

Stock Market Review



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HSBC to continue returning maximum capital to shareholders

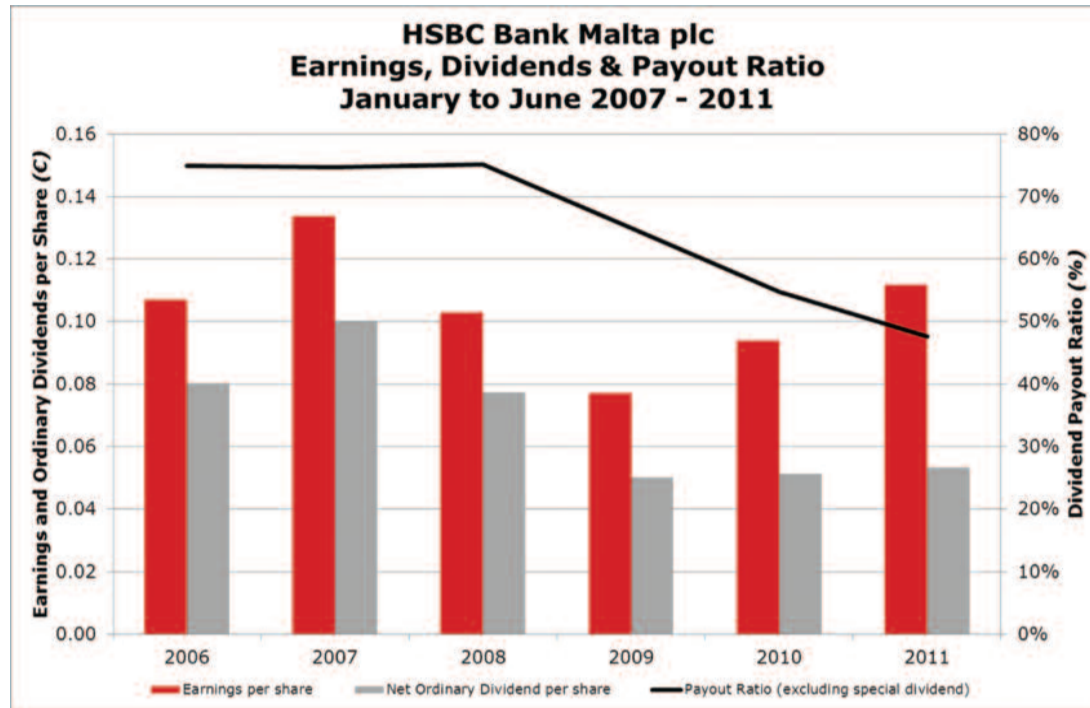
The interim financial statements published by HSBC Bank Malta plc last Friday afternoon continue to prove the resilience of the local banking group despite the present challenging market conditions. The pre-tax profit of €50.4 million is the highest in four years; the annualised return on average equity improved to 19.3 per cent and the cost to income ratio showed further progress with a decline to 43.9 per cent.

Initially, shareholders may be disappointed that the increase in interim dividends (+3.8 per cent) was lower than the 19.3 per cent growth in profitability. The half-year results were positively impacted by a change in methodology used by the life insurance subsidiary which is a one-off non-cash item of €6.9 million. In fact, excluding this one-time uplift to profitability, HSBC's payout ratio was maintained at the 55 per cent level. HSBC Malta's CEO Alan Richards maintained the bank's policy of seeking to return the maximum amount of capital to shareholders in the form of dividend payments.

Despite the pressures being made by regulators for increased capital retention in view of more stringent regulations, Mr Richards explained that HSBC Malta should maintain adequate levels of capital through profit retention in the coming years. Naturally, this is all dependent on an assumed level of growth in the balance sheet. While a higher growth in deposits and loans than that envisaged will require increased capital, a subdued increase in the balance sheet figures could well mean a higher payout ratio in future years.

HSBC's policy of returning capital to shareholders is also widely practiced by its subsidiary companies. During the first half of 2011, HSBC Malta received a sharp increase in dividend income of €15.4 million mainly as a result of a maiden dividend from its fully-owned subsidiary HSBC Life Assurance (Malta) Ltd as this was deemed to be in excess of present requirements.

The financial performance of HSBC Malta during the first half of 2011 was impacted by two major items. On the one hand, a change in the methodology used by the life insurance subsidiary reflecting overall group policy, helped HSBC Life register a significant increase in profitability during the first half of the year. This contributed €6.9 million to overall group profit which may be regarded as a one-off non-cash item.



Meanwhile, HSBC Malta absorbed a net loss of €3.7 million on the sale of a number of corporate bonds exposed to the higher risk eurozone periphery countries. Although movements in HSBC's portfolio (which is termed as 'held to maturity') are normally reflected in the balance sheet rather than in the income statement (as opposed to BoV), the actual loss incurred on the sale of these bonds is shown in the income statement and this dented the profitability by €3.7 million. HSBC Malta disposed of its positions in a number of bonds to eliminate its exposure to the 'higher risk' eurozone countries. HSBC's held-to-maturity portfolio of just over €950 million is now mostly composed of 'AAA'-rated instruments and substantial holdings of Malta Government Stocks.

The heightened volatility in the eurozone bond markets due to the ongoing developments in Greece and other eurozone periphery countries also hit HSBC's performance by a further €2.4 million. This reflects some sovereign paper in the Life portfolio and these changes are directly reflected as impairments in the income statement. In fact, excluding this movement from the overall impairment provision of €4.2 million gives a total impairment of €1.8 million from the loan book. This is only marginally higher than the charge taken in the first half of last year. An overall impairment charge of €1.8 million may be surprisingly low given current economic circumstances and when compared to the level of €10 million recognised by BoV during the first half of their financial year to 31 March 2011.

Mr Richards explained that although certain sectors of the economy are showing signs of weakness, this shows up in the higher level of 'non-performing loans' as opposed to actual impairments. HSBC's CEO indicated that due to the high level of security pertaining to HSBC on its loan book, an increased level of 'non-performing loans' does not automatically translate into higher impairments.

HSBC's CEO indicated that the overall level of impairments of just 0.11 per cent of the total loan book is extremely low by international standards and reflects the high level of collateral given to the bank. HSBC reported a record level of net interest income (+5.7 per cent to €64.2 million) with net fee and commission income maintaining last year's record of €16.9 million. The bank noted that fees on account services and new loans (new loans totalled €355 million during the first half of 2011) offset the reduction in income from the lower level of activity in the local capital market.

During the first half of 2011, deposits at HSBC dropped by €181.6 million (4.1 per cent) to €4,300 million while net loans eased by €7.9 million to €3,300 million. A ratio widely used in the banking sector is the level of loans to deposits which at HSBC Malta stood at 77 per cent at June 30, 2011. HSBC Malta's loan to deposit ratio is below the HSBC international policy of 90 per cent and reflects further lending capability of the Bank with their current deposit base. According to CEO Alan Richards, the decline in

deposits registered by HSBC reflects the volatile nature of institutional deposits rather than a trend evident by retail deposits.

HSBC Malta is attracting a higher number of institutional clients (namely international fund managers) and movements in the flow of funds - which is normal with such clients - leads to volatility in the deposit base. As an increased number of institutional clients relocate to Malta, the volatility in the deposits of the two major local banks is likely to become increasingly evident. More importantly, however, is the overall level of retail deposits and it is a good sign that HSBC maintained a high market share of such deposits despite the aggressive competition from the smaller and younger banks who are seeking to penetrate the market through offers of substantially higher rates of interest. Since June 2010, HSBC Malta recorded a rise of €56 million in retail deposits.

The decision by HSBC Malta to eliminate any direct exposures to the eurozone periphery countries from its bond portfolio seems to be a wise one given the increased risk of contagion evident across the eurozone. In recent days, there has been increased speculation that Cyprus will become the fourth country requiring direct financial assistance from the EU and possibly also the IMF in the form of a bailout. As such, the positioning of HSBC's bond portfolio to maintain a very large exposure of highly rated instruments and Malta Government Stocks reduces the risk of further potential losses for HSBC Malta shareholders.

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