

## Alpha shares analysis

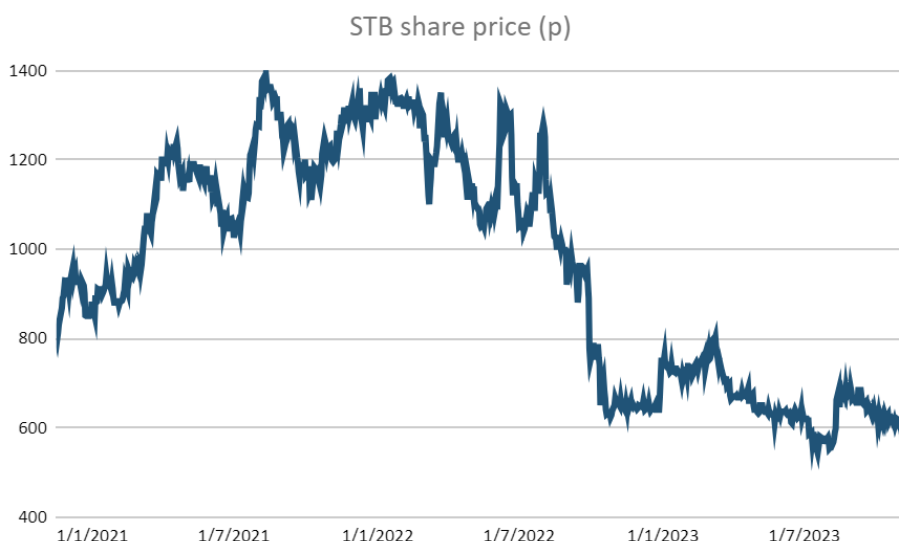
17 November 2023

### How to judge if a high-risk investment is worth it

*This week we look at very cheap bank stock which, judging by some metrics, looks to show some signs of promise. However, it's important to take in the whole picture when assessing whether a risky deep value play may come good. We also ask if a US logistics company can improve its profitability and gain market share.*

Analyst: Phil Oakley

#### Secure Trust Bank (STB)



Source: LSEG

The basics of making money from banking is fairly simple: Lend money at a higher interest than you borrow it; take care about who you lend money to and keep your running costs under control. In theory, if a bank gets these basics right then it can make decent profits for its investors.

In practice, lending money is more complicated – particularly when economic conditions get tougher.

When this happens, the risk that some of your borrowers won't be able to pay you back increases. If borrowers default on their interest and loan repayments, it can blow a big hole in a lender's profits and can even put them out of business if the losses wipe out the equity in the company.

Banks are essentially leveraged plays on the health of an economy. Their business models are based on huge amounts of borrowed money (usually deposits from savers but also loans as well) which means the returns that they generate and the risks taken on in the process need to be understood.

In very simple terms, many banks are financed like a house with a very big mortgage. What this means in practice is that their borrowings are very high compared to their assets. This leaves very little equity – the difference between the asset value and borrowings – to soak up any falls in asset values.

If you were to buy a property for £100,000 with a 95 per cent mortgage (£95,000), you would have £5,000 of equity. Your assets to equity ratio would be 20 – £20 of assets is supported by £1 of equity.

If your asset value appreciates by 5 per cent to £105,000 the £5,000 gain represents a 100 per cent return on your equity.

This looks like a fantastic return and it is. However, it has been due to the massive financial gearing taken on. The 5 per cent return on assets has been magnified by the 20 times gearing (asset/equity).

Gearing can work both ways. A fall in the value of our property by 5 per cent or £5,000 would wipe out the equity. In other words, the investment returns are delivered by taking on a lot of financial risk.

This sums up the risks taken by investors in many banks and lenders.

## Bank Gearing

Lender	Assets/Equity	Equity/Assets
Secure Trust Bank	10.66	9.4%
NatWest Group	22.74	4.4%
Lloyds Banking Group	19.85	5.0%
Barclays	28.19	3.5%
HSBC Holdings	16.53	6.0%

Source: FactSet/Investors' Chronicle

If you turn the assets to equity ratio around and look at equity to assets, it tells you how much a company's asset value can fall before its equity is wiped out.

For banks, the answer to this question is not very much. This was highlighted in the global financial crisis when bad loans piled up and many banks had to be rescued by taxpayers pumping money into them.

To put this into context, a high quality non-financial company such as **Spirax-Sarco (SPX)** has an assets to equity ratio of 2.4 times – its asset value can fall by more than 41 per cent before its equity disappears.

The high gearing and high risks that come with it explain why the stock market rarely puts a high valuation – such as a PE multiple – on banking shares. History suggests that this is sensible.

### Why Secure Trust Bank shares are so cheap

With this very basic analytical framework, it is possible to understand why the shares of specialist lender **Secure Trust Bank (STB)** are valued so cheaply by the stock market.

At its current share price of 654p, it trades on a one year forecast PE ratio of just 3.1 times and at a very big discount to its latest tangible net asset value per share of 1,746p.

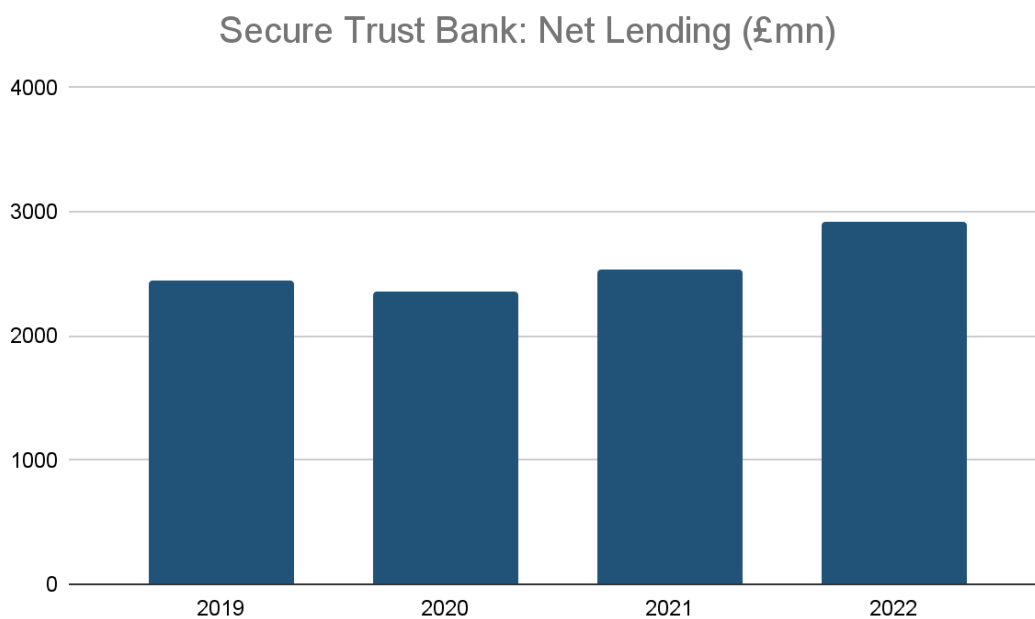
These are the kind of valuations that have deep value and contrarian investors salivating. However, whilst the stock market can harshly treat companies it doesn't like, a very cheap valuation is often a sign that there is a lot to worry about with a company.

If you read Secure Trust's medium term financial targets then you will be forgiven for thinking that its shares are a screaming buy.

They are:

- A 14-16 per cent return on average equity
- CET1 ratio - a measure of its financial strength – of more than 12 per cent. This compares with its current regulatory requirement of 8.6 per cent.
- A net interest margin of more than 5.5 per cent.
- A cost to income ratio of 44-46 per cent.
- Growth in its net lending to at least £4bn.

A financial performance with these characteristics would likely see a much higher valuation attached to the shares and trade at a reasonable premium to their net asset value.



Source: Company

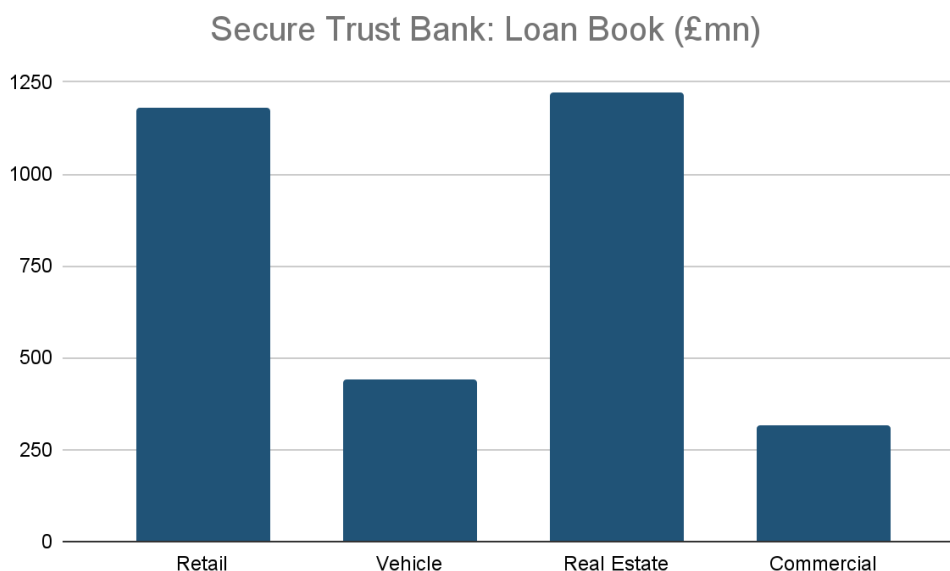
It is just about meeting its net interest margin target and is exceeding its CET1 ratio target. The business is growing its loan book towards its £4bn target but on its other measures it is falling well short.

Why?

### **Risky lending leads to lots of bad loans**

Secure Trust is a specialist lender. It focuses on four key markets:

- Retail Finance – this is largely interest free credit finance provided to furniture retailers, jewellery stores, home improvement and electrical retailers and even Arsenal and Tottenham Hotspur season tickets. It also offers interest bearing loans. This business trades under the V12 Retail brand.
- Vehicle Finance – also using the V12 brand to provide loans for second hand cars.
- Real Estate Finance – loans for property developers and financial landlords
- Commercial Finance – secured working capital loans for small and medium sized businesses.



Source: Company

The Retail business has been the main area of focus in recent years and has grown rapidly. Over the last couple of years V12's market share has increased from just over 8 per cent to 13.2 per cent as the company has thrown money at it. It accounted for 37 per cent of the bank's lending during the first half of 2023.

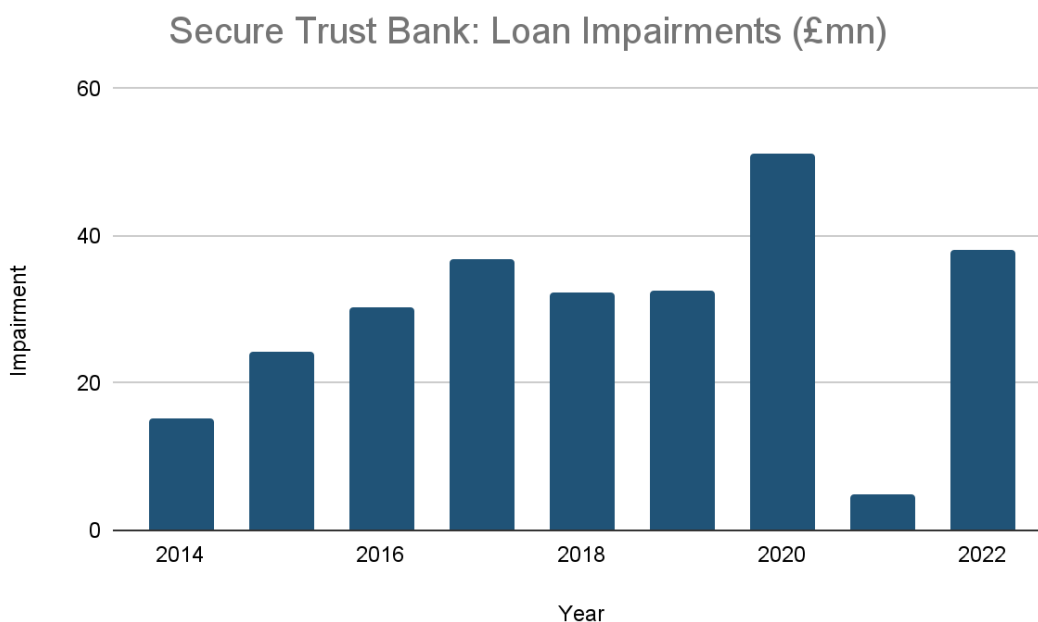
Interest free credit accounts for around 85 per cent of the business, which the company reckons has a lower risk profile and better credit quality than retail loans.

The net interest margins on offer in this market are over 7 per cent and a lot higher than achievable on secured loans made by high street banks. Vehicle loans also have chunky margins whilst those achievable in real estate and commercial loans are lower as they tend to be secured against assets.

By lending more money into interest free credit, Secure Trust is hoping to drive up its net interest margin by moving to this higher margin business.

This is not a free lunch though. High margins are on offer because the lending comes with a higher risk of default.

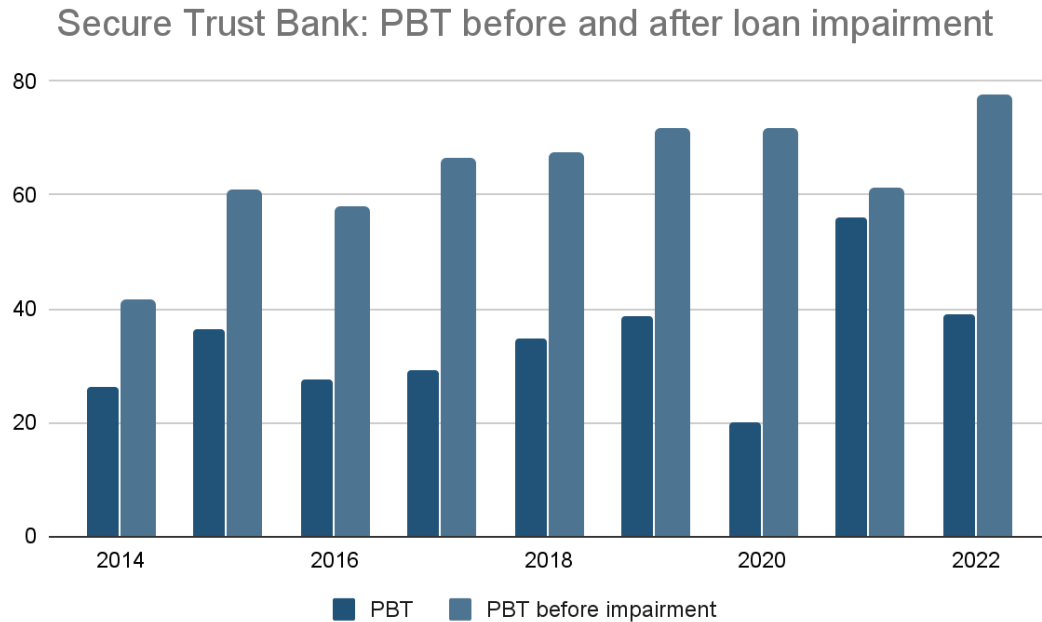
One of the recurring themes across Secure Trust's business over the years is that it racks up a lot of loan losses which blow big holes in its profits.



Source: Company

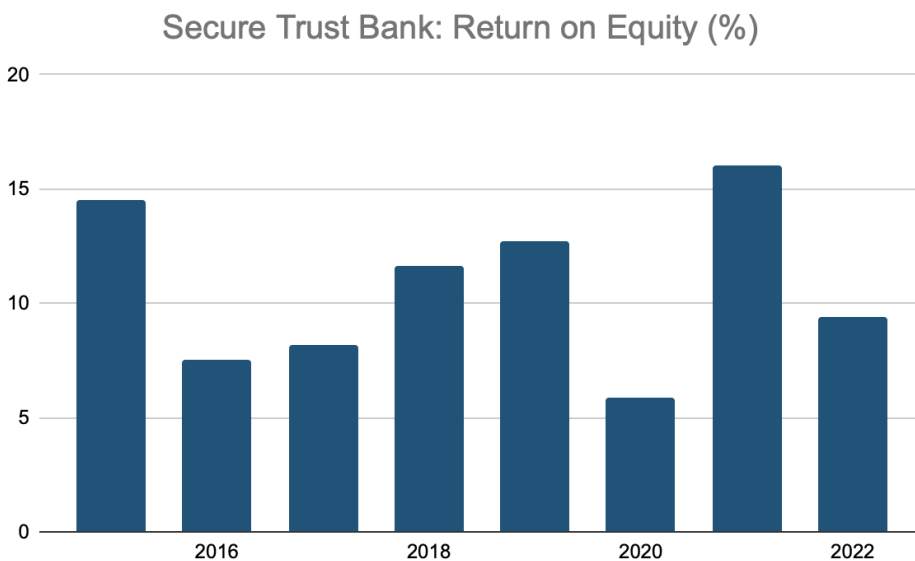
In many years, the size of loan impairments has been big and substantially reduced pre-tax profits. Without them, the progression of the business would look quite respectable.

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Source: Company/Investors' Chronicle

However, the consistency and size of these losses is what is largely responsible for Secure Trust Bank failing to earn respectable returns on equity (ROE) for any prolonged period of time.



Source: FactSet

The company's management is asking investors to believe that the future will be different. Costs will be slashed from around 56-57 per cent of income currently to 44-46 per cent in the future, so the bank can cope with losses better.

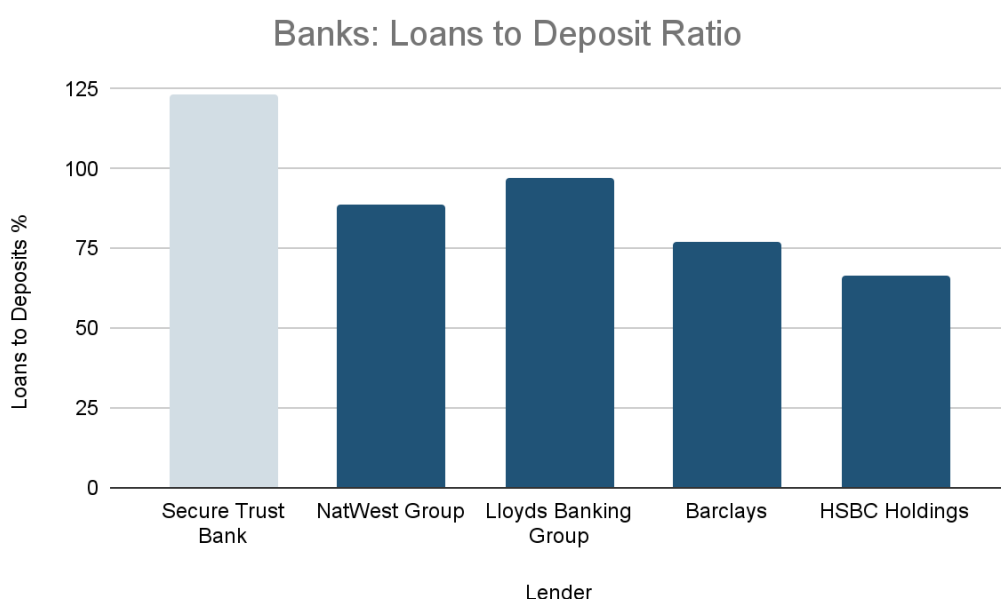
If this can be done then all is well and good, but looking at the fragile state of UK household finances, the property market and the economy in general, it's hard to believe that the days of big loan impairments are over as was seen with another sizeable charge in the first half of the financial year.

Furniture, electrical and household store chains have used interest free credit to drive sales for years. It's great for their cash flow, and even though they have to give away margin to the credit provider, it removes any bad loan risk from them.

That said, a sluggish economy and housing market is not a good backdrop to grow credit in this market and there is always a slight worry that Secure Trust's rapid growth in this area in recent years may have come with additional risk.

## Rising cost of finance highlights the business risk

Whilst it is no surprise that higher interest rates in general are driving up funding costs for lenders, the cost that Secure Trust Bank is having to pay to access additional finance has been eye-wateringly high.



Source:FactSet

A prudent way for a bank to finance its loans is with its deposits. During the financial crisis, banks such as Northern Rock got into trouble by having much larger loans than deposits which meant it had to rely on expensive wholesale finance to make them. When these loans were called in, the bank was left high and dry.

Secure Trust isn't in the same category of leverage as Northern Rock was but has a very high loan to deposit ratio and finances nearly £500mn of its loan portfolio with sources of funding other than deposits. This includes circa. £390mn from the Bank of England's Term Funding Scheme (TSFME).

This, along with some pressure on its key solvency ratio has seen it having to pay very high interest rates to borrow.

Earlier in the year, the company issued a £90mn 2033 callable bond with interest rates of 13 per cent and used some of the proceeds to buy back £25mn of its 6.75 per cent 2028 bond.

The fact that it had to pay 13 per cent to raise money – which is heavily into junk bond territory – is a red flag for equity investors as it says that lenders view the company as a very risky proposition. The current price of the bond of £99.50 is below its par value of £100 and shows that the bond market has not changed its view.

It is also worth noting that the company has £390mn of term loans that need refinancing in 2025. What price will it have to pay and what will this do to its net interest margin?

The margin is already coming down because of higher interest costs, despite an increase in the interest rates on its loans (which in itself could be a sign of more risky lending).

### Secure Trust Bank: Net Interest Margin (%)

	H1 21	FY 21	H1 22	FY22	H1 23
Gross yield	7.4	7.3	7.1	7.5	9.3
Cost of Funds	1.4	1.2	1.4	1.9	3.9
NIM	6.0	6.1	5.7	5.6	5.4

Source: Company

### A lot of bad news looks priced in but the shares look only a buy for the very brave

The whole of the UK banking sector is lowly valued right now. PE multiples are low and the discounts to book values are very big.

## Secure Trust Bank vs Big UK Lenders

Name	CET1 FY1 (%)	NIM FY1 (%)	ROE (%)	P/E NTM (x)	P/BV (x)	Efficiency Ratio (%)
Secure Trust Bank	12.7%	5.49%	9.0%	3.17x	0.37x	56.9%
NatWest Group	13.4%	2.98%	14.8%	4.84x	0.55x	55.2%
Lloyds Banking Group	14.3%	3.03%	12.1%	5.71x	0.59x	51.1%
Barclays	13.8%	3.10%	9.8%	4.23x	0.37x	63.0%
HSBC Holdings	14.5%	3.88%	14.4%	5.81x	0.78x	49.3%
Average	13.7%	3.69%	12.0%	4.75x	0.53x	55.1%
Median	13.8%	3.10%	12.1%	4.84x	0.55x	55.2%

Source: FactSet

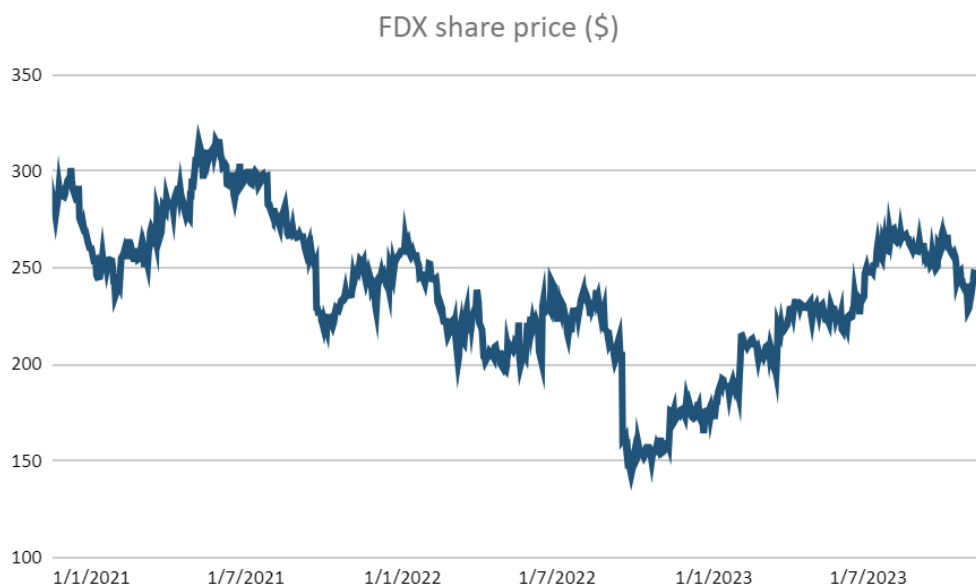
Despite having the highest net interest margin and a similar cost to income ratio to many of the big lenders, Secure Bank Trust has the lowest forecast ROE.

Its lending profile and financing position also arguably makes it more risky than any of the big UK lenders.

If the company sorts itself by becoming more efficient and de-risking its business – reducing bad loan charges – then investors could make a lot of money from the current share price. Whether they would sleep well at night owning the shares is another matter.

Continued below

## Fedex Corp



Source: LSEG

**Fedex (US:FDX)** has one of the most recognisable brand names when it comes to the global transportation of parcels and freight.

The company has three major revenue streams and is dominated by its Fedex Express division which has been in business since 1973.

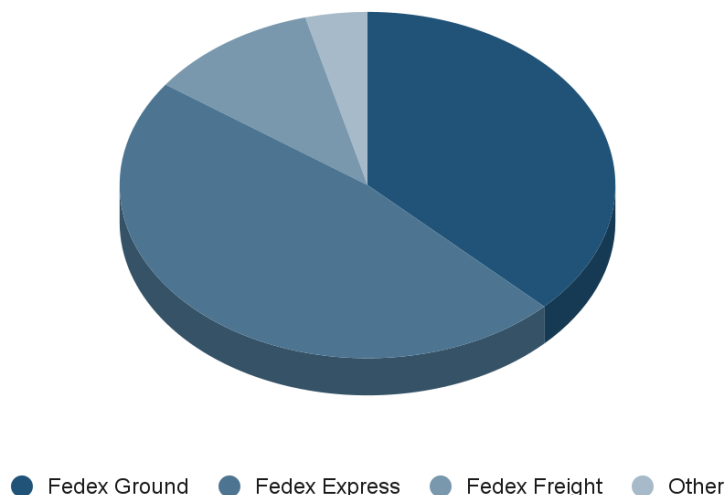
Express provides a worldwide delivery service of products to over 220 countries. Despite fierce competition, it remains the world leader for providing fast, reliable and time definite delivery of packages. This is done with a door-to-door customs-cleared service.

Customers can choose from a range of different delivery services ranging from overnight, same day or deferred freight across North America. International deliveries take between two and five days depending on location. Delivery fees are based on criteria such as weight, service chosen, the end destination and fuel surcharges.

The Ground division is Fedex's biggest source of profits and specialises in business and residential package deliveries in North America up to a maximum weight of 150 pounds (68 kilograms).

The Freight Business is based in North America and deals with part truckload (known as less than a truckload) freight packages.

## Fedex Corp: Revenue by Business FY23



Source: Company

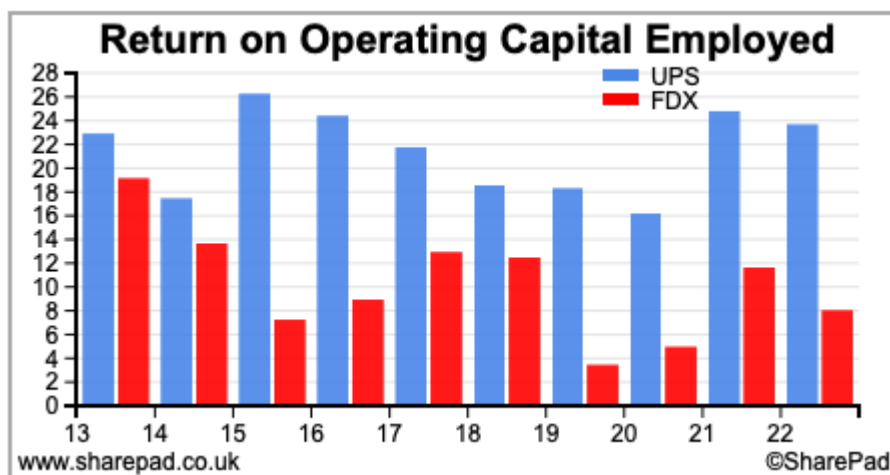
Arguably Fedex's greatest strength is the scale of its network which consists of over 70,000 drop off locations, 700 aircraft, 82,000 vehicles and 245,000 employees.

The business has a series of regional hubs across continents which end up in city delivery networks before reaching the end customer. This is not something that a new entrant could quickly build up and to do so would cost a great deal of money.

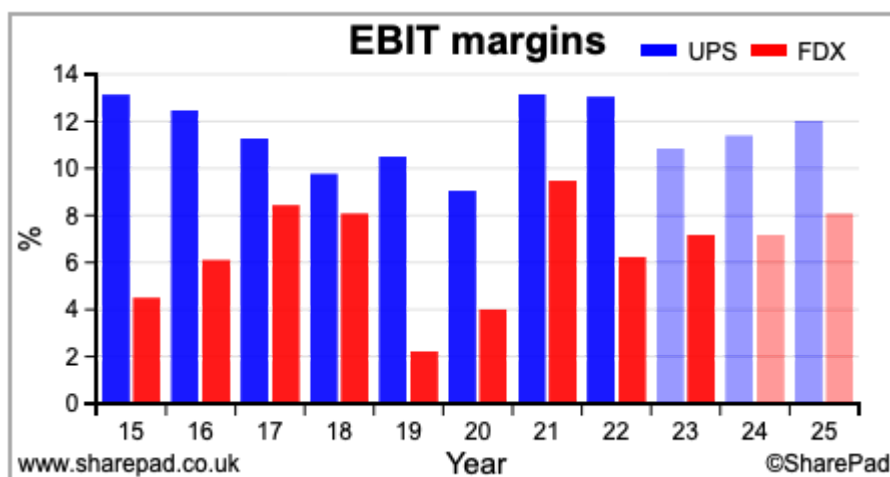
### Poor levels of profitability

Scale is a big advantage in this industry but making good money for investors is not easy. The business is highly correlated with the ups and downs of the economy and the network needs to be kept busy and well utilised to earn its keep.

In terms of profitability, Fedex has lived in the shadow of its biggest rival, United Parcel Service (UPS) in recent years. However, there are encouraging signs that Fedex is closing the gap.



UPS is making very decent returns on operating capital employed (ROOCE), but that can't be said for Fedex. Management's bonuses are linked to return on capital and so they are highly incentivized to drive it up.



Fedex's margins also lag UPS's but there have been improvements during the last year. However, Fedex continues to be held back on the margin front by the wafer thin margins of its Express business which were running at just two percent in the first quarter of its 2023/24 financial year.

### Cost savings and Efficiency plans are very ambitious

Fedex knows it is underperforming and has some big plans to make more money. These are based around two big projects:

1. DRIVE - this is a cost saving plan to take \$4bn of costs out of the business. It will be achieved by a number of initiatives such as increased digitalisation, cutting

third party delivery rates, more efficient rail usage, reduced Sunday coverage, closing freight terminals and optimising flight schedules

2. Fedex Network 2.0 – DRIVE is expected to enable the merging of Fedex’s Express, Ground and Freight businesses into one consolidated company with the aim of bringing in another £2bn of extra operating profit by 2027.

These are massive projects and if realised in full with almost double Fedex’s operating profits from the \$6.6bn made in the year to September 2023.

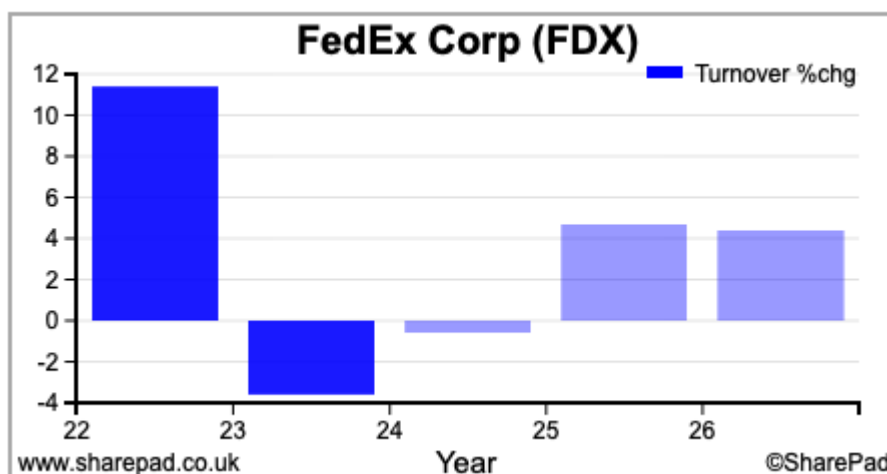
The potential has generated plenty of excitement amongst investors and has pushed Fedex shares up by over 50 per cent so far in 2023.

## The need to improve revenue growth

The potential for cost savings is bullish for the shares, but the company arguably needs to prove that it can grow by increasing revenues in a sustainable way.

This will not be easy in a US parcel market which isn’t showing much growth at the moment. The boost that came from companies restocking after Covid has come and gone whilst the world economy is not expected to drive growth higher in the short-term.

Fedex’s Ground business has been a source of optimism in recent months and has grown revenues and improved margins. It has benefitted from the bankruptcy of Yellow – a less than a truckload operator – and has picked up customers from UPS where the threat of strike action earlier this year saw customers come across to Fedex.



Fedex sees the small and medium sized business market as an area where it is under represented and can grow.

Another sizable opportunity comes from the huge amounts of data that Fedex generates from its network. The company intends to use this not only to make its services more efficient but to offer more value added supply chain services to its customers.

Fedex is also continuing to improve its service quality so that it can go after higher quality and higher margin revenue streams.

For example, it is now offering a four hour estimated delivery window to 96 per cent of global inbound routes into 48 centres. Picture proof of delivery (PPOD) which reduces disputes is now in 53 markets.

However, there are still risks that the company has to overcome.

Fedex has a long standing relationship with the United States Postal Service (USPS) which is the biggest customer of Fedex Express in the US. It has a contract for the airport to airport transportation of US first class and priority mail.

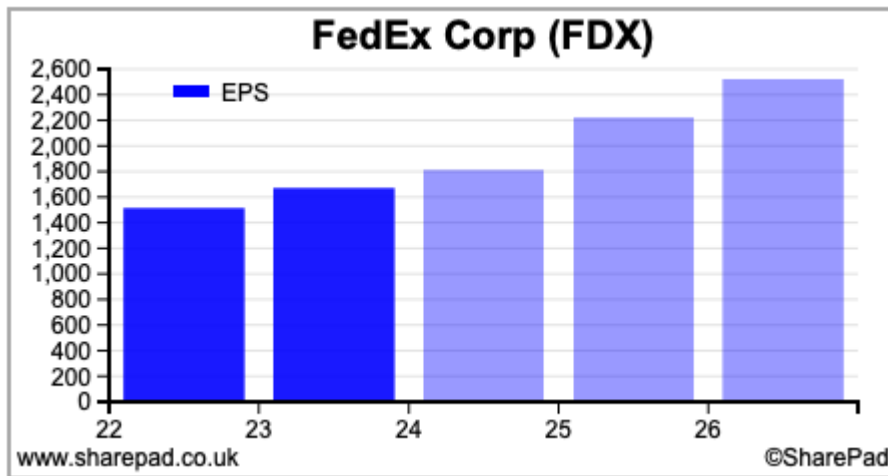
USPS is trying to reduce its reliance on Fedex and has significantly reduced its volumes through the network this year.

The contract is due to expire in September 2024 and may not be renewed or could be renewed on less favourable terms.

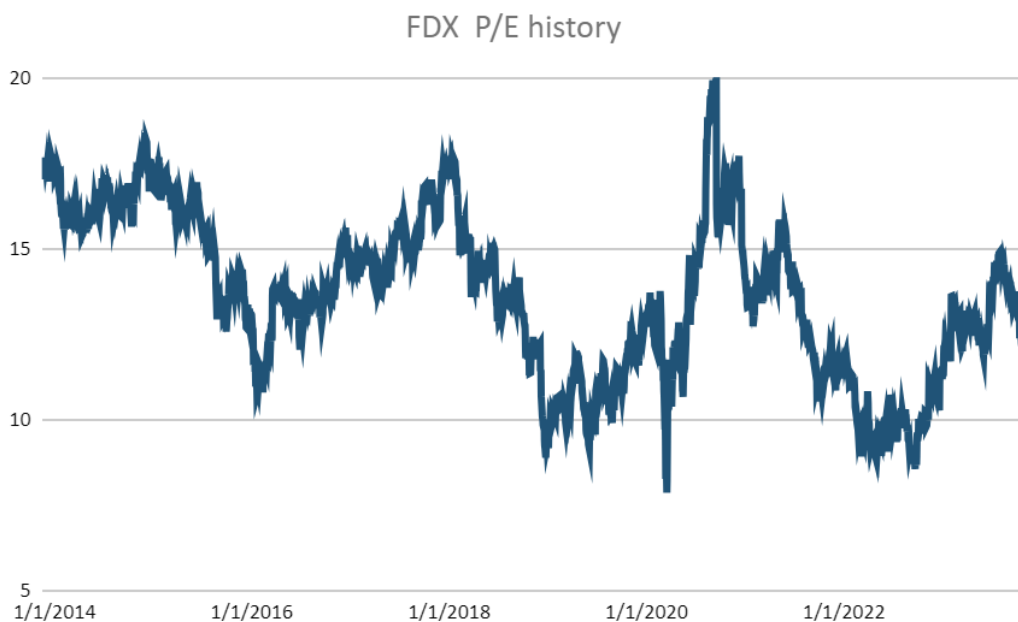
Competition remains fierce. **Amazon.com (US:AMZN)** has invested huge amounts of money in its logistics and supply chain infrastructure and is offering shipping services to third party sellers on its website. Fedex seems relaxed about this and believes that most of the losses of Amazon traffic have already happened.

### **Strong earnings growth expected but quality needs to improve**

Cost savings are expected to see Fedex deliver strong earnings growth over the next few years.



However, after a strong share price performance this year, it is difficult to see the shares re-rating to a much higher valuation with an improvement in revenue growth.



Source: FactSet

The shares do not look expensive and trade in the middle of their ten year historic range on a one year forecast PE basis.

This doesn't look too unfair given the low levels of profitability and quality of earnings growth from the company. Throw in its sensitivity to the global economy and high levels

of operating leverage and you can make a strong case for not paying a high valuation for a company like this.

## Fedex vs Peers

Company	Price (\$)	Mkt Cap (\$mn)	EBIT Mgn NTM (%)	ROE NTM (%)	P/E NTM (x)	EV/EBIT FY1 (x)	Net debt/Ebitda (x)
FedEx	254	64,827	7.5%	17.3%	12.71x	12.66x	3.13x
United Parcel Service B	143	122,628	11.3%	37.6%	14.99x	13.78x	1.36x
Deutsche Post	44	52,667	7.8%	15.8%	11.87x	8.25x	1.62x

Source:FactSet

Where there is possibly ground for optimism is the company's ability to improve its cost competitiveness with UPS and take market share.

UPS's delivery drivers are unionised while Fedex's are not as most of its ground deliveries are outsourced to subcontractors.

UPS is likely going to take a big profit hit from its recent pay deal with its unions and may look to recover some of its cost increase in higher prices. The threat of strike action has already seen it lose business to Fedex. Winning this business back may not be easy.

Fedex is not going to have an easy time with wages but its non unionised employees may give it an edge in maintaining its price leadership and service levels in tough markets.

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