative as feared, the sharp rise in interest rates – the central bank policy rate is now 13.75% – has negatively impacted Bradesco's results. Credit losses are up as inflation and high interest rates put increased stress on borrowers. Given how balance sheets are structured, assets in Brazilian banks tend to reprice more slowly than liabilities when interest rates go up, so net interest income has also been squeezed.

Our premise is that the time to buy a quality cyclical business is when profits are under pressure and the stock price is significantly down. Bradesco is one of the two well-run private banks in Brazil and has historically generated high-teens returns on tangible equity. We expect it to continue to take share across its product lines in a banking market that is still quite under-penetrated by developed-market standards. As it shifts more and more of its services online, there's considerable potential to take out cost and improve margins. We own the ADRs, and at the current price [of around $3.15] the market is recognizing none of that.

What changes that?

CM: We think it's as simple as the evolution of the cycle. Profits are depressed currently because of higher credit costs and lower net interest income, both of which we see reversing as we get into 2024 and 2025. As that happens, we would expect a return to at least historical returns on tangible equity and for the stock to re-rate from the current 1x tangible book value to more in line with the historical level of above 1.5x. In the meantime, book value continues to grow and we're collecting a 5%-plus dividend yield.

How are you handicapping political risk?

CM: That is always going to be an issue in Brazil and is an important element in our due diligence. I'd say we are wary of the extent of the ongoing shift to the left as Lula remains in power, but the good news is that the central bank has not been influenced by changing political winds and has so far managed through the volatile economic situation in a way that has significantly cooled inflation and kept the currency relatively stable. All of this we constantly monitor – for now we believe we'll be more than compensated for the political risk attached to owning Bradesco.

In addition to following financials globally for Causeway, you also lead the research effort around materials-related stocks. How would you summarize the investment opportunity there relative to financials?

CM: There are certainly pockets of opportunity in materials, but the issue is that we're coming off a period of very high commodity prices and the normalization of that over the short to medium term is likely to weigh on the profitability of many of these businesses. You can believe that normalized prices will be higher than is conventionally thought and still have a tempered outlook for near-term shareholder returns.

I would say generally that we're more excited today by financials. We're quite confident that the banking system is underappreciated by investors for the sustainability of returns on capital as well as the consequent capital returns to shareholders. At the valuations at which many banks trade, if we're right about that the upside should be extremely attractive. VII

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