Standard Chartered 26/07/2018 **FAT-UK-743**

STAN GBP £6.93 Spec. **MED.** **S**

Parting Ways

Emerging Markets' lender, Standard Chartered (LSE.STAN) has long been in a turnaround situation; since 2015. Despite the best efforts of its management to turnaround the company, progress has been slow and unwieldy as the bank is plagued with issues both internal and external. We also no longer believe that it's worth the wait as there are emerging risks from its markets as well as tightening regulation globally. Thus, we believe it's time to part ways and issue a **SELL** rating on STAN.

Retracing the steps

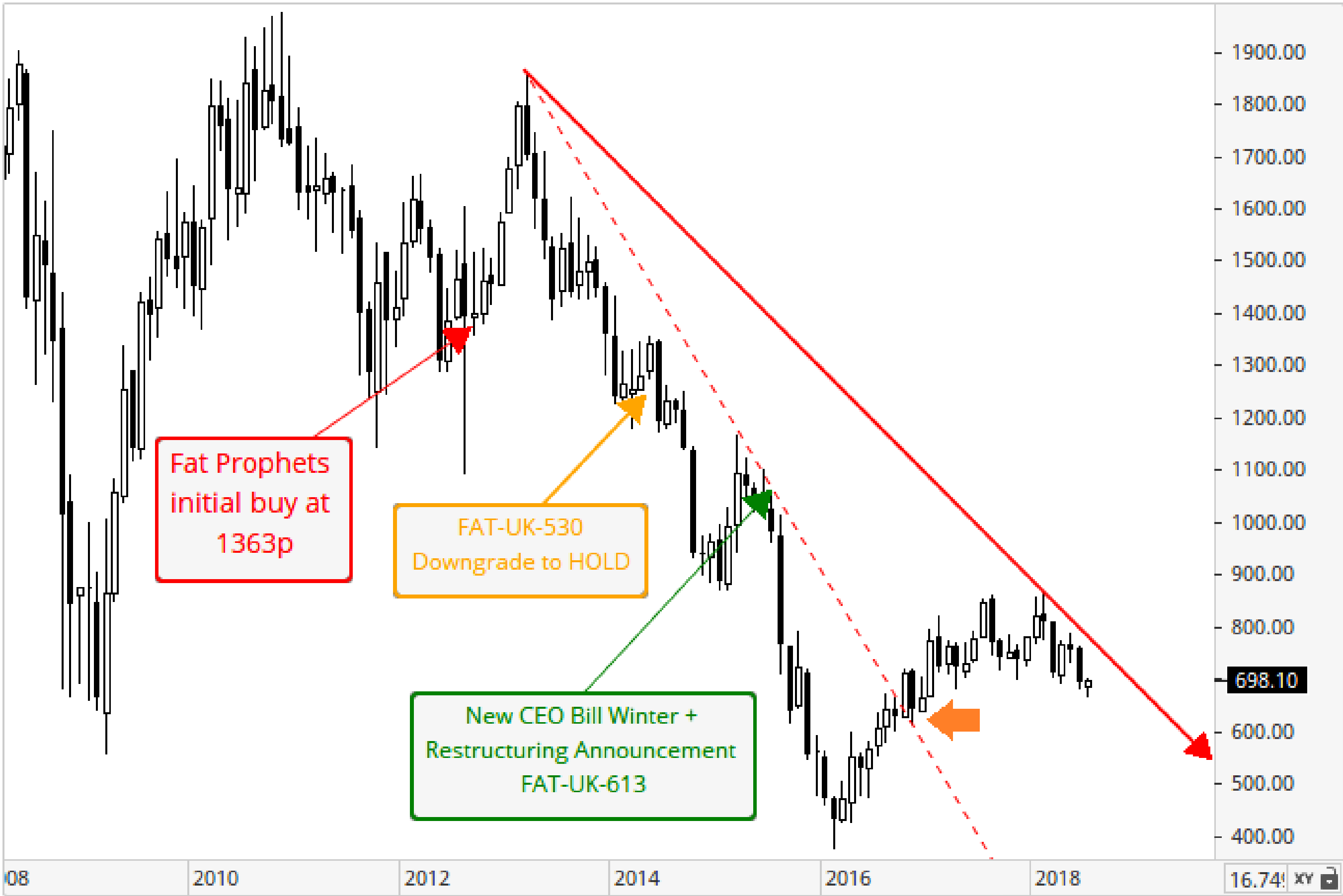
It has slightly been over a year since we last updated our views on Standard Chartered bank, when we began to see improvements in profitability for the bank. The bank's focus on controlling costs and structure rationalisation (read: branch closures & mass layoffs) lead to lower provision requirements. That aside, under the leadership of William Thomas "Bill" Winters, he has managed to clean up the problems in South Korea and India.

Despite Mr Winters' efforts, however, we now update our view on the stock and rerate it as a **SELL**. To understand this change of view, let's retrace the steps:

First, Standard Chartered has been one of our older positions having been added to the Fat Prophets UK portfolio back in August 2012 (FAT-UK-449); on the back of attractive valuations stemming from a politically motivated attack from US regulators and insulation from the GFC due to its wider banking market.

The chart below summarises our entire journey with the bank:

Standard Chartered Plc - STAN (LSE) - 1 Month CandleStick Chart - GBP



Following our initiation piece, the events that followed initially proved our thesis right as the regulatory issues had been settled with costs lower than initially feared. Furthermore, the bank ended 2012 on a strong note following the success of its Wholesale Banking business and Asia region performances.

However, **things started to go sour for the bank as 2013** proved to be a difficult year with increasing scrutiny from short sellers (Carson Block's Muddy Waters) due to sizable lending into China and emerging headwinds in South Korea that ultimately led to a US$1 billion impairment.

The problems didn't end there as the credit boom in Asia, supported by central bank liquidity, led to permissive lending from **management seeking to ride on the rapid growth in the region**. In fact, where most banks were cutting staff post GFC, the bank managed to balloon its (FTE) workforce from 60,000 in 2006 to circa 90,000 in 2012.

This rapid growth had significant consequences as the bank's sizable lending towards the commodity sector (China and India) eventually led to bad debts while headwinds in South Korean proved to be too much and led to the aforementioned impairment.

The bank, at the time, led by Peter Sands, responded with announced mass layoffs numbering in the thousands and shutting down unprofitable businesses like its loss-making equities unit to save up some $400 million. Thus, we adjusted our views to a HOLD (FAT-UK-530) and monitored developments.

We then continued to monitor the bank's steady climb back, and by the first quarter of 2015 (1Q15), we began to see some improvements as the bank managed to reduce its loan impairments on a quarter-on-quarter basis while the economic recovery in Asia augured the better times ahead. The graphic below shows the bank's financials over that time period:

Group income statement	3 months ended 31.03.15	3 months ended 31.03.14	YOY better/ (worse)
	$million	$million	%
Operating income	4,395	4,572	(4%)
Operating expenses	(2,467)	(2,451)	(1%)
Restructuring costs	(35)	(32)	(8%)
Pre-provision operating profit	1,893	2,089	(9%)
Loan impairment	(476)	(265)	(80%)
Other impairment	2	2	nm
Profit from associates and joint ventures	48	49	(2%)
Profit before taxation	1,467	1,875	(22%)

Source: 28 April 2015 Company Filing

Admittedly, results continued to be disappointing while the **Loan Impairment of $476 million was larger year-on-year**, this was, more importantly, **lower than the amount reported for the previous two quarters**. However, this period also marked the end of Mr Sands' banking career where he announced his departure and replacement with former JP Morgan's Investment Banker, Bill Winters.

We believe that it was the right time for a change in management as Mr Sands' long tenure (~9 years) made him highly entrenched and complacent in our view leading to the slow response from the headwinds that cropped up over time. Mr Sands aptly ended his tenure with a quote: "it was always our intention to begin a handover process around now ... now is the right time for me to hand over,"

Following his departure, we looked eagerly to the start of Mr Winters tenure as his new administration meant that he would embark on a decisive and ambitious effort to clean up the business and eventually led to cost savings of some $2.9 billion from "structure rationalisation" and the sale of unprofitable businesses. Mr Winters also pushed to raise some $5 billion in capital wherein we recommended to members to take up the rights (FAT-UK-613).

Since his tenure, we did see some tangible results as Mr Winters slashed the dividend while reduced expenses as revealed via the official annual report employee count saw the FTE employee layoff of circa 6,864 staff to 84,076 while the bank reduced the footprint from over 1,200 branches in 71 countries to the latest tally of 1,026 in 63.

But if Mr Winters was successful in his efforts to turnaround the bank, why then do we now recommend cutting our losses and leaving for good?

There are a few issues that Mr Winters hasn't completely addressed after all these years. In fact, an exposé from Bloomberg reveals that the bank continues to struggle with a toxic culture that led to the unfettered lending a few years back (Korea impairment, Muddy Waters Short Selling) as well the regulatory issue (anti-money laundering) we mentioned above.

Toxic cultures would be seen as “business as usual” as many corporations struggle with employee misconduct though the major issue is that one of the major culprits are part of senior management themselves.

Case in point is the Global Head of Anti-bribery and Corruption, Matt Chapman, who resigned after reportedly facing allegations that he changed the performance review of a colleague he was having an affair with and promoted her before stepping down. While another is Neil Barry, former Compliance Head, who made inappropriate statements about his female subordinate and made a disrespectful comment about the sexuality of the woman’s companion.

As value investors, we recognise the importance of management and a firm’s culture as part of the investment process, **and though we are not claiming that such behaviour is “standard” (pun intended) for the bank**, we are nevertheless concerned that such issues are prevalent at the upper levels of management.

With massive issues at the group level, we are not surprised that progress has been extremely slow. A look at the following graphics and starting with the 3Q15 (under Mr Winters’ leadership) show that barely a dent was made after all:

Group	3 months ended 30.09.15 US$ million	3 months ended 30.09.14 US$ million
Income	**3,682**	4,514
Operating expenses	**(2,238)**	(2,314)
Regulatory expenses	**(237)**	(198)
Restructuring costs	**(25)**	(11)
Operating profit before impairment losses and taxation	**1,183**	1,991
Impairment losses on loans and advances and other credit risk provisions	**(1,230)**	(536)
Other impairment	**(161)**	(3)
Profit from associates and joint ventures	**70**	78
Profit/(loss) before taxation	**(139)**	1,530

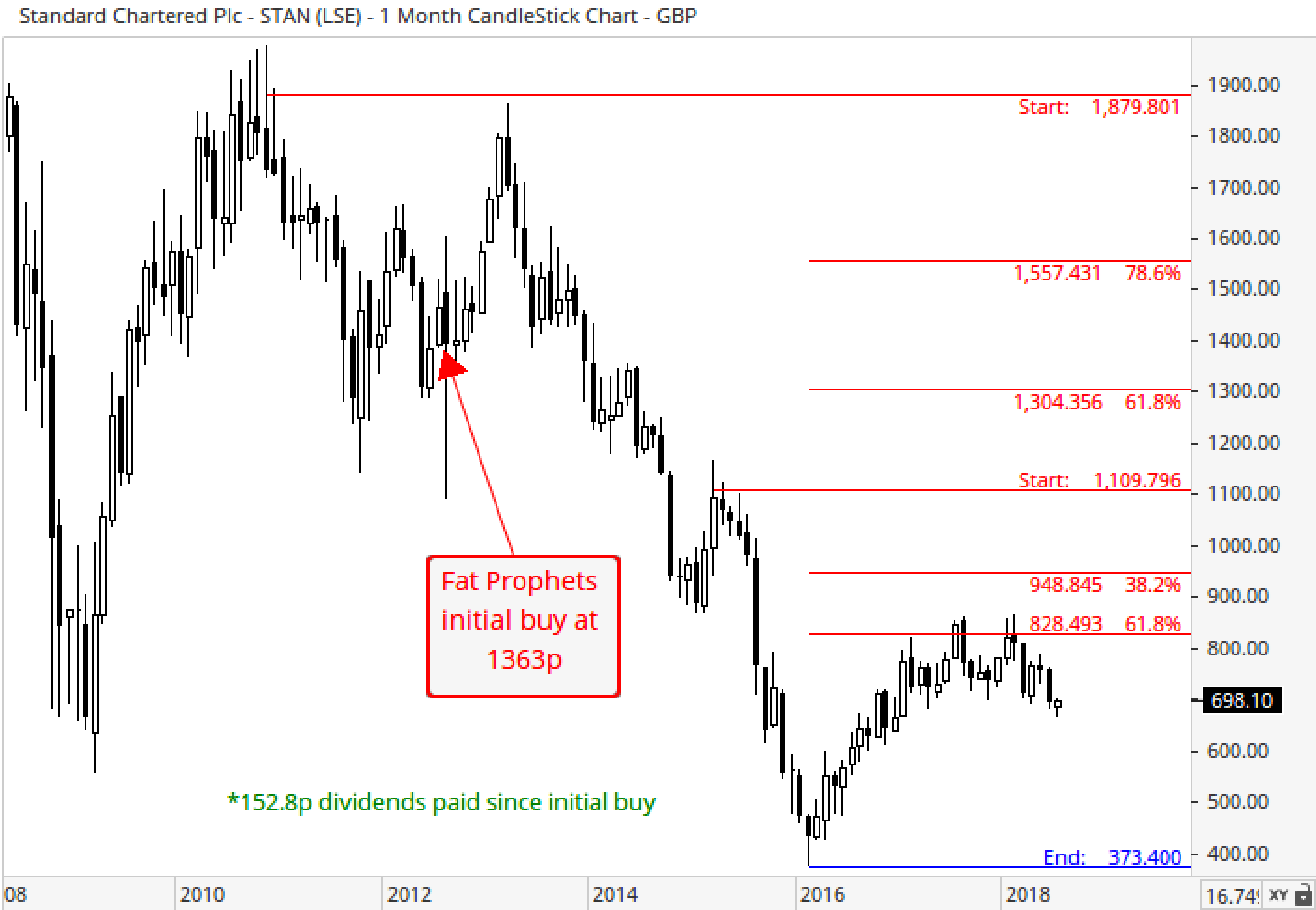
Source: 03 November 2015 Company Filing

Compare this with the most recent financials (1Q18) show that after all this time, expenses barely budged downwards while staff numbers have climb (FY17: 86,021), while operating income (i.e. bank revenues) year-on-year did not make meaningful progress with the chief gains only coming from lower impairments:

Performance summary

	3 months ended 31.03.18 $million	3 months ended 31.12.17 $million	3 months ended 31.03.17 $million	Q1 18 vs Q4 17 Better/ (Worse) %	Q1 18 vs Q1 17 Better/ (Worse) %
Operating income	**3,873**	3,478	3,608	11	7
Other operating expenses	**(2,166)**	(2,283)	(2,069)	5	(5)
Regulatory costs	**(303)**	(366)	(309)	17	2
UK Bank levy	**-**	(220)	-	n.m.	-
Operating profit before impairment and tax	**1,404**	609	1,230	131	14
Net impairment on financial assets	**(191)**	(269)[1]	(198)[1]	29	4
Other impairment	**(24)**	(66)	(53)	64	55
Profit/(loss) from associates and joint ventures	**68**	3	66	n.m.	3
Underlying profit/(loss) before taxation	**1,257**	277	1,045	354	20
Restructuring	**(70)**	(120)	(55)	42	(27)
Other items	**-**	(270)	-	n.m.	n.m.
Statutory profit/(loss) before taxation	**1,187**	(113)	990	n.m.	20

Source: 02 May 2018 Company Filing



Investment Conclusion

Though Standard Chartered seems well placed having a large exposure to the emerging economies in Asia, we are seeing more risks appearing on the horizon as regulatory tightening will require increasing amounts of capital for the group to keep in reserve while simultaneously facing higher costs of servicing the regulatory hurdles.

Besides, the bank hasn't even made significant improvements in its capital base over the years as show in the graphic below:

Capital Base	31.03.18	31.12.17	30.09.17	30.06.17	31.12.16
CET1	13.9%	13.6%	13.6%	13.8%	13.6%
Tier 1 capital	16.2%	16.0%	16.0%	16.2%	15.7%
Total capital	21.3%	21.0%	21.0%	21.3%	21.3%

Source: 02 May 2018 Company Filing

While rival banks trade at more attractive valuations, HSBC trades at a P/E of 20.4x while Lloyd's Bank trades at 13.3x compared to Standard Chartered's 35.3x. This is also substantially higher than sector median of 13.4x as well.

The bank, recently reinstated its full year dividend in February, also has a paltry 1.6% yield based on the latest closing price of £6.929, but lags behind Lloyd's' 4.9% and HSBC's 5.2% not to mention the sector's 3.4%. <u>That said, we believe that it's time to part ways as there is more value at lower risk elsewhere in the sector</u>.

Accordingly, we recommend to Members to SELL their position in Standard Chartered (LSE.STAN) at current levels as we will cease coverage of the stock and remove it from the Fat Prophets Portfolio.

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Snapshot STAN

Standard Chartered

Latest Closing Price: £6.929

The Company operates globally and is principally engaged in the business of retail and commercial banking. Around a third of profits come from consumer banking and two thirds on wholesale banking. The historical roots of the bank are in Asia and Africa and around two-thirds of profits currently come from Asia. The profits generated from Europe and the Americas are not a significant part of total profits.

Market Capitalisation:£22.1b

	FY1	FY2
Price to Earnings	35.3	12.5
Dividend Yield (%)	1.0	2.6
Price to Book	0.68	0.64
Return on Equity (%)	-	5.2