Stock Market Review

HSBC Malta dividends decline

■ Affected by lower profits and new MFSA directive

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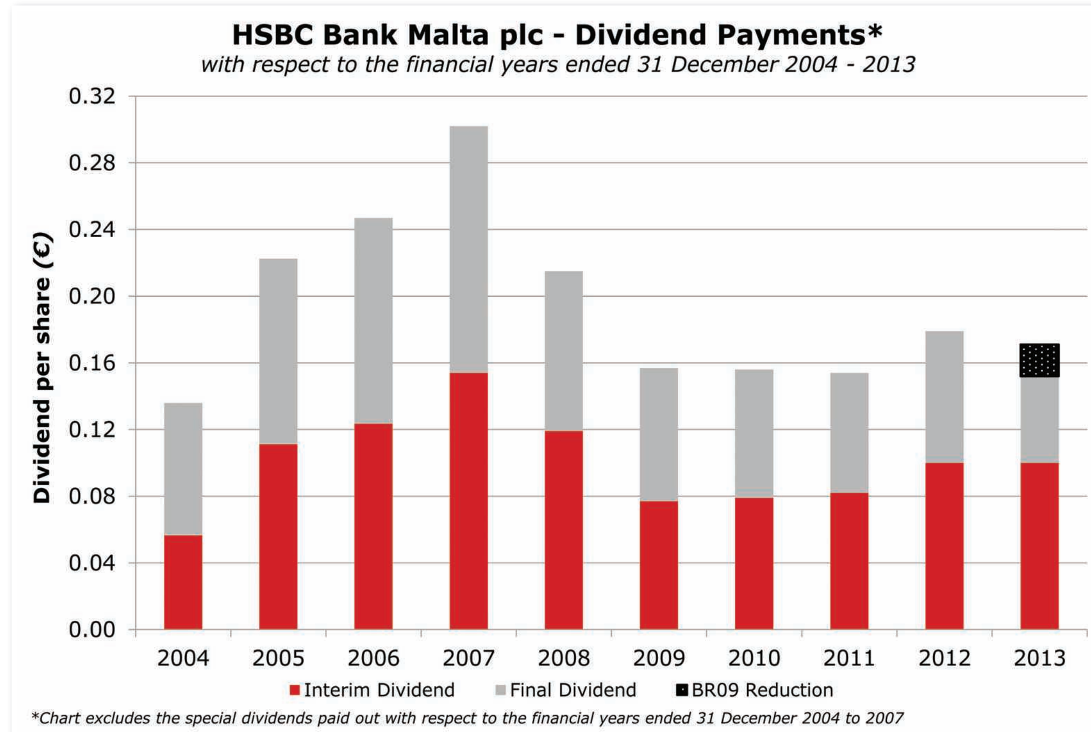

On Monday morning, HSBC Bank Malta plc kicked off the reporting season for those companies with a financial year to December 31, 2013.

HSBC Bank Malta plc published its annual financial statements just before the start of Monday's trading session concurrently with the publication by HSBC Holdings plc also of their 2013 financials on the London Stock Exchange.

The HSBC Malta Group reported a 5.1 per cent drop in pretax profits to €90.5 million largely due to the continued pressure on net interest income as well as lower investment returns from the life assurance subsidiary. This result should not have been a major surprise for the market given the flat performance during the first half of the financial year and the Interim Directors' Statement published on November 18, 2013, in which HSBC explained that since the half-year ended on June 30, 2013, it experienced a modest decline in pre-tax profits. In fact, the performance during the second half of the year was actually slightly weaker mainly due to lower gains on sale of investments of €0.7 million compared to €3.6 million in the first six months. Moreover, net fee and commission income during the second half of the year was also lower compared to the first six months.

The real surprise was probably the extent of the decline in the final dividend being recommended to shareholders at the upcoming Annual General Meeting scheduled for April 16. Last Monday, the board of directors of HSBC Malta recommended the payment of a final gross dividend of €0.052 per share (€0.034 net of tax), representing a decline of 34.2 per cent from last year's final dividend of €0.079 per share. Given the unchanged gross interim dividend of €0.052 per share, the total dividend in respect of the 2013 financial year is 15.1 per cent below the previous year's distribution.

At the press conference convened on Monday afternoon, HSBC Malta's CEO Mark Watkinson gave a very clear explanation of the background behind the dividend recommendation. He confirmed that the dividend payout ratio was maintained at 55 per cent. However, the CEO added that on December 31, 2013, the Malta Financial Services Authority's revised Banking Rule 09 (BR09) came into effect. The ultimate aim of this new rule is to increase the level of bank reserves partly to address the recommendation made by the European Commission for Maltese banks to improve their coverage ratios and increase provisioning of non-performing loans. BR09 now requires local banks to hold an amount of capital equivalent to 2.5 per cent of non-performing loans less impairments and interest in suspense.

However, the reserve must rise to five per cent for those non-performing loans with capital and/or interest which are past due by more than 24 months. The rule stipulates that this "reserve for general banking risks" has to be funded from planned dividend distributions and this can be built up over a three-year period.

> **The required reserve in each financial year is then also split up equally divided between the interim dividend and the final dividend**

The CEO explained that HSBC Malta currently estimates that their new reserve requirement amounts to €10 million. In line with the MFSA Directive, HSBC set aside 40 per cent of the currently estimated reserve, i.e. €4 million, from the final dividend recommendation in respect of the 2013 financial year.

As such, Mr Watkinson claimed that had BR09 not come into force, HSBC's final dividend would have amounted to €0.071 per share, compared to €0.079 in respect of the previous year. This decline would have mainly reflected the lower level of profits during 2013. However, the CEO added that when one takes account of the €4 million requirement in respect of BR09, the final dividend had to be reduced to €0.052 per share.

This is the lowest dividend distribution in the last nine years as shown in the graph. As a result of the decline in dividends, the yield on HSBC Malta shares decreased to below six per cent compared to a level of seven per cent based on the 2012 distribution.

Further allocations to the "reserve for general banking risks" are required to be taken from dividend distributions for the current financial year to December 31, 2014 and the next financial year to December 31, 2015. In fact, HSBC's CEO indicated that the remaining reserves currently estimated at €6 million are expected to be set aside "in two equal instalments over the next two years" as stipulated by BR09. Moreover, one expects that the required reserve in each financial year is then also split up equally between the interim dividend and the final dividend.

Mr Watkinson also indicated that following the introduction of BR09, the MFSA also indicated that any dividend recommendation also needs to be finally approved by the regulator. It is clear that as a result of such stringent regulation, local banks will be forced to distribute lower levels of dividends to shareholders at least over the next two years unless, although highly unlikely, profitability growth exceeds the required allocation to the new reserves.

It is disappointing that the joint MFSA/Central Bank financial stability board entrusted with the consultation process of BR09 as well as the local banks did not feel the need to communicate this new rule to the market as soon as it came into force. In my view, locally listed banks impacted by this regulation should have actively considered the publication of a specific company announcement to inform the market accordingly.

Last Monday's announcement by HSBC Malta also included the recommendation for the distribution of bonus shares following approval at the upcoming AGM. An amount of €10 million in reserves will be capitalised to fund the distribution of one new share for every nine shares held until April 24. This will increase the total issued share capital from 291,840,000 shares to 324,271,380 shares with effect from April 29.

The performance of the HSBC Malta Group should not only be analysed on the basis of some headline figures in isolation but also by reviewing some key financial indicators and comparing these to their peers.

The cost-to-income ratio deteriorated slightly to 49.9 per cent as income declined by more than total costs. This is still well above the more attractive ratio of Bank of Valletta plc at below 40 per cent. HSBC's return on equity also declined in 2013 reflecting the lower profitability and higher level of shareholders' funds. The after-tax return on average equity dropped from 16.1 per cent in 2012 to 14.3 per cent during 2013 (equivalent to BOV). While a double-digit return is still very positive given the very challenging conditions with low interest rate levels and weak loan growth, the ROE's in recent years are significantly below the very attractive returns of well above 20 per cent that were easily achieved by HSBC before 2009.

During the press conference the CEO also touched upon the bank's strategy going forward and the outlook for 2014. Mr Watkinson claimed that there is still an "enormous level of uncertainty across the eurozone" with high level of unemployment in various countries and weak economic growth. In view of this backdrop, the CEO expects the euro interest rate environment to remain challenging for banks as some members of the European Central Bank recently also discussed reducing interest rates to 0.1 per cent in view of the continued deflation risks. Moreover, Mr Watkinson referred to the regulatory perspective which will remain tough for the entire banking industry.

In the circumstances, the CEO explained that HSBC Malta is seeking profitability growth through the positioning of the bank around Malta's international strategy. Mr Watkinson claims that this strategy offers better opportunities for growth. The CEO made reference to the €50 million Malta Trade for Growth Fund which was recently launched and was very well received with almost 70 per cent of the fund already committed in less than three months. Meanwhile, HSBC continued to experience steady growth for mortgages and the CEO confirmed that there are indications of an increase in loan demand although this will not filter through the financial statements in the near term given the long lead time on certain projects.

The challenging environment being faced by the banking industry is one of the main factors that must be taken into account by those investors who accumulated bank shares over several years and have large exposures to such securities.

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